IAIS

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

Public

ICS Consultation Document – Responses to Comments on Target Criteria, Risk Mitigation and Credit for Participating/Profit Sharing and Adjustable Products (Sections 7.2.1 and 7.2.3-7.4)

9 March 2016

About this slide deck

1. This is the next tranche of resolutions of ICS Consultation Document (ICS CD) responses and comments received from IAIS Members and Stakeholders.
2. Member comments are grouped, noting that:
   i. Members who provided confidential responses are not explicitly identified, but the total number of responses received is reported; and
   ii. it is the policy of some Members to not comment on public consultations.
3. Stakeholder comments are presented on a thematic basis.

Glossary of Member Acronyms

AMF	Autorité des Marchés Financiers, Quebec, Canada
BaFin	Federal Financial Supervisory Authority, Germany
BMA	Bermuda Monetary Authority
CIRC	China Insurance Regulatory Commission
EIOPA	European Insurance and Occupational Pensions Authority
MAS	Monetary Authority of Singapore
NAIC	National Association of Insurance Commissioners, United States
OSFI	Office of the Superintendent of Financial Institutions, Canada
Russia	Central Bank of the Russian Federation

7.2 Target criteria

Questions 42, 43, 46, 47 and 48 will be considered together and one combined IAIS response will be provided.

Question 42. Which risk measure – VaR, Tail-VaR or another – is most appropriate for ICS capital requirement purposes? Why?

BaFin, CIRC, EIOPA, MAS, OSFI and six other Members support using VaR for the ICS standard method.

AMF and BMA support using Tail-VaR for the ICS standard method.

Most stakeholders commented that VaR is the most appropriate from a practical perspective (i.e. easier to implement). Some stakeholders commented that TVaR is theoretically superior (particularly if used in conjunction with internal models), but far more difficult to implement, so VaR should be used for a standard method.

7.2.1 Risk measure

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?

BaFin suggested the use of qualitative requirements to complement ICS quantitative requirements.

MAS suggested prescribed diversification benefits to ensure better comparability between IAIGs.

Some stakeholders stated that approved internal models could be used. Others stated that scenario testing may help address difficulties with tail determination.

7.2.3 Basis of measurement

Question 46. In what ways are the proposed initial field testing target criteria appropriate or inappropriate for the development of the ICS?

AMF, EIOPA, OSFI and four other Members commented that a target of 90% Tail-VaR is too low.

BaFin commented that the proposed targets do not represent a similar level of confidence.

MAS and OSFI support a target criteria of VaR 99.5, assuming the ICS is a PCR.

NAIC supports the Tail-VaR approach , if it were not a significant imposition on industry to extract, supply and use the necessary data. NAIC also commented that assuming the ICS is a PCR, a VaR 99.5 is not unreasonable as a standard.

Several stakeholders commented that TVaR is not suitable for a standard approach and should not be field tested. Others commented that the proposed targets do not represent a similar level of confidence.

7.2.3 Basis of measurement

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

MAS identified the following cost: resource intensive for both IAIS and the IAIG.

Stakeholders identified the following costs:

- Increased field testing resources (both workload and financially) to field test TVaR, which requires extensive data on the tail

Stakeholders identified the following benefits:

- Increased information on volunteer's loss distribution tails
- Better calibration of the ICS capital requirement

7.2.3 Basis of measurement

Question 48. In order to field test a Tail VaR measure, how should the IAIS specify the Tail VaR measure for a given confidence level?

BaFin, EIOPA and four other Members do not support field testing the Tail-VaR approach.

Many stakeholders did not answer this question. Some stakeholders reiterated their view that the TVaR approach should not be field tested. One stakeholder commented that the IAIS should provide Volunteers with the tail distribution of risk factors. One stakeholder suggested that a TVaR could be approximated for some risks using a simple scaling of VaR figures (assuming a normal distribution).

IAIS Response: Through 2015 Field Testing, the IAIS learned that Volunteers largely support the use of a VAR measure on practical grounds. Given this, and the complexity of implementing a Tail-VaR measure, the IAIS will focus on only a VaR risk measure in 2016 Field Testing. It is proposed that for 2016 Field Testing the IAIS will attempt to calibrate all risks at 99.5% VAR.

7.3 Risk Mitigation

Question 49. Do the proposed principles adequately address the concept of risk mitigation? If not, which principles should be changed and why? What additional principles should the IAIS consider and why? What unintended consequences do the proposed principles create?

BaFin, BMA, EIOPA, MAS, NAIC, OSFI and six other Members support the principles outlined in this section.

EIOPA and four other Members do not believe dynamic hedging arrangements should be considered within the scope of recognized risk mitigation techniques, while AMF believes dynamic risk mitigation should be considered for life business as for non-life business.

Stakeholders generally agree with the principles outlined in this section, with a few suggestions for clarification.

IAIS Response: The principles for risk mitigation as set out in the ICS CD have adequate support to continue as the basis for developing more detailed methods of allowing for risk mitigation in the ICS with respect to individual risks. Dynamic hedging arrangements will not be included in the scope of recognised risk mitigation techniques for the ICS Version 1.0.

7.3 Risk Mitigation

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Themes from Responses	**IAIS Response**
Principle c): *"The calculation should be made on the basis of assets and liabilities existing at the reference date of the ICS calculation."* Stakeholders suggest this principle should be modified to recognise credits due to dynamic hedging.	Dynamic hedging arrangements will not be included in the scope of recognised risk mitigation techniques for the ICS Version 1.0.
Principle c) may be in conflict with paragraph 135, which indicates that renewal of risk mitigation arrangements may be taken into account.	This needs clarification. Paragraph 135 mainly refers to the situation of reinsurance arrangements and existing hedging arrangements at the balance date which are expected to be renewed rather than dynamic hedging arrangements which are expected to evolve with the circumstances faced by the IAIG.

7.3 Risk Mitigation

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Themes from Responses	IAIS Response
Dynamic hedging strategies and rolling risk arrangements are not adequately addressed by the principles.	Dynamic hedging arrangements will not be included in the scope of recognised risk mitigation techniques for the ICS Version 1.0.
The allowance of risk mitigation in the ICS should not produce bias in favour of one type of insurer over another.	The risk mitigation principles are not designed to produce bias. Ongoing field testing will reveal if there are any disadvantages to particular structures of IAIGs.
Principle b) should be modified because a direct third party may not exist.	This seems to be a matter of detail to be addressed in specifications relating to individual risks and does not require the principles to be modified.

7.3 Risk mitigation

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?

BaFin, EIOPA and four other Members, commented that the following criteria should be met for full recognition: (1) a written policy on the replacement of the risk mitigation arrangement; (2) replacement is not required too often; (3) replacement is not conditional on any future event that is not within the IAIG's control; (4) replacement is assessed on the basis of realistic assumptions, taking into account previous experience; (5) risk of lack of coverage due to illiquidity of the underlying instrument is immaterial; (6) any additional risk stemming from the risk mitigation arrangement is reflected in the calculation of the ICS capital requirement.

MAS commented that all risk mitigation arrangements existing at measurement date should be accounted for, regardless of expiry. Adequacy of risk mitigation activities could be addressed qualitatively via requirements on reinsurance management strategy.

OSFI commented that the following criteria should be met for full recognition: a well-defined reinsurance program that assumes a continuous renewal of current reinsurance arrangements and sufficient capacity in the market.

7.3 Risk mitigation

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(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?

Several stakeholders commented that documented intent to renew a risk mitigation arrangement is sufficient for recognition (e.g. renewal is included in business plan). Others commented that past practice of renewal and the probability of renewing the arrangement should be considered. Several stakeholders commented that the expected changes to the cost of renewal should be reflected.

IAIS Response: 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. The IAIS will develop a set of criteria to be met in order to recognise the renewal of risk mitigation arrangements. For example:

- The renewal is consistent with previous business practice and documented strategy and realistic with regards to availability and cost;
- There is demonstrable availability of the arrangement and reasonable cost for renewal that is reflected on the balance sheet
- Any additional risk stemming from the risk mitigation arrangement (e.g. credit risk) is taken into account in the ICS capital requirement.

7.4 Credit for par/profit sharing and adjustable products

Question 51. Should credit for participating/profit sharing and adjustable products be calculated in a last step adjustment as an overall adjustment to the capital requirement, or along the intermediate calculation steps in the determination of individual risk charges? Why?

BaFin, EIOPA and four other Members support applying the credit along the intermediate calculation steps.

OSFI and one other Member support applying the credit as a last step adjustment.

AMF commented that both approaches are acceptable as long as no excess credit is recognized.

MAS commented that requiring credit for participating/profit sharing and adjustable products be calculated as an overall last-step adjustment to the capital requirement or as an intermediate adjustment for each individual risk charge may be overly complex and not necessarily be suited for all jurisdictions.

Most Stakeholders commented that it is more appropriate to apply the credit along the intermediate calculation steps in the determination of individual risk charges. A few stakeholders prefer applying a last step adjustment to the capital requirement, while a few stakeholders that either approach is appropriate and insurers should be allowed to choose.

7.4 Credit for par/profit sharing and adjustable products

Question 51. Should credit for participating/profit sharing and adjustable products be calculated in a last step adjustment as an overall adjustment to the capital requirement, or along the intermediate calculation steps in the determination of individual risk charges? Why?

IAIS Response: For 2015 Field testing, a credit for exercising management actions with respect to participating/profit sharing and adjustable products was taken into account at the level of each risk in the ICS post diversification. Volunteers were asked to report how much of their total insurance liabilities were liabilities for future bonuses or other discretionary benefits. This amount was used as a cap on the overall credit allowed in the ICS. There was no significant adverse comment on this approach among volunteers and so this will be taken forward in field testing for 2016.

7.4 Credit for par/profit sharing and adjustable products

Question 52. How can an overall adjustment for discretionary credits be calibrated in a manner that takes account of the reaction of policyholders to extreme scenarios into account? How can it be made comparable to calculations based on scenario projections?

The Members that prefer a credit along the intermediate step calculations (Question 51) did not directly answer this question.

OSFI suggested that the difference in the present value of best estimate cash flows without discretionary credits and the estimated cash flows with maximum discretionary credits can be used to quantify the potential credit. A proportion of this credit can be determined as an appropriate reduction to the capital requirement.

Few stakeholders responded to this question. One stakeholder suggested the use of correlation parameters to account for policyholder reactions, while another suggested the use of expert judgement, such as the Appointed Actuary , to determine an appropriate adjustment. One stakeholder commented that reactions of policyholders should not be included in the ICS, but rather in ComFrame considerations. One stakeholder commented that it is difficult to model policyholder behavior, so an adjustment could be approximated using haircuts or caps to credits.

IAIS Response: See response to question 51. Since the IAIS is apply the credit at the level of each risk for field testing purposes, this issue is currently redundant.

7.4 Credit for par/profit sharing and adjustable products

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

EIOPA and five other Members commented that index-linked and unit-linked products should not be included.

EIOPA and four other Members commented that these products should be legally or contractually based on either the performance of a specified group of contracts/specified type of contract/single contract, the realised or unrealised investment return on a specified portfolio of assets held by the insurer or the profit or loss of the insurer/fund corresponding to the contract.

Stakeholders suggested the following criteria:

- Management's willingness to make adjustments to dividends/adjustable features in a stress
- Legal ability to reduce benefits, as well as the practical ability
- Reputational ability to reduce benefits, shown through internal policies and/or track record

IAIS Response: For 2015 field testing, the criteria for allowing a credit for participating or profit sharing and adjustable products is that the management actions to reduce those benefits should be realistic. The management actions cannot be contrary to the Volunteer IAIG's obligations to policyholders or to legal provisions applicable to the Volunteer IAIG.

7.4 Credit for par/profit sharing and adjustable products

Question 54. What are some of the considerations for determining the aggregation of the credit for participating/profit sharing and adjustable products? What are some of the limitations with respect to cross-subsidisation of different products, the application of the credit generally or its ability to be used across the IAIG?

EIOPA, MAS and four other Members commented that grouping of policies should be used as long as (i) experience within the group is relatively homogenous, (ii) the grouping does not misrepresent the risks, compared to calculating on a policy-by-policy basis.

AMF, MAS, OSFI and one other Member commented on the need for safeguards to prevent cross-subsidy between participating blocks of policies where the risks/rewards are not shared and/or the risks are not diversifiable.

7.4 Credit for par/profit sharing and adjustable products

Question 54. What are some of the considerations for determining the aggregation of the credit for participating/profit sharing and adjustable products? What are some of the limitations with respect to cross-subsidisation of different products, the application of the credit generally or its ability to be used across the IAIG?

Few stakeholders responded to this question. One stakeholder suggested that the credit should be calculated by portfolio of participating products managed together. One stakeholder commented that the credit determination should be consistent with what management would do with respect to cross-subsidisation and the level of aggregation in the determination of participating dividends/adjustable features. One stakeholder commented that the credit should not be so large that it completely offsets the Capital Requirement post-aggregation.

IAIS Response: See response to Question 51. For 2015 field testing, a credit for par/profit sharing and adjustable products was set at the total amount of liabilities for future bonuses or other discretionary benefits. This was applied after aggregating the total of management actions post-diversification across the risks. As volunteers did not object to this overall approach, it will be repeated in 2016 field testing.

7.4 Credit for par/profit sharing and adjustable products

Question 55. As a starting point for determining the value of the credit, does the approach described above represent any challenges? What other options or methodologies should be considered and why?

EIOPA and four other Members commented that only a stress/scenario approach can provide a reasonable response in this area, providing an adequate degree of risk sensitivity.

BaFin commented that only a modular approach is sensitive enough to appropriately capture the risk mitigation of future profit sharing.

Few stakeholders responded to this question. One stakeholder commented that a grouping of products/policies is a more practical/logical basis. One stakeholder proposed that an alternative approach is to assume that all future discretionary benefits are fully loss absorbing and apply stresses to individual risk drivers without allowing for loss absorbing capacity.

IAIS Response: There was no information provided in responses to this question that suggests that the IAIS should change the approach to the credit for par/profit sharing and adjustable products that it used in 2015 field testing.