Risk-based global insurance capital standard

An EY perspective
Introduction

On 17 December 2014, the International Association of Insurance Supervisors (IAIS) published its consultation paper on the development of a risk-based global insurance capital standard (ICS). This follows the announcement of the ICS as a component of the IAIS’s future common supervision framework (ComFrame) for internationally active insurance groups (IAIGs) in October 2013 and initial field testing conducted during 2014.

The capital standard is not intended to be a legal entity capital requirement. ICS will apply only at a group consolidated level to the (approximately 50) IAIGs and those insurers designated by the Financial Stability Board (FSB) as global systemically important insurers (G-SIIs), even if not technically IAIGs. It will not replace existing arrangements or capital standards for legal entity supervision.

ICS will ultimately form the baseline for the planned higher loss absorbency requirements for G-SIIs, replacing the current proposals for a basic capital requirement.

Relative to the IAIS’s Insurance Core Principles, the ICS is intended to achieve a greater degree of comparability, providing supervisors with a common lens for assessing IAIGs’ capital requirements and capital resources - however this will be a minimum standard and local supervisors are not precluded from demanding higher standards / higher levels of capital.

Following further field testing and consultations in 2015-16, IAIGs will be required to commence private reporting to supervisors in 2017. In 2017, there will also be final consultation on the complete ComFrame, with a view to formal adoption by the IAIS in 2018, in line with the FSB mandate.

**EY recognizes the clear mandate the IAIS has received from the G20/Financial Stability Board to deliver a standard by 2018 and supports the development of effective group-level regulation of all IAIGs.**

**An ICS that is transparent and comparable will enhance public confidence in the insurance sector’s capital adequacy. However, at all points, this needs to be a risk-sensitive measure and designed in a way that promotes effective risk management.**
Consultation details

Consultation process
The IAIS has requested feedback to 169 questions covering a full range of topics: from the principles being followed to construct the ICS through valuation approaches, definition of capital resources, calibration of each of the major risk types for life and non-life business and aggregation/diversification.

The deadline for responses to the consultation is 16 February 2015. This potentially allows for the most significant feedback points to be included in the second IAIS field testing to be launched at the end of April 2015, with reporting by August 2015. A consultation on ComFrame, including the ICS, will then follow by the end of 2015.

A further round of field testing will take place in 2016, before confidential reporting to supervisors begins in 2017, with formal adoption of ComFrame (including the ICS) by the end of 2018.

EY supports the breadth of the consultation on the ICS and notes that although the proposals reflect current trends in development of regulatory frameworks, (including the new regimes being introduced or developed in Europe, Asia, South Africa and South America), the detail is being extensively tested through consultation questions, given the more targeted application of the ICS to large insurance groups.

We encourage IAIGs to respond fully to this consultation to ensure that the ICS developed is as coherent and sensible as possible. The demanding timelines for delivering the ICS allow very limited opportunity for making material changes later in the process.

Key features of the ICS consultation proposals

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<th>Balance sheet</th>
<th>Risk charges</th>
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<td>The core proposal is a “market adjusted” valuation approach, which requires prescribed adjustments to be made to local GAAP accounting valuations. Adjustments are likely to include introducing a common margin over current estimate (MOCE), discounting using an IAIS-prescribed yield curve and adopting prescribed approaches to contract boundaries, valuation of options, guarantees and discretionary benefits. Capital will be classified into at least two tiers, reflecting permanence and quality. Limits on eligibility of lower-quality capital items may apply.</td>
<td>A standard method of risk charges is proposed, with the IAIS’s preferred methods being factor-based for non-life premium/reserve risks, asset concentration, credit risk and operational risk. Approaches to stress the balance sheet (capturing both asset and liability impacts) are proposed for other market and non-market risks. The IAIS recognizes that catastrophe risk may require a different approach, including IAIG self-assessment of prescribed scenarios.</td>
<td>A relatively simple variance/covariance approach to aggregation is proposed. This may be a single correlation matrix across all risk factors, or aggregation through multiple sub-matrices. Limited detail is currently provided on how this is intended to consider constraints on capital movement that may exist within a group.</td>
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Overview
With the introduction of Solvency II as of 1 January 2016, the prudential regulation of (re)insurers in Europe is set to adopt economic capital as the main approach to establishing regulatory capital requirements. In the case of companies with approval to use a (partial) internal model, some of the methodology and assumptions used in the model will have been determined by the firm. These are subject to meeting the internal model tests and standards, rather than having been prescribed by the regulator.

These capital requirements are considered relative to own funds that are determined on a standard basis and prescribed for all companies (covering measurement of liabilities and eligibility of capital resources). Key results will be subject to public disclosure through the Solvency and Financial Condition Report (SFCR). All insurance companies are also required to prepare their ORSA, which includes the assessment of the capital that they require over the business planning cycle.

There is a significant track record in Europe over the last decade of economic capital information being included in (re)insurers’ supplementary reporting. In addition to the one-year value-at-risk (VaR) approach used in Solvency II, other methods have included tail VaR or run-off approaches, which generally target a confidence level consistent with the company’s credit rating. In recent years, many organizations have aligned their methodology with the Solvency II approach of a one-year VaR, calibrated to a 99.5% confidence level.

Most European IAIGs are currently preparing to make an application to their supervisors for approval to use a (partial) internal model to assess their regulatory capital requirements under Solvency II.

Implications of the ICS proposals
In the short term, the implications of the ICS proposals are likely to present challenges to European IAIGs, as they will be simultaneously operating under two risk-sensitive prudential regimes. Differences in capital and risk management incentives will inevitably arise unless the regimes are identical.

The development of an approach to setting a discount rate to value insurance liabilities that would be robust to times of market stress was a key aspect of the compromise negotiations that completed the design of Solvency II. The final 2013 impact assessment illustrated the importance of such a mechanism (“volatility adjustment”) for the solvency of the European insurance industry. The proposed market-adjusted yield curves for ICS followed a similar approach during the initial IAIS field testing, and any evolution in the proposed approach will be closely scrutinized by IAIGs.

Most European IAIGs have made significant investment in (partial) internal models, which are now being embedded into their risk management systems at both a group and legal entity level. We expect that a process to permit the use of these models for the purpose of ICS will be a high priority for European IAIGs so that their ICS results reflect the detail of both their risk profile and their group structure.

The Solvency II directive requires that the calibration be revisited in 2020, which would provide a natural opportunity to reflect on the initial period of implementation and to potentially align the requirements of Solvency II with the ICS.
Overview

The US regulatory position is currently as follows:

- All US companies are subject to regulation by the insurance department in the state of domicile, with the National Association of Insurance Commissioners (NAIC) serving as a standard setting and regulatory support organization.
- US companies that own a bank, or have been designated a systemically important financial institution (SIFI) by the Financial Stability Oversight Council are regulated by the Federal Reserve.

There are small modifications being made to the current regulatory capital framework, risk-based capital (RBC). However, there will be no significant change to the overall methodology or approach, and the calculation will still remain primarily factor-driven.

In addition, from 2015 the NAIC requires an ORSA from all insurance companies writing over $500mm gross premium or insurance groups writing over $1bn gross premium. This will include a group risk capital assessment as well as a multi-year prospective solvency assessment, although a time horizon, risk measure or confidence level are not prescribed.

With the recent passage of the Insurance Capital Standards Clarification Act, the Federal Reserve has the ability to determine a group capital standard for the insurance companies it regulates. This is a positive step that effectively removes any obligation to apply banking minimum capital and leverage requirements to insurance. There is an expectation that any future standard will now be appropriate to the risk profile of insurers rather than banks; there is no publicly stated time frame for such a standard at this point.

In the US market, economic capital is primarily used as an internal risk management tool, although risk management practices vary among companies. Those selling variable annuity products with a defined hedging strategy tend to have strong practices in place.

Implications of the ICS proposals

There is a significant amount of business in the US market that is spread-based (i.e., relies on being able to realize a significant portion of credit spread to meet profit targets). The proposed market-adjusted approach to valuation has the potential to make these products look unappealing and likely unprofitable to US companies. This is primarily dependent on the discount rate that is selected. Even the rates that were used for the IAIS’s 2014 field testing resulted in poor results for spread-based products.

For non-life business, liabilities are typically not discounted at all (although there are exceptions, such as workers’ compensation being discounted at prescribed rates). Performing discounting consistently for non-life business throughout a group may be a new challenge for many US companies.

A number of companies in the US favor a cash flow-based run-off approach for determining capital needs for life insurance business given the long-term nature of the liabilities. The proposed transfer value/one-year VaR approach may force the realization of risks that would actually materialize over the life of the business and may not be appropriate for a capital requirement. We believe that the issue of time horizon will be a more important topic for the IAIS to consider than the choice of VaR or tail VaR as the risk metric.

Proper treatment of policyholder behavior is an important consideration for the US, given the material amount of variable annuities with living benefits and fixed annuities. Recognizing the risk that exists in the embedded options and guarantees should be a key component of the ICS framework.

The current ICS proposals would require a significant investment in new infrastructure and processes, as the current estimate approach requires different calculations from those currently in place. This is particularly true if there is an opportunity to rely on internal models. This could potentially put the US market at a disadvantage relative to its European peers that have been preparing for a similar approach that is required for Solvency II. We believe that consideration needs to be given to a suitable timeline and process for regulatory approval to enable the US IAIGs to be able to use internal models for regulatory capital, and for there to be a level international playing field.
Australia
In 2009, the regulator began its Life and General Insurance Capital project (LAGIC) to review the capital standards for insurers. The changes were designed to increase risk sensitivity and align across financial services industries.

The revised regime became effective on 1 January 2013 and includes capital requirements based on 99.5% one year VaR, an internal model option (although very few insurers have pursued an internal model), more risk sensitive capital formulae and some changes to quality of capital requirements. LAGIC also includes an “individual capital adequacy assessment” report – similar to ORSA.

China
The China Risk Oriented Solvency System (C-ROSS), which is expected to be officially published in early 2015 and be effective from 2016, shares principles that are analogous with ICS proposals. Companies in China are in the early stages of building more advanced risk management systems, which include asset and liability models, to measure C-ROSS capital and/or economic capital.

For the present, insurers in China plan to identify the difference between ICS and C-ROSS. A principles-based approach to ICS, whereby local C-ROSS results may be (partially) re-used, would be helpful.

Given the size of the Chinese insurance market and its growth potential, it is likely that there will be local demand for a specific Chinese calibration of risk charges in cases where the IAIS uses a regional calibration.

Japan
In June 2014, the Japanese regulator launched a field test for all insurance companies, with the aim of introducing an economic value-based solvency regime, similar to other emerging regimes and the ICS proposals. This is also consistent with its stated intention for gaining “full equivalence” status under the European Solvency II regime. Reporting of the field test results is expected in May 2015.

Among the larger Japanese (re)insurers (both life and non-life), many companies either have already introduced economic value-based management or have most of the capabilities necessary to do so. However, practical challenges remain to adopt this approach as a robust group solvency calculation.

For general insurers, the market-adjusted approval may be significantly different from some locally prescribed approaches (e.g., reserving for compulsory automobile liability insurance and earthquake insurance) with significant implications for insurers’ tools and processes.

Singapore
In Singapore, risk-based capital has been in place since 2004, and the regulator is currently revising the required RBC calculations. In addition, the regulator implemented new enterprise risk management guidelines (including ORSA requirements) in 2014 and has referred to the need to consider an economic view of risks.

Some local companies are in the early stages of initiating risk calibration work. In contrast, multinationals are relying heavily on their group or regional frameworks.

Other Asian markets
In Malaysia, although there is no explicit requirement for an economic capital calculation, certain aspects (e.g., individual target capital level) are considered. The regulator has increased its focus on ORSA-type calculations by insurance companies to determine the target capital and risk appetite.

Thailand has initiated a market testing exercise for its proposal to revise RBC calculations, which includes a recalibration of risk charges.

Other regulatory jurisdictions in Asia are primarily focused on risk-based capital, using more factor-based approaches.
Insights for Asia-Pacific

continued

Implications of the ICS proposals
Since the financial markets of the emerging Asian economies vary in their maturity, the future detailed proposals for the ICS discount rate will need to address the issue of limited market data, especially given the long duration of savings business. A market-adjusted approach is likely to provide a practical solution, whereas a full market-consistent approach would not be viable.

Even for the more established Japanese financial markets, life insurers will focus heavily on the derivation of the ICS discount rate and, in particular, how the regime deals with the hyper-long (30 years or more) duration of insurance liabilities.

Treatment of negative liabilities reflecting high product margins in certain Asian markets will be an important focus area. IAIGs with Asian business will wish to recognize the value being generated within their capital resources without implicit prudence and with associated risks (such as liquidity) explicitly recognized in either the capital requirements or in qualitative measures such as ORSA.

There is likely to be a general regional preference to address operational risk outside of the capital standard on the grounds of the inherent difficulties in quantification.

Participating business in certain markets (including Japan, China and Singapore) is material, and affected insurers will need to see that the loss-absorbing capacity of discretionary bonuses is sufficiently addressed in ICS proposals.
Contacts

Global
Martin Bradley
mbradley@uk.ey.com

Africa
Alex Thompson
alex.thomson@za.ey.com

Asia-Pacific
Jonathan Zhao
jonathan.zhao@hk.ey.com

ASEAN
Sumit Narayanan
sumit.narayanan@sg.ey.com

Australia
Grant Peters
grant.peters@au.ey.com

Belgium
Kris Volkaerts
kris.volkaerts@be.ey.com

Canada
Ted Price
ted.price@ey.com

China
Bonny Fu
bonny.fu@hk.ey.com

France
Pierre Planchon
pierre.planchon@fr.ey.com

Germany/Austria
Bernd Greuel
bernd.greuel@de.ey.com

Jan Leiding
jan.leiding@de.ey.com

Greece and Turkey
Lampros Gkogkos
lampros.gkogkos@gr.ey.com

India
Shrawan Jalan
shrawan.jalan@in.ey.com

Ireland
James Maher
james.maher@ie.ey.com

Italy
Stefano Battista
stefano.battista@it.ey.com

Dario Zuppi
dario.zuppi@it.ey.com

Japan
Yuji Ozawa
ozawa-yja@shinnihon.or.jp

Toshihiko Kawasaki
kawasaki-tshhk@shinnihon.or.jp

Latin America
Pedro Subtil
pedro.subtil@br.ey.com

Fernando P. Belaunzaran
fernando.belaunzaran@mx.ey.com

Rodrigo Leiva
rodrigo.leiva@cl.ey.com

Luxemburg
Jean-Michel Pacaud
jeanmichel.pacaud@lu.ey.com

Netherlands
Paul de Beus
paul.de.beus@nl.ey.com

The Nordics
Pehr Ambuhm
pehr.ambuhm@se.ey.com

Poland
Marcin Sadek
marcin.sadek@pl.ey.com

Portugal
Rita Costa
rita.costa@pt.ey.com

Spain
Manuel Martinez
manuel.martinezpedraza@es.ey.com

Switzerland
Phil Vermeulen
phil.vermeulen@ch.ey.com

UK
Rodney Bonnard
rbonnard@uk.ey.com

Jeff Davies
jdvries7@uk.ey.com

Michael van Vuuren
mvanvuuren@uk.ey.com

Tim Ford
tford@uk.ey.com

US
Doug French
doug.french@ey.com

Rick A. Marx
rick.marx@ey.com

Michael Hughes
michael.hughes@ey.com

Chad R. Runchey
chad.runchey@ey.com
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