IAIS

ICS as a PCR
ICP 14 and 17

Public background call

29 June 2023

Content of the presentation

- ICP 14 and 17
  - Background
  - Overview of changes

- Insurance Capital Standard (ICS) as a PCR
  - Goals, history and timeline
  - Consultation document
  - Evolutions from ICS Version 2.0

ICP 14 and 17

Background

- ICP 14 and ICP 17 were not included in the 2019 ICP review, as the ICS work was still on-going.
  - ICP 14 (Valuation) establishes requirements for the valuation of assets and liabilities for solvency purposes.
  - ICP 17 (Capital adequacy) establishes regulatory capital resources and requirements.

- As part of the Abu Dhabi agreement, it was decided that these two revised ICPs along with their related terms in the IAIS glossary, would be adopted by the end of the monitoring period.

- Review of ICP 14 and ICP 17 started in Q4 2021.

- Integration of ComFrame (ICS) material into ICPs 14 and 17 is planned after the adoption of ICS as a Prescribed Capital Requirement in December 2024.

ICP 14 changes

- In most cases, changes were limited to updates to the text and additional clarifications
- Key changes:
  - Review of some terms (eg fulfilment value) to determine whether they should be defined in the IAIS Glossary. No terms added to the glossary. However, ICP 14.4.13 was enhanced to provide more context
  - A number of editorial changes were made to improve consistency and readability

ICP 17 changes

- Changes were generally limited to:
  - Updating obsolete or outdated text; and
  - Providing clarifications where necessary.

- Key changes:
  - Text was streamlined and shortened, where needed.

  - The terms resolution / liquidation are now used consistently across all ICPs, and in particular between ICP 12 and 17.

  - A number of editorial changes were made to improve consistency and readability.
    - Capital resources vs regulatory capital resources
    - Supervisor, group-wide supervisor, involved supervisor

The Insurance Capital Standard (ICS)

Goals, history and timeline

What is the ICS and what are the ICS key components?

Scope

- Quantitative element of the Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs) (ComFrame)
- Consolidated group-wide standard; **<u>not</u>** legal entity
- Minimum standard that all IAIS members will implement or propose to implement, taking into consideration specific market circumstances in their respective jurisdictions
- Focus on insurance activities; non-insurance activities in the ICS will leverage on existing international frameworks (e.g. Basel III for banking activities)

3 Main Components

- Valuation
- Capital requirement
- Qualifying capital resources

Risk Coverage

- The ICS reflects all material risks of an IAIGs' portfolio of activities taking into account assets, liabilities, non-insurance risks and off-balance sheet activities (e.g. insurance, market, credit, operational). To the extent that risks are not quantified in the ICS, they are addressed elsewhere in ComFrame

How did the IAIS approach the development of the ICS?

- Developing a global insurance capital standard is a complex matter….
- The journey to get where we are has been long…
- A marathon rather than a sprint…

- Since its announcement in October 2013, the IAIS has followed a structured and evidence-based approach to the development of the ICS by undertaking a multi-year quantitative Field Testing process with **volunteer insurance groups**

How did the IAIS approach the development of the ICS?

- The IAIS has conducted **six quantitative Field Testing exercises** throughout the development stage of the ICS – from 2014 to 2019
- Technical specifications for each ICS Field Testing exercise have been informed by IAIS analysis of submitted data, as well as additional feedback and comments provided by Volunteer Groups as part of their submissions or through dedicated Field Testing workshops

CSFWG
More than 41 members from over 25 member organisations

Roughly 9 weeks of CSFWG meetings + 10 weeks of data meetings per year since 2013

c. 40-50 Volunteer Groups per year from more than 15 Jurisdictions – all continents/regions represented in the sample

Over 180 questions per Consultation and close to 3,600 comments covering over 1,300 pages just for the 2018 Consultation

In addition to the Field Testing process, the IAIS has reached out to the broader group of stakeholders during dedicated, **in-person stakeholder meetings** and by engaging in three **public consultations** (2014, 2016 and 2018) and **meetings with volunteer insurance groups**

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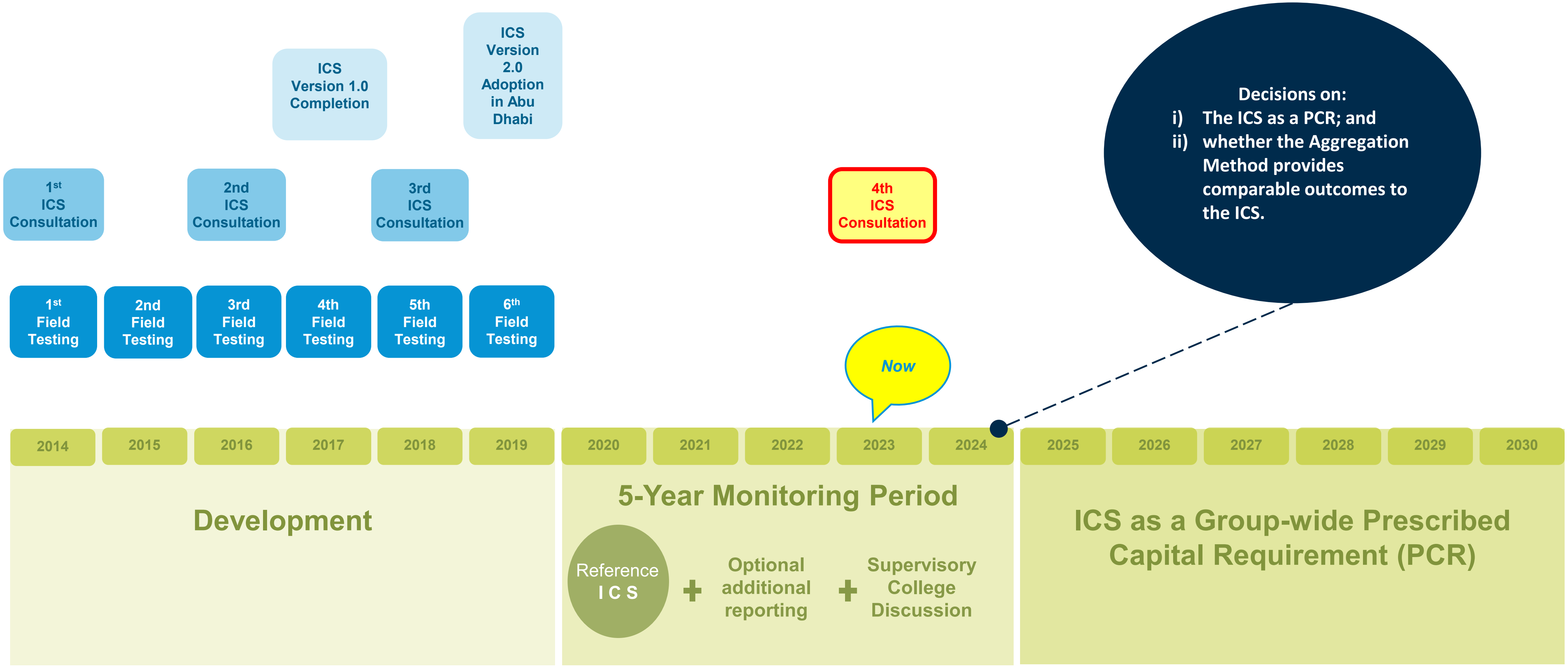
How did the IAIS approach the development of the ICS?

- Our goal has been to develop a truly global insurance capital standard for IAIGs. We have been striving to create something **unique** that works for different firms, markets and supervisors across the world….

- Achieving this goal is not easy because of the different valuation methods and capital standards currently used by different jurisdictions to assess group capital adequacy.
- Nevertheless, progress made over the last few years shows that this convergence process is possible.

Where are we now?



ICS as a PCR

Consultation document

ICS – fourth public consultation

- After 3 public consultations (2014, 2016, 2018), exploratory in nature…
- … the IAIS is now consulting on the near-final version of the ICS

➔ *Last public consultation before the standard is adopted and becomes subject to implementation by IAIS Members.*

- Through this consultation, feedback is sought on all aspects of the ICS, with questions on each section.
- In addition, the document provides specific background information and targeted questions related to changes made between ICS Version 2.0 and the candidate ICS as a PCR.

ICS consultation document – structure

- The ICS consultation document is comprised of three main parts:
  - The **introductory part** (sections 1 and 2): provides formal information on the consultation process and background information on the ICS (structure, principles, history)
  - The **core part** (sections 3 to 9): contains the standard itself (paragraphs numbered L1- and L2-), together with background explanations and consultation questions (blue boxes)
  - The **Economic Impact Assessment** part (section 11): provides information on the EIA, and contains all questions related to the EIA.
- Section 10 includes an overall “catch-all” question, offering the possibility to provide feedback not already captured in responses to the core part.
- Four annexes complement the core part. Two of them:
  - **Annex 1** “Treatment of non-voting interest entities”
  - **Annex 3** “Definitions and criteria applicable to infrastructure debt and equity”

are an integral part of the standard (Level 2 text), but have been kept as annexes for the ease of reading).

The ICS Economic Impact Assessment

- As part of the Abu Dhabi agreement in 2019, the IAIS committed to producing an Economic Impact Assessment (EIA) of the ICS ahead of its implementation as a Prescribed Capital Requirement (PCR) starting from 2025.
- The purpose of this EIA is to assess potential significant effects arising from the introduction of the ICS, focusing on the following four areas:
  - Product availability
  - IAIGs' business model and capital position
  - Financial markets
  - Implementation of the ICS
- The EIA will draw on quantitative and qualitative data collected during the ICS monitoring period, as well as the responses to the questions included in part 3 of the ICS consultation

The ICS Economic Impact Assessment

- We would like to receive responses from a wide range of stakeholders
- This goes beyond IAIGs and insurers directly impacted by the introduction of the ICS, including other market participants as:
  - Ratings agencies;
  - Industry bodies;
  - Non-IAIG insurers;
  - Investors; and
  - Consumer bodies
- The outcomes of this assessment will be considered when finalising the ICS and support the implementation process of the ICS as a PCR.

From ICS Version 2.0 to candidate ICS as a PCR

List of evolutions

Changes made

- Valuation:
  - Adjustments to the Middle Bucket eligibility criteria
  - Recognition of multiple portfolios within the same currency for the Middle Bucket
  - Contribution of non-fixed income assets to the spread adjustment
  - Introduction of a term structure for spreads
  - Modulation factor to limit the impact of the spread adjustment in some cases

- Capital resources:
  - Introduction of a limit to the recognition of minority interests
  - Adjustments to some eligibility criteria for Tier 1 Limited and Tier 2 instruments

Changes made

- Capital requirement:
  - Update of the Non Default Spread risk (linked to envisaged changes for MAV)
  - Update of the Life risks calibration
  - Differentiated treatment for investments in eligible infrastructure debt and equity
  - Introduction of a counter-cyclical adjustment for Equity risk
  - Optionality in the calculation of the non-insurance risk charge
- Tax:
  - Simplified approach to the recognition of tax effect on the ICS capital requirement
- Other methods:
  - Use of internal models for the calculation of the capital requirement
  - Use of Supervisory Owned and Controlled Credit Assessments (SOCCA) for unrated exposures in the Credit risk calculation

Market Adjusted Valuation

Middle Bucket criteria

Criterion L2-69 d.

In this criterion, the risk-free rate has been replaced by the General Bucket curve to allow for spreads on the liability side that are consistent with the asset side.

The total market value of assets identified for this portfolio is, at the reporting date, greater than the current estimate of the liabilities calculated using the ~~risk-free~~ General Bucket yield curve.

Criterion L2-69 e.

- The wording has been amended to clarify that premium cash flows that are at the discretion of the IAIG are not precluded from qualifying for the Middle Bucket. This does not decrease the predictability of cash flows for the IAIG as the changes are at their discretion.
- Products with certain policyholder options (eg top-up options or paid-up additions, which are quite common) are not excluded automatically from the Middle Bucket. However, these type of cash flows (that decrease the predictability of cash flows for the IAIG) should be unbundled and put in the General Bucket.

Revisions to criterion L2-69 e:

The contracts underlying the liabilities do not include future premiums or include only future premiums that are contractually fixed or are at the discretion of the IAIG. Policyholder options to pay additional future premiums do not disqualify these liabilities from the Middle Bucket, but all corresponding cash flows that are not at the discretion of the IAIG have to be unbundled and are subject to the General Bucket.

Market Adjusted Valuation

Multiple Middle Bucket portfolios

Multiple Middle Bucket portfolios

- Introduced the possibility (ie optionality) to have multiple Middle Bucket portfolios in a single currency to allow for a better representation of economic reality in the ICS (eg different subsidiaries manage ring-fenced insurance liabilities)
- All of the Middle Bucket criteria need to be **satisfied by each individual portfolio**.

Criterion L2-69 a requires each Middle Bucket portfolio to be ring-fenced and prevents the double use of assets.

Market Adjusted Valuation

Treatment of Non Fixed Income assets

Treatment of Non Fixed Income assets (NFI)

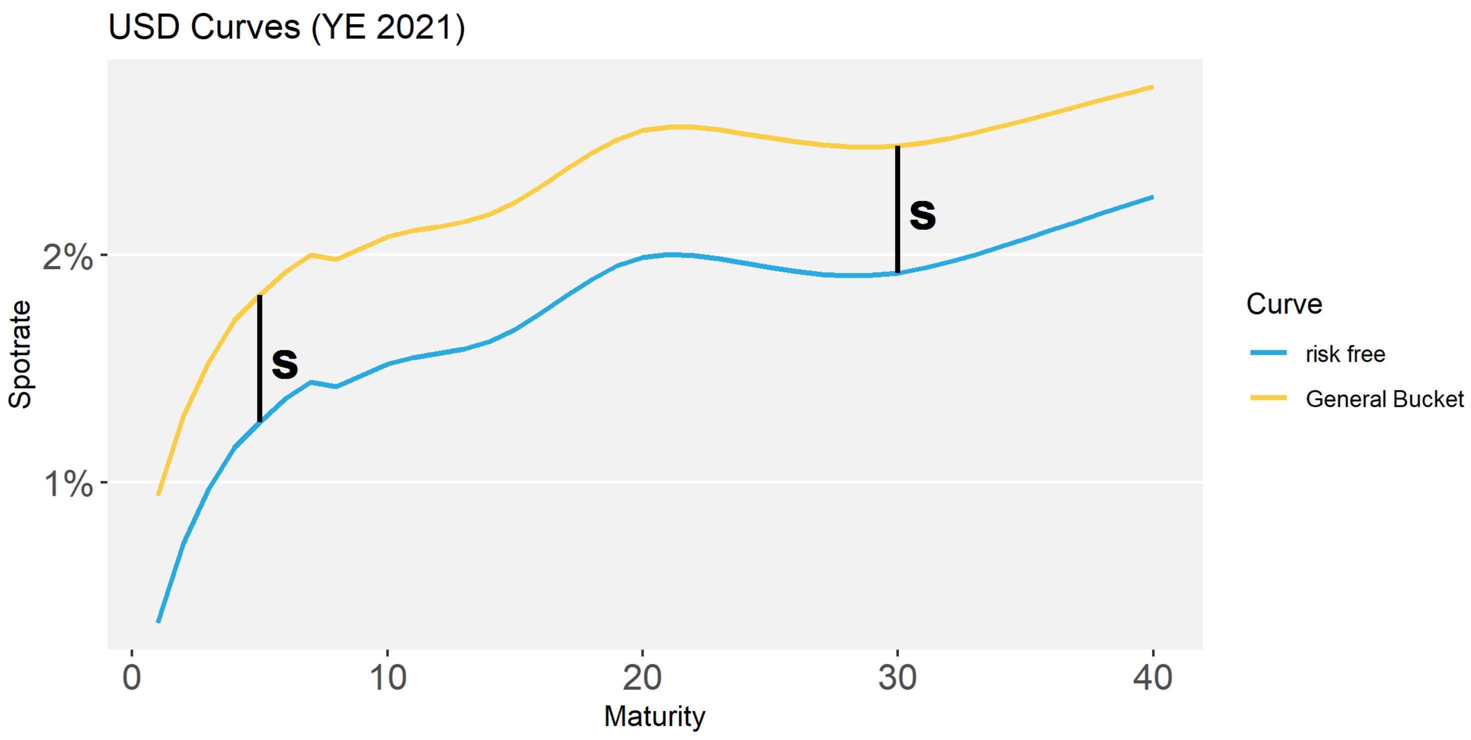
- Given that the General and Middle Buckets are conceptually different, and additional safeguards are in place for the Middle Bucket, a different treatment of NFI for these two buckets has been introduced. More specifically:
  - NFI has been excluded from the calculation of the **Middle Bucket** spread adjustment – until this revision NFI contributed to a spread of zero and therefore, lowered the spread adjustment
  - The approach for the **General Bucket** has not been changed (ie NFI contributes to a spread of zero)

Market Adjusted Valuation

Term structure approach for spreads

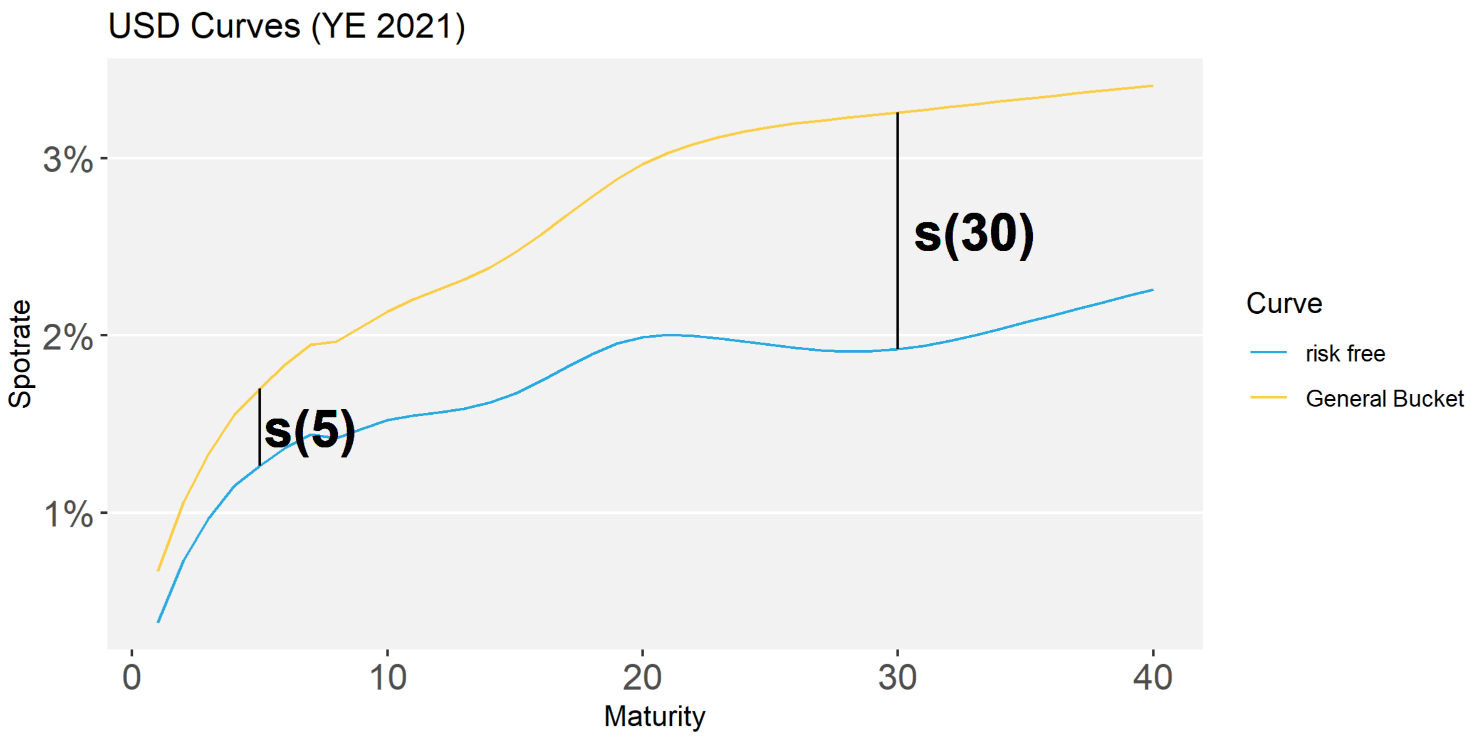
ICS Version 2.0

In ICS Version 2.0, yield curves for the General and Middle Buckets are obtained by taking the risk-free yield curve and adding a flat spread adjustment, ie a parallel shift of the risk-free yield curve.



Credit Spread Term Structure

Given that credit spreads are typically dependent on maturity, during the ICS monitoring period information of an approach that allows for the use a credit spread term structure was collected.



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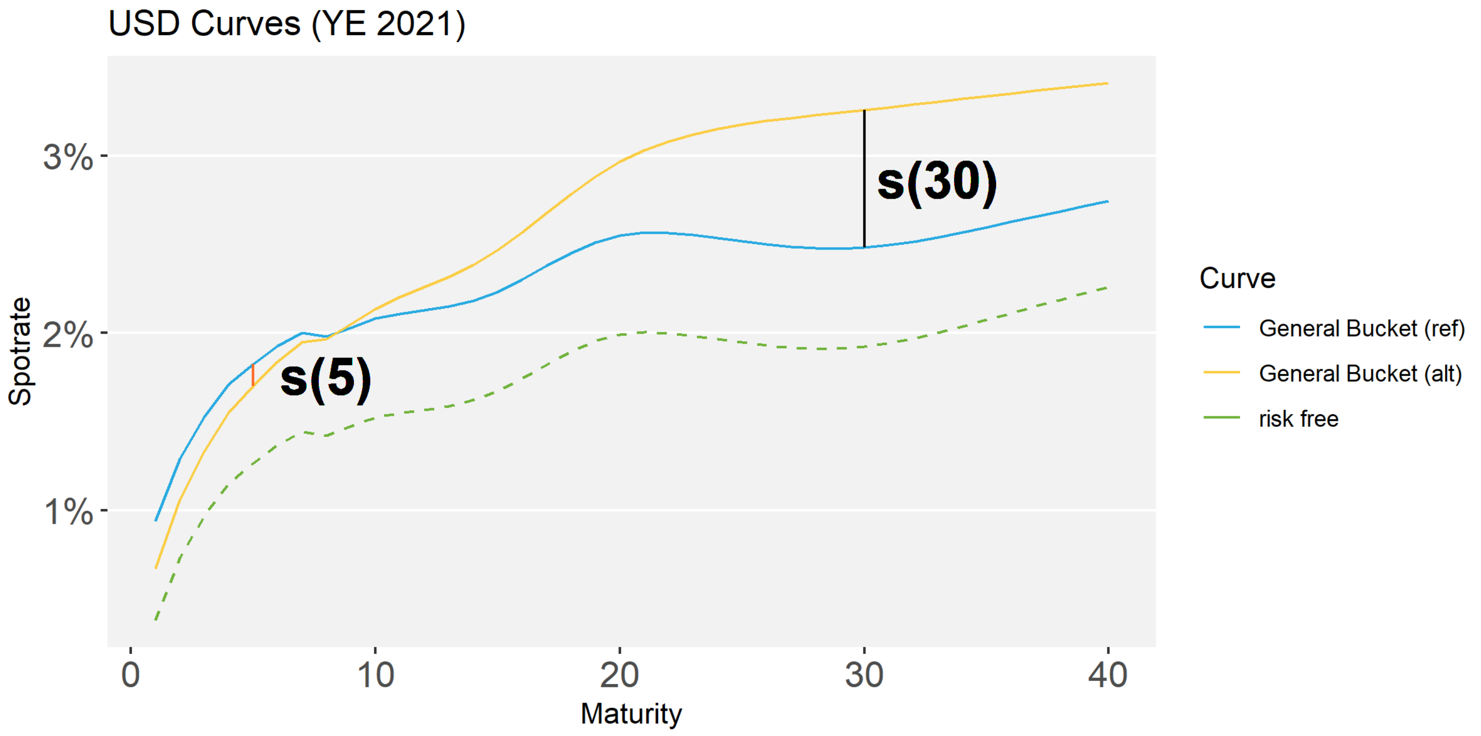
ICS v2.0 vs Credit Spread Term Structure

In general, the introduction of a credit term structure leads to lower spread adjustments for shorter maturities and higher spread adjustments for longer maturities compared to the current design.



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Credit Spread Term Structure

Revisions:

- Introduction of a spread term structure to determine General and Middle Bucket yield curves using the Nelson Siegel approach
- As a consequence, to ensure consistency with other parts of the framework, the NDSR stress, previously based on a flat spread, has been revised.

Market Adjusted Valuation

Modulation Factor

Modulation Factor – Tested in 2022

- Identified risk of overshooting: in times of credit spread stress the release on the liability side is bigger than the loss on the asset side, leading to the counter-intuitive situation that a stressed situation improves the solvency position.
- To mitigate that risk, information on a Modulation Factor was collected during year 3 of the ICS monitoring period.
- This approach compared the movement of assets and liabilities due to changes in spreads.
- However, its design was deemed too conservative as it assumed that an increase of 1bp in credit spreads also leads to an increase of 1bp in discount rates, whereas not all assets contribute to the spread adjustment for the General and Middle Buckets and the application ratios further reduce the effect.

Modulation factor in the Candidate ICS

- Introduced a revised Modulation Factor that takes into account application ratios (of the respective bucket) and weights of spread contributing assets.

- This removes the conservatism of the Modulation Factor and still addresses the potential overshooting.

Capital resources

Limit on non-controlling interests (NCI)

Limit on non-controlling interests (NCI)

- For each subsidiary generating non-controlling interests (NCI), a limit has been set, beyond which NCI are deducted from ICS capital resources

- The limit is calculated as:

NCI proportion x *estimated contribution to group ICS*

- Where:
  - $NCI\ proportion = \frac{Equity\ elements\ issued\ to\ 3rd\ parties}{Total\ equity}$
  - $Estimated\ contribution\ to\ group\ ICS = \alpha.liabilities$
  - $\alpha = \frac{Group\ ICS\ capital\ requirement}{Group\ GAAP\ liabilities}$

Capital resources

Eligibility criteria

Revision of eligibility criteria

- Some eligibility criteria that specify limitations to the possibility to call a financial instrument for Tier 1 Limited and Tier 2 Paid-up instruments have been amended
- The aim of these amendments is to remedy unintended exclusions of some financial instruments from ICS capital resources

Criteria for Tier 1 Limited instruments

- ICS Version 2.0:
  - Calls are not allowed within the first 5 years of issuance…
  - … except in the case of tax and regulatory calls, subject to prior replacement and supervisory approval

- Candidate ICS as PCR:
  - Calls are not allowed within the first 5 years of issuance…
  - … except in the case of:
    - tax and regulatory calls, subject to supervisory approval
    - calls considered economic (ie: the instrument can be replaced at a lower cost for the issuer), subject to supervisory approval and prior replacement

Criteria for Tier 2 Paid-up instruments

- ICS Version 2.0:
  - Any call within the first 5 years is subject to prior replacement

- Candidate ICS as PCR:
  - Calls within the first 5 years are subject to prior replacement, unless:
    - The call is linked to a tax or regulatory event; or
    - The instrument can only be called at a make-whole price.

  - The waiver for instruments featuring a make-whole provision will be applicable only on a transitional basis

Capital requirement

Non Default Spread risk

Non Default Spread risk (NDSR)

- To acknowledge different spread adjustments to the yield curve at different maturities (ie introduction of a credit spread term structure), the approach to NDSR has been amended, to move from absolute to relative shocks, ie:
  – A relative shock of -75% for spreads has been introduced for the NDSR down stress scenario, up to the LOT.
  – A relative shock of +75% for spreads has been introduced for the NDSR up stress scenario, up to the LOT

Previous design

ICS RC	Up (in bps)	Down (in bps)
1	+50	-50
2	+50	-50
3	+70	-70
4-7	+100	-100
Subject to the following relative limit, calculated based on the absolute value of the spread over the risk-free yield curve:		
Relative limit	No relative limit	50%

Capital requirement

Life risks

Life risks – calibration

- Data on Life risks collected during the monitoring period indicated the need for adjustments to some calibrations

- Stress factors have been revised for two segments:
  - Mortality, business written in China: 12.5% → 15%
  - Morbidity/disability (long term Category 2), business written in Japan: 8% → 15%

Capital requirement

Equity counter-cyclical measure

Equity counter-cyclical measure

- A countercyclical measure, the Neutral Adjusted Dampener (NAD), has been introduced to reduce the Equity risk charge during a sharp equity market downturn and increase it during an upturn.
- This aims to counteract the effects of equity market changes on IAIGs, thereby reducing the risk of procyclical investment behaviour of IAIGs (fire sales).
- A countercyclical measure is viewed as a macro-economic tool, as it is meant to reduce systemic risk.

Infrastructure equity

Revisions:

- Identification of infrastructure equity subject to definitions and criteria
- Creation of sub-segments within the developed and emerging markets segments
- Reduction in risk factors by about 23% for infrastructure equity (compared to non-infrastructure equity)
- Introduction of correlation factors between infrastructure and non-infrastructure equity

Public

Capital requirement

Credit risk

Infrastructure debt

Revisions:

- Introduction of a new exposure class (infrastructure debt), subject to definitions and criteria
- Specific risk factors for exposures to unrated infrastructure debt: reduced by about 25% compared to unrated corporate exposures

Capital requirement

Non-insurance risk charge

Non-Insurance Financial Entities (non-banking)

- Under ICS Version 2.0, non-insurance financial entities that are not banks such as broker/dealers receive a risk charge of 15% of 3-yr average gross income
- This charge is equal to the Basel Basic Indicator Approach (BIA) for measuring operational risk
- Basel II had three operational risk charge approaches
  - Basic Indicator Approach (BIA) – 15% 3-yr gross income
  - Standardised Approach (SA) – Divides activities into 8 business lines, applies a weight to each line and applies a factor assigned to that line ranging from 12-18%
  - Advanced Measurement Approach (AMA) – Statistical (internal model) derived amount
- Basel 3.1 replaced the BIA and SA with a revised Standardised approach after concluding BIA and the current SA were under-calibrated for large, complex institutions.
- Under candidate ICS as a PCR: we retained the ICS Version 2.0 approach as a default, but provided supervisors with the flexibility to require the Basel III approach when deemed appropriate.
- If some material risks are not covered by either the default or the Basel III approach, the group-wide supervisor may require an additional risk charge.

Tax

Tax

- The ICS Version 2.0 approach used to calculate the tax effect on the insurance capital requirement penalises jurisdictions with higher tax rates by limiting the effect to 20% of the insurance capital requirement.
- To eliminate that penalty, the candidate ICS as a PCR applies a global haircut on the gross tax impact, rather than the limit prevailing in ICS Version 2.0.
- The new approach results in a simplification, as ICS Version 2.0 introduced a level of complexity that did not provide for additional accuracy of the utilisation assessment for most jurisdictions.
- That simplified approach comes with the possibility for supervisors to use a more complex utilisation approach for the tax effect on the insurance capital requirement by considering tax loss carry backs, future taxable income as well as deferred tax assets and liabilities.

GAAP Plus

GAAP Plus

- Continue to collect US GAAP Plus and IFRS GAAP Plus as part of the annual ICS data collection; however, neither will be included in the "candidate ICS as a PCR"
- Development of IFRS GAAP Plus and further refinement of US GAAP Plus can continue, provided sufficient data and resources are available.
- Japanese GAAP Plus, Chinese C-ROSS Plus and US SAP Plus approaches will be set aside for future consideration, if requested by a supervisor.
- GAAP Plus is a viable option that could be considered for a future version of the ICS, if requested by a supervisor.

Other Methods

Credit risk - SOCCA

SOCCA framework

- **Scope** - Reduced scope compared to ICS Version 2.0:
  - For rated exposures, IAIGs are subject to the same principles on the use and reliance of ratings as stipulated under the ICS standard method (ie SOCCA ratings are not be considered for rated exposures)

- **Location** - a SOCCA framework will be recognised as an Other Method in calculating the ICS capital requirement for unrated exposures only.

Other Methods

Internal models

Internal models

- In the candidate ICS as a PCR, internal models are recognised as an Other Method for the calculation of the ICS capital requirement
- The use of internal models is subject to requirements related to the development, use and maintenance of the model.

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