



International Association of Insurance
Supervisors (IAIS)

16 February 2015

submitted via online tool

IFoA response to the IAIS consultation: Risk-based Global Insurance Capital Standards

(please note this was submitted via the IAIS' online tool – listed below are the responses we submitted via this tool)

Question 1. Are these principles appropriate as the foundation for a global consolidated insurance capital standard? Are any enhancements or modifications needed to the ICS Principles?

The ICS Principles should ideally highlight more explicitly the desirability of balancing the costs IAIGs might incur implementing the ICS, versus the regulatory benefits of them doing so. This could perhaps be included in Principle 8 by rewording it to refer to “an appropriate balance between risk sensitivity, simplicity and cost of implementation by IAIGs”. Alternatively, a direct reference to proportionality could be included. We appreciate this consultation aims to strike an appropriate balance, but feel this should be recognised at outset as a critical factor in how the ICS should be developed.

Question 2. What does comparability mean for the ICS from your perspective?

The design of the ICS should reflect all the ICS principles. It should avoid achieving a high degree of comparability at the expense of the results being genuinely useful (e.g. in fulfilling the objective of protecting policyholders or in promoting prudentially sound behaviour) due to the simplifications used.

Question 3. Should the IAIS consider integrating the measurement of some or all risks across different sectors?

Financial conglomerates dominated by insurance business include (to an increasing extent) other business in some territories; such other business includes banking, securities and asset management. Where there is no Basel requirement for non-banking sectors, should the local regulatory requirement be counted as the ICS requirement as a practical solution? It may also be challenging to determine a mechanism to determine the diversification benefit between these subsidiaries within the Group as the business nature is very different and there is limited ready data available for the analysis.

Question 14. Would your IAIG/jurisdiction be likely to consider the use of a GAAP with adjustments valuation approach, and why?

This question (and questions 15 to 17) focus on the measurement of liabilities, and specifically relate to the use of local GAAP balance sheets; with adjustments where necessary. We note that the disparate nature of international accounting standards does not help in the development of a consistent ICS.

Question 37. Should the ICS capital requirement be developed so that it can be implemented as a PCR? If not, why not?

Assuming that the ICS and local capital regimes will co-exist, having the ICS capital requirement implemented as a PCR could lead to inconsistencies with local (national) prudential regimes e.g. when capital is deemed inadequate by the national regulator but is above the ICS minimum level. Therefore, it is desirable that the ICS is implemented as local PCRs by national regulators.

Question 39. What other risks should be included in the ICS capital requirement? Should any of the risks identified be excluded from the ICS capital requirement? Please provide reasons.

One of the reasons for the introduction of ICS is that some insurers have been deemed systemically important. It would therefore seem appropriate to target risks that are particularly associated with systemic risk, including liquidity risk. We suggest there should be some attempt to include liquidity risk within the ICS, even if, as many argue, most insurers do not carry material amounts of liquidity risk.

Question 41. Is it appropriate to not quantify risks other than those identified in Table 2 in the ICS capital requirement? If not appropriate, what risks in addition to those in Table 2 should be quantified in the ICS capital requirement, and how could they be quantified?

The ICS calculation should allow for the impact of Group risk. Some of the risks mentioned in para. 113, for example, group transactions and capital fungibility, could also be dealt with in the capital aggregation process.

Question 43. What are some of the practical solutions which may be used to address known issues with respect to modelling tails and diversification benefits, e.g. in the internal risk measures used by IAIGs, particularly in ORSA?

Whichever risk measure is used, modelling tails and tail dependencies almost always requires expert judgement to set parameters in the face of a lack of sufficient historic data. Some approaches, for example using Bayesian networks or methods that focus on the underlying drivers of risk, allow modellers to understand what causes dependency between risks. Scenario testing can also help modellers ensure that they have captured all the dependencies that might arise in a real life extreme scenario; their use in verifying the capital requirement is limited because it is difficult to estimate the probability of a given scenario.

Question 44. Is the prescription of a one-year time horizon appropriate? If not, what are the alternatives and why?

It is possible to get the same result using different time horizons by adjusting the confidence level used within the computation. Therefore the two need to be set in tandem.

Question 45. Should the ICS capital requirement include an assumption that the IAIG will carry on existing business for the one-year time period as a going concern? Should the ICS capital requirement only apply to risks at the existing measurement date? Why?

The most important issue here is that there is a clear definition of the capital requirement – is it the capital for an instantaneous fall or the capital required at a valuation in 12 months' time? If the definition is clear, much of the current uncertainty will be resolved. For example the extent to which risk mitigation measures should be allowed for or whether new business written in the one-year period should be included or not. This would be important for developing markets as the ICS capital would be different if new business is taken into account.

Question 47. Describe the costs and benefits of conducting field testing on either one or both target criteria.

In order to calculate a Tail-VaR, a probability distribution function (PDF) of change in available capital at each percentile is required (or at least at a sufficient number of percentiles in the tail).

Assuming that a full PDF is available, there is little additional effort in calculating the VaR or Tail-VaR at one or more confidence levels. However, this exercise will not show whether VaR or Tail-VaR is a more accurate measure, because all the numbers will be coming from a single calibration of the model. What the exercise can show is what confidence level for Tail-VaR is equivalent to a given confidence level of VaR.

Question 50. Existing risk mitigation arrangements with respect to non-life business could be in force for a shorter period than the time horizon for the calculation of the ICS. If that is the case:

a) Which criteria should be considered in order for the renewal of risk mitigation arrangements to be recognised in the ICS calculation?

b) In particular, which criteria should be met for a full recognition of the renewal of risk mitigation, and which criteria should lead to partial recognition of the renewal of risk mitigation?

It is important to stress that the assumed cost of renewal should make allowance for the costs of renewal at the valuation date and how this could further change in an adverse scenario.

Question 53. What are some other criteria or considerations in determining qualifying participating/profit sharing and adjustable products?

The criteria in para. 143 are fine, but concentrate on the legal ability to reduce benefits. Two other important elements are (1) practical ability (does the IAIG have the necessary systems in place to identify when to start making the changes and to implement the changes?) and (2) reputational ability (would the IAIG implement the changes given the potential damage to its reputation and the need to treat customers fairly). For (2), it is more subjective to assess this, but an IAIG should be able to show that it has internal policies and even has made the changes in previous times of stress.

Question 57. Are there any aspects of diversification of an IAIG's activities that are not identified in this section and that the IAIS needs to consider?

The diversification benefit between the subsidiary companies within the Group should be considered in the ICS.

Question 59. Should a look-through approach be applied on the basis of Option 1 or Option 2?

Option 1 is appropriate. Option 2 is excessive and goes beyond the principle that the available and required capital are based on the balance sheet and risks at a point in time. A forward-looking assessment of how the balance of risks might change is part of a wider supervisory assessment.

Question 60. Is the proposed grouping above appropriate? How can the grouping be refined?

A policy-by-policy assessment (testing the worst of up and down stresses) should be used to validate the level of grouping used – i.e. to demonstrate that the grouping approach does not lead to a material understatement of the risks. If the standard method involves individual stresses and not a stochastic model, a policy-by-policy valuation should not be ruled out due to computational constraints.

Question 78. Does the proposed scope of the capture the key risks relating to lapses? If not, please provide comments on any other key risks that should be considered.

In some cases, the risk that premiums cease but the policy remains in-force (so-called paid-up policies) should be considered. For example, for certain pension policies, the policy cannot be surrendered by the policyholder and there is no incentive to transfer the policy to another provider.

Question 79. Is the proposed grouping by geographical region appropriate for lapse risk? If not, what should be the appropriate geographical grouping?

We would expect there to be national differences (e.g. in Europe) in the way lapse rates react to market movements due to differences in product design, the availability of alternative savings vehicles, tax treatment, sales distribution channels and consumer attitudes. However, it would be hard to justify and calibrate specific national parameters.

Question 80. Should the mass lapse risk charge depend on the type of products? If yes, how should the mass lapse risk charge be considered by product?

There are many factors, including product type which may lead to mass lapses. For example:

- > link of policy benefits to general market movements,
- > is the policy compulsory in certain circumstances like house purchase,
- > is it a Group or Individual policy and
- > are the policy proceeds immediately available to the policyholder or only to be transferred to a similar approved product?

Question 81. Is the above methodology appropriate? If not, please provide comments on how the methodology can be refined.

It is preferable to separate level/trend component from mass lapse component, as these will have different correlations with market and other risks.

Question 82. Is lapse risk also relevant for Non-life business, and if so, to what extent would the methodology described for measuring lapse risk for life business be appropriate for non-life business?

Lapse risk is likely to be less relevant to non life business. However this depends on whether one-year policies can be lapsed mid-year in return for some sort of surrender payment and also whether capital requirement includes allowance for new business written over the year.

Question 106. In case of a defined scenario by the IAIS:

a) What elements should be part of the description of the scenario defined by the IAIS? Please provide an example.

b) Which calculation method by the IAIG of the impact of a defined scenario should be allowed by the IAIS for the ICS standard method? Please explain why this is appropriate.

The definition must be precise in terms of the nature of the event but also refer to the event happening in the city/region where it would cause the IAIG greatest loss.

Question 108. Should the use of partial models be allowed for the calculation of catastrophe risk for the ICS standard method? Why or why not.

The use of partial models should be used, to allow for a calculation of the impact specific to the exposure of the individual IAIG.

Question 112. What should be the form of the prescribed interest rate shocks, and in particular how should the shocks relate to the existing term structure? Are there any other scenarios besides upwards and downwards shocks at all terms that should be included in the set of prescribed scenarios?

Interest rate shocks need to be suitable for initial yield curves of different levels and shapes. This suggests shocks defined in terms of relative rather than absolute movement. Given the low yields in certain parts of the world, thought should be given to a floor after downward shocks, recognising this might not necessarily be 0%.

Stresses giving different shapes of yield curve are important. It may not be possible to include all variations in the standard method i.e. when a IAIG has material exposure to particular shape changes in the yield curve, a partial internal model may be appropriate.

Question 115. Should the IAIS consider inclusion of interest rate volatility shocks in addition to the term structure shocks?

An interest rate volatility stress would be appropriate, where the risk is material. This follows from ICS Principle 4.

Question 117. Is it appropriate for the equity risk to include a stress on volatilities? For IAIGs, is the impact of a stress on volatilities likely to be material when compared to the impact of a stress on equity prices?

An equity volatility stress would be appropriate, where the risk is material. This follows from ICS Principle 4.

Question 118. Would implementation of a volatility stress result in a significantly increased implementation complexity? In particular, would such a stress result in the necessity to set up IT tools not required otherwise, or a significantly increased time calculation when computing the effects of stress scenarios? Please provide any quantitative or qualitative detail if possible.

From a good risk management perspective, we would expect any IAIG writing significant amounts of business with equity optionality would already have the means of quantifying this risk e.g. as part of a hedging programme.

Question 123. Assuming that a volatility stress is included in the ICS framework, is it sensible to use the same relative stress across all types of equity?

Different equity markets could have different volatility levels, for example developing markets versus developed markets. Even within developing markets, different countries tend to have different equity volatilities e.g. China and India. Therefore a universal parameter approach may not be appropriate.

Question 138. How should the currency risk charge be applied to net capital investments in foreign subsidiaries?

While an IAIG may not be able to avoid the risk of currency exposure from net investments in foreign subsidiaries, it is nevertheless a risk (to the extent that the net assets contribute to the group available capital) and capital should be held for it.

Question 141. Should the ICS credit risk factors vary by maturity?

Credit risk factors should vary by maturity. Otherwise an assumption must be made about the mean term of credit assets, which is likely to vary from IAIG to IAIG, depending on the term of the liabilities and availability of bonds.

Question 142. Are there any other major asset classes that this list has omitted? Should some of the classes in this list be further segmented or merged? Why?

Securitisation might vary by tranche.

Investment in long-term infrastructure projects.

Question 143. Are there any proposed alternatives for assessing credit quality that do not rely on rating agencies or on internal models?

Credit quality can be assessed by reference to market spreads, if the bonds or securitisations in question are actively traded.

Question 146. Should a different approach be used for reinsurance exposures than is used for other credit risk exposures?

Usually, unrated exposures default to being treated as poorly rated. Some reinsurance exposures may be (externally) unrated but may still be of relatively high credit quality as might be evidenced by strong solvency ratios derived using something like the ICS. In these circumstances a different approach is likely to be desirable.

Question 148. Which of the options presented above should be pursued? Why should this method be pursued? How can the drawbacks to that method be addressed within the standard method?

Option (b) is preferable.

Risk capital is a poor proxy in many cases. For example, the operational risk from running a bond portfolio does not depend so much on the credit quality of the bonds if a hedging strategy is used. Moreover the use of derivatives introduces a lot of operational risk, even though the market risk capital may be greatly reduced. There are some types of insurance (e.g. some types of unit-linked business) where most risks other than operational risk may have been transferred back to policyholders.

Question 151. Should the operational risk charge include an additional component for growth? Why or why not?

In theory, the operational risk charge should include an allowance for growth. However this may be spurious given the broad brush nature of the standard model operational risk factor approach.

Question 153. Is the use of a variance-covariance matrix approach appropriate for the example standard method for the ICS capital requirement? If not, please explain what other approach would be more appropriate and why.

Given the limitations posed by a standard method, a variance-covariance matrix is acceptable.

Question 154. Which approach (i.e. single or multiple steps) should the IAIS adopt for the example standard method for the ICS capital requirement and why? If a multiple steps approach is recommended, please describe and explain why this will be appropriate.

A single stage (i.e. one large matrix) approach is preferable, because it deals better with the situation where an IAIG writes (for example) only non-life insurance risk business. In a two-stage approach, the correlation between (for example) market risk and insurance risk is an average correlation between a mix of all market risks and all insurance risks.

The text does not consider the question of where geographical diversification should be brought in.

Question 157. Should any variation to the standard method be allowed? If so, should IAIG-specific variations to the standard method be allowed? If yes, for which risks should IAIG specific parameters be allowed?

For some insurance risks, allowing shocks/factors based on the actual portfolio held could be allowed. It is important to position this as a half-way point between the standard method and a partial internal model i.e. the justification required by the IAIG to use its own shocks/factors should be similar to, but not greater than, that to justify own portfolio parameters in a partial internal model.

Comments on Section 1 – Introduction

Unless the ICS is to be a “minimum standard” Standard Model with the ‘bar’ set very low, European IAIGs will be subject to two different capital regimes. Relevant IAIGs will then have to manage their capital according to both bases and this is likely to be costly in terms of capital and resource whilst yielding limited benefit.

A Standard Model does not capture some of the risks to which an entity is exposed and tends to over charge other risks particularly where mitigation techniques are applied, including diversification. This is evident in the proposed regime looking at how, for example diversification is treated within the equity module and mortality/longevity modules. The option of using an internal model would be preferred.

Comments on Section 7.3 – Risk mitigation

We agree that operational risk can usually be considered a downside risk only (section 139). However, some firms (e.g. outsourcers, asset servicers, custodians) focus on business models that can be viewed as deliberately taking on exposure to operational risk for upside gain (i.e. for a suitable charge that it is hoped will more than outweigh any additional operational risk losses they might then experience). IAIS may wish to bear in mind that some IAIG insurers might currently or might in the future target such business models.

Comments on Section 7.4 – Credit for participating/profit sharing and adjustable products

It would be helpful to include the term “with-profits” in the title and para. 140. The term is used several times later in the document e.g. para. 191(a).

In para. 141, where allowance for the reduction is made independently for each risk then added, an IAIG should be expected to demonstrate that the total allowance is appropriate. The condition mentioned that the total should be less than the amount of future discretionary benefits is not sufficient.

Para. 143 (a) is a little narrow in its definition. Suggested wording is:

“Adjustable products may include policies and other products only if the cost of insurance (COI), expense charges and/or credited interest, fees or parts of the claim amount are adjustable.

Comments on Section 9 – ICS capital requirement: an example of the standard method using the market-adjusted valuation basis

In this section, the answer to questions about whether a particular method is appropriate or sufficient depends significantly on whether or not internal models are available as an alternative. If the standard method is to be reasonably simple, then it will not be able to capture all incarnations of a particular risk. This is acceptable, provided there is the alternative of internal models open to IAIGs and supervisors.