

Capital Requirements for Global Systemically Important Insurers (G-SIIs):¹ Basic Capital Requirements (BCR) and Higher Loss Absorbency (HLA)

Background

The International Association of Insurance Supervisors (IAIS) has developed a framework of policy measures for global systemically important insurers (G-SIIs).² This framework is in line with the Financial Stability Board (FSB) framework for addressing the systemic and moral hazard risks posed by systemically important financial institutions (SIFIs),³ which calls for several integrated policies that combine to:

- (a) apply more intensive and co-ordinated supervision of SIFIs
- (b) ensure that all financial institutions, including SIFIs, can be resolved in an orderly manner without destabilising the financial system or exposing taxpayers to risk of loss
- (c) require higher loss absorbency (HLA) for SIFIs to reflect the greater risks that these institutions pose to the global financial system, and
- (d) apply other supplementary prudential and other regulatory requirements.

The Basic Capital Requirements (BCR), combined with the HLA requirement for G-SIIs, delivers a key component of the IAIS' G-SII policy measures and directly addresses item (c) above.

The IAIS finalised development of the BCR in October 2014 and it was subsequently endorsed by the FSB and G20. The initial version of the HLA was developed by the IAIS and endorsed by the FSB in September 2015, and it is anticipated that the G20 will endorse it in November 2015, therefore achieving the schedule put forward by the IAIS in 2013.

From 2019, G-SIIs will be expected to hold regulatory capital that is not less than the total required by the sum of the BCR and HLA requirements. These capital requirements apply to all group activities, including non-insurance subsidiaries.

The BCR and HLA will be reviewed annually to reflect experience gathered through ongoing field testing and to reflect improvements in related policy and methodology, including the refinements of the definitions of Non-Traditional (NT) and Non-Insurance (NI) business and the G-SII Assessment Methodology⁴ as well as regulatory developments in other sectors.

¹ The full documents can be found on the IAIS website (www.iaisweb.org).

² For more information on the framework, please refer to the document Global Systemically Important Insurers: Policy Measures, 18 July 2013 at http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf.

³ Global SIFIs (G-SIFIs) are defined by the FSB as "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." Global systemically important insurers (G-SIIs) are one class of G-SIFIs. The SIFI framework is available at http://www.financialstabilityboard.org/publications/r_101111a.pdf.

⁴ Public consultations on the NT and NI definitions and the G-SII Assessment Methodology are planned to begin in November 2015.

About the IAIS: The IAIS is a global standard setting body whose objectives are to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to contribute to global financial stability. Its membership includes insurance regulators and supervisors from more than 200 jurisdictions in nearly 140 countries. For more information, please visit www.iaisweb.org.

The HLA

Development of the HLA has been guided by a set of 10 HLA Principles, published by the IAIS in October 2014, which are included in Annex 1.

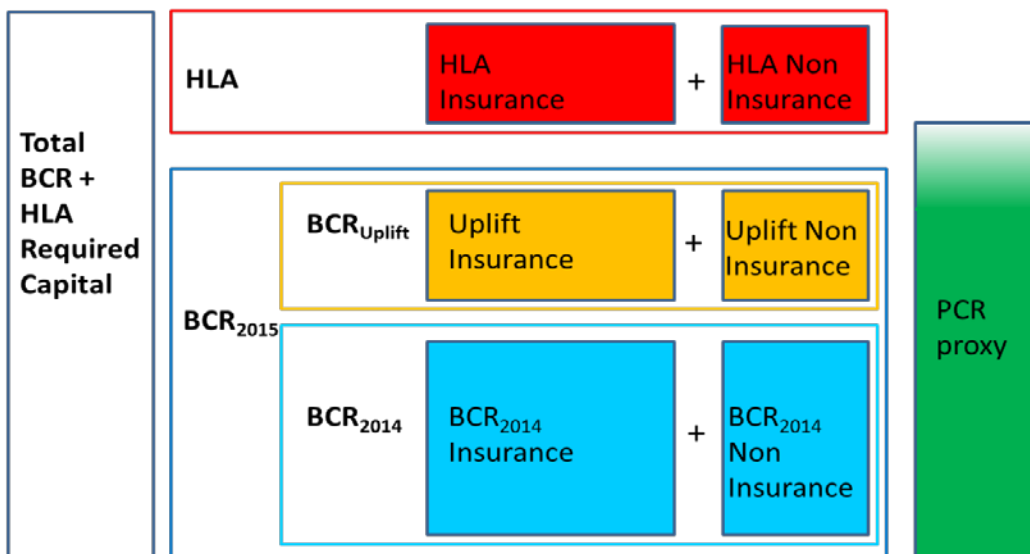
A field testing exercise to collect data to inform HLA development commenced in 2014 and continued in 2015. In both years, thirty-four volunteer insurance groups (including all nine G-SIIs), covering a wide range of products and geographical markets, participated in the exercise. The data collected was used to inform the HLA design, specific factors and calibration level. The calibration level of the BCR was also reviewed.

The combined BCR+HLA required capital is determined in two stages. In the first stage, an “uplift” is applied to the BCR as it was specified in 2014 (see the figure below). The uplift is essentially 33%, with a different approach taken for regulated banking to respect the current global sectoral requirements in place in that sector.

In the second stage, the HLA is calculated using a combination of a “bucket” and a “factor-based” approach. G-SIIs are first placed into one of three buckets – a “Low,” “Mid” or “High” bucket – depending on its G-SII designation score. The Mid bucket utilises factors 50% higher than the Low bucket, with the High bucket similarly utilising factors 50% higher than the Mid bucket. The IAIS anticipates that the High bucket will initially remain unpopulated and therefore act as a disincentive for G-SIIs to increase their systemic importance.

Once placed in a bucket a factor-based approach is taken with separate factors for Traditional Insurance and Assets, Non-Traditional Insurance business and some Non-Insurance business, Non-Insurance regulated banking, and unregulated banking (the later to reflect current global banking sectoral requirements). These factors are then applied to the exposures that are the uplifted BCR required capital amounts. Through the use of multiple buckets and the different factors that directly reflect the various business mixes of G-SIIs this design introduces risk sensitivity to the HLA.

BCR, BCR uplift, and HLA components (not to scale)



The BCR

The development of the BCR was guided by six principles, which are included in Annex 2.

The BCR required capital is determined using a “factor-based” approach with 15 factors applying to defined segments and their specified exposure measures within the main categories of a G-SII’s activity, namely Traditional Life (TL) insurance, Traditional Non-Life (TNL) insurance, Non-Traditional (NT) insurance, Assets (A) and Non-Insurance (NI).

BCR + HLA Regulatory required capital

The status of a G-SII, from the perspective of regulatory required capital, is captured by its BCR+HLA Ratio:

$$\text{BCR+HLA Ratio} = \frac{\text{Total Qualifying capital resources (for BCR and HLA)}}{\text{BCR+HLA required capital}}$$

For the purposes of the BCR+HLA Ratio, BCR Qualifying capital resources are classified as either Core or Additional capital. Qualifying Additional Capital cannot exceed 50% of BCR required capital. BCR+HLA Qualifying capital resources are determined on a consolidated group-wide basis for all financial and material non-financial activities.

A Market Adjusted Valuation Approach is the valuation approach to be initially adopted for the BCR.⁵ Under this approach, a G-SII starts with the amounts as reported on its audited, consolidated, general-purpose balance sheet, whether that be on an IFRS or GAAP basis, and makes adjustments to major balance sheet items (as specified by the IAIS) which are necessary to achieve sufficient comparability.

The BCR+HLA required capital is calculated as the sum of the BCR required capital and the HLA required capital. In both cases, the calculation is on a consolidated group-wide basis for all financial and material non-financial activities.

All holding companies, insurance legal entities, banking legal entities and any other companies in the group will be included in the consolidation. Individual non-financial entities within the group may be excluded from the scope of the BCR if the risks of/from those entities are negligible. Any entities excluded from the scope of supervision should be regularly reconsidered for inclusion.

Impact on G-SIIs

At a group level, based on field testing data for 2014 and 2015:

- The average uplifted BCR for G-SIIs approximately matches their average Prescribed Capital Requirement (PCR).
- The average HLA for the G-SIIs is 10% of their uplifted BCR.
- The average BCR+HLA Ratio for G-SIIs is 260%.

⁵ This will be reviewed, as the IAIS develops the valuation approach for ICS purposes.

Reporting and review

Commencing in 2015, the BCR is reported by G-SIIs on a confidential basis to group-wide supervisors, subject to access by the IAIS. Beginning in 2016, the HLA will also be reported by G-SIIs on the same basis. The IAIS will maintain appropriate governance and security protocols to protect the confidentiality of the information collected.

The IAIS will conduct an annual review of the BCR and HLA to ensure that each remains fit for purpose. When the ICS is developed, the HLA will also be reviewed and its foundation changed from the BCR to the ICS.

From 2019, G-SIIs will be expected to hold regulatory capital that is not less than the sum of the BCR and HLA required capital amounts. The HLA was designed so that, on average, G-SIIs will then hold higher regulatory capital requirements than would be the case if they were not designated as G-SIIs.

Next Steps

With the development of the HLA, the IAIS has now completed two steps its development of group-wide global insurance capital standards. The third step is the development of a risk-based group-wide global Insurance Capital Standard (ICS) to be applied to Internationally Active Insurance Groups (IAIGs). The development of the ICS will also be informed by the annual review work on the BCR and HLA. For more information on the ICS see the document [ICS Goals, Principles and Delivery Process](#) on the IAIS website.

Key milestones for the implementation of the IAIS' global capital standards are:

Expected timing	Key milestone
November 2015	IAIS General Meeting expected to formally adopt HLA G20 Leaders expected to endorse HLA
Mid-2016	Publication of 2 nd ICS Consultation Document and ComFrame Consultation
Mid-2017	Approval of ICS Version 1.0 for confidential reporting
Mid-2018	Publication of ICS Version 2.0 and ComFrame Consultation
IAIS 2019 General Meeting	Adoption of ComFrame, including ICS Version 2.0

Annex 1: HLA Principles

The following 10 Principles were approved by the IAIS in September 2014 to provide guidance for the development of the Higher Loss Absorbency (HLA) capital requirement.

There are 6 Substantive principles and 4 Construction principles.

Substantive Principles

HLA Principle 1 - Comparability. Outcomes should be comparable across jurisdictions.

Additional explanation:

- This implies the need to minimise distortions, including those arising from differing levels of conservatism included in valuation or other relevant processes or requirements. The level of discretions that may be applied or introduced should be minimised across jurisdictions and over time.
- “Comparable” implies results should be similar and consistent across jurisdictions, but does not require that they be identical.

HLA Principle 2 - G-SII risks. The HLA should reflect the drivers (but is not restricted to only those drivers) of the assessment of G-SII status.

Additional explanation:

- These drivers are indicative of the risks intended to be addressed by the HLA.
- The HLA should reflect individual characteristics of each G-SII.

HLA Principle 3 - Internalise costs. The failure or distress of a G-SII may result in costs to the financial system and overall economy. The HLA should internalise some of these costs that are otherwise external to that G-SII.

Additional explanation:

- G-SIIs should be required by their group-wide supervisors to hold higher levels of regulatory capital than would be the case if they were not designated as G-SIIs.
- The HLA should be set at a level that offsets any advantage that may be expected to arise from the G-SII designation.
- Through internalising external costs, HLA may lead to a reduction in systemic activities as they become more expensive and therefore less attractive.

HLA Principle 4 - Resilient. HLA should work, and remain valid, in a wide variety of economic conditions (including a stressed macro environment).

Additional explanation:

- In order to reflect the impact of major drivers of economic experience that are relevant to the scope of HLA, the adopted approaches should be able to be tested against historic data and circumstances.

HLA Principle 5 - Going concern. The HLA, and its foundation, assume G-SIIs are “going concerns.”

Additional explanation:

- In practice this requires that the capital requirement given by the sum of the foundation requirement and the HLA requirement is set reflecting a ‘going concern’ perspective, not a “gone concern” perspective.
- The current foundation for the HLA is the BCR, but it is intended to replace the BCR with the ICS when the ICS is developed.

HLA Principle 6 - Quality of capital. The HLA capital requirement is to be met by the “highest quality capital.”

Construction Principles

HLA Principle 7- Pragmatic. The design of the HLA needs to be pragmatic and practical, with an appropriate balance between granularity and simplicity.

Additional explanation:

- The form of presentation of the HLA, focusing on meaningful communication to external parties, should be practical yet sufficiently granular for the results to be fit for purpose.
- The HLA should utilise the minimum number of parameters and data requirements while attaining valid and robust outcomes with a focus on material issues.

HLA Principle 8 - Consistent. The structure of the HLA should be consistent and be applicable over the range of insurance and non-insurance entities it will need to cover and over time.

HLA Principle 9 - Transparent. The level of transparency, particularly with regard to the final results provided and the use of public data, should be optimised.

HLA Principle 10 - Refinement. The HLA will be refined in light of experience and data gathered by the IAIS in the course of Field Testing exercise.

Annex 2: BCR Principles

Substantive principles

BCR Principle 1 - Major risk categories should be reflected. The BCR must reflect major insurance risks, including risks from both assets and liabilities, and non-insurance risks.

BCR Principle 2 - Comparability of outcomes across jurisdictions. Outcomes should be comparable across jurisdictions. This implies the need to minimise distortions, including those arising from differing levels of conservatism included in valuation processes. The level of discretions that may be applied or introduced should be minimised across jurisdictions and over time.

BCR Principle 3 - Resilience to stress. The BCR should be able to function in a wide variety of circumstances (including a stressed macro environment) and remain valid. Approaches adopted should be testable against historic data and circumstances to reflect the impact of major drivers of experience that are appropriate for basic capital requirements.

Construction principles

BCR Principle 4 - Simple design and presentation. The design of the BCR needs to be pragmatic and practical. The form of presentation of the BCR, focusing on meaningful communication to external parties, should be “simple” and “intuitive” at a high level, yet sufficiently granular for the results to be fit for purpose. The BCR should utilise the minimum number of parameter and data requirements while attaining valid and robust outcomes with a focus on material issues.

BCR Principle 5 - Internal consistency. The structure of the BCR needs to be consistent and should be applicable over the range of insurance and non-insurance entities it will need to cover and over time.

BCR Principle 6 - Optimise transparency and use of public data. The level of transparency, particularly with regard to the final results provided, and the use of public data should be optimised.