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IAIS
INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

ICS Version 1.0 for extended field testing

ICS Stakeholder Meeting
1 November 2017, Kuala Lumpur

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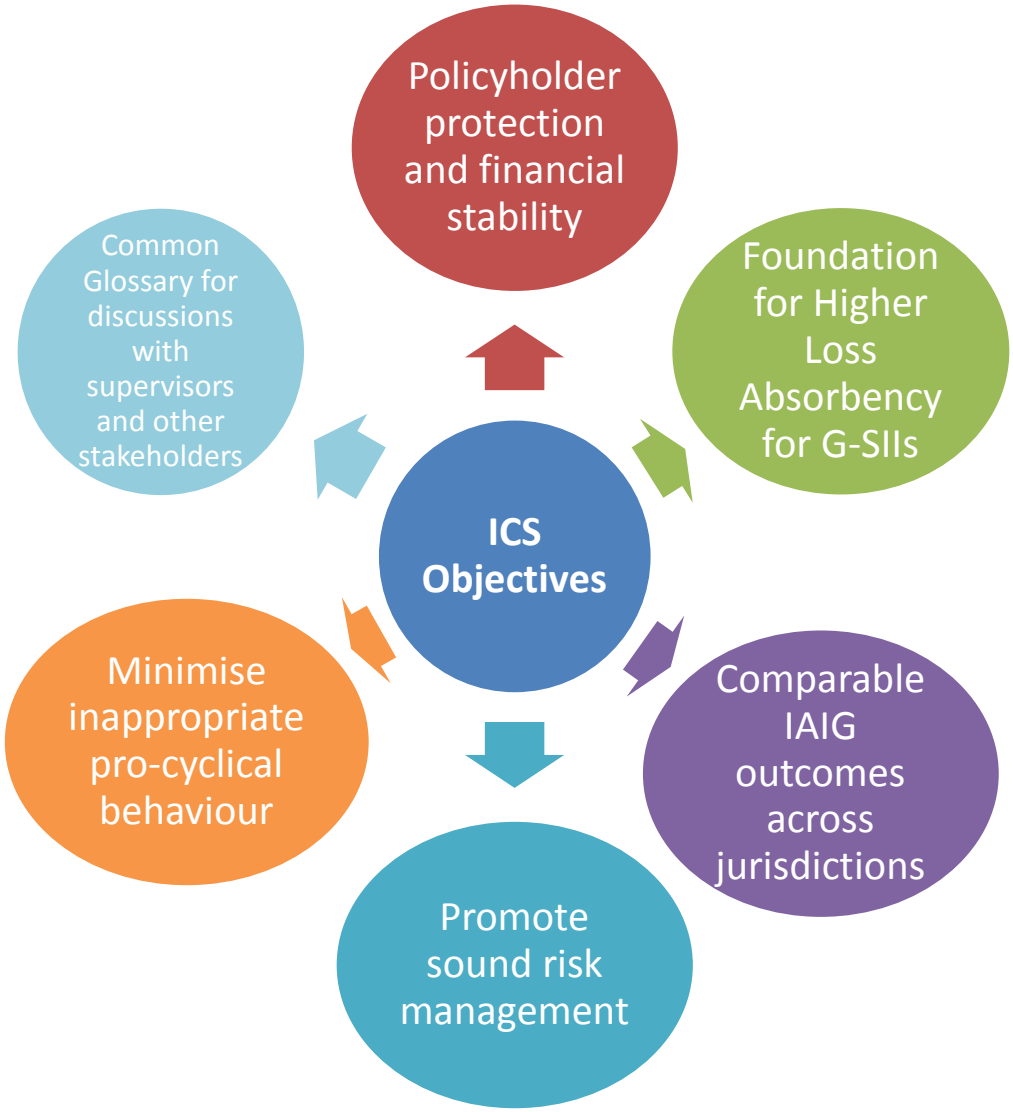
THE INSURANCE CAPITAL STANDARD (ICS)

ICS Objectives



ULTIMATE GOAL

A single ICS with a common methodology that achieves comparable, i.e. substantially the same, outcomes across jurisdictions

Key Elements of the ICS

Group-wide, consolidated standard for IAIGs

- Minimum standard – all IAIS members should propose for adoption in their jurisdictions
- Measure of capital adequacy for IAIGs
- **Not** legal entity requirement

Main Components

- Valuation
- Qualifying capital resources
- Capital requirement

Risk Coverage

- Takes account of all material risks (insurance, market, credit, operational) – does not explicitly cover group and liquidity risks
- More risk sensitive than the Basic Capital Requirements (for G-SIIs) – ICS will replace the BCR as basis for Higher Loss Absorbency requirements

ICS Versions and Goals

ICS Version 1.0 (Mid-2017)

- Two identified **valuation approaches**
- **Standard method** for ICS capital requirement

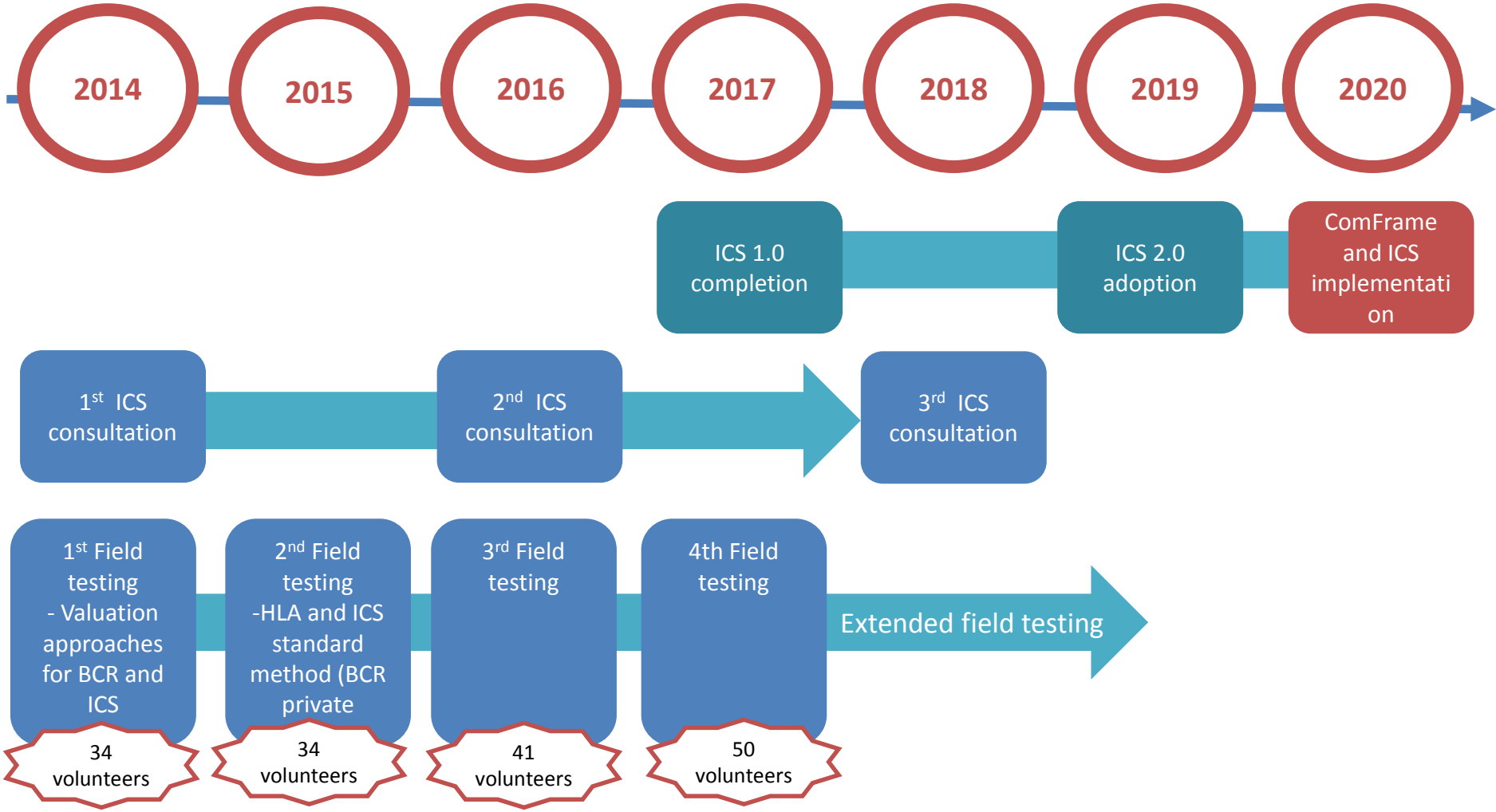
ICS Version 2.0 (End-2019)

- Improved level of **comparability** than ICS Version 1.0
- May still include two valuation approaches, but aspire to **reduce differences**
- May allow for standard **and other methods** for ICS capital requirement

ICS Ultimate Goal (No date)

- A single ICS that includes a common methodology to achieve **comparable** (substantially the same) outcomes across jurisdictions

ICS Development



ICS Version 1.0 'for Extended Field Testing'

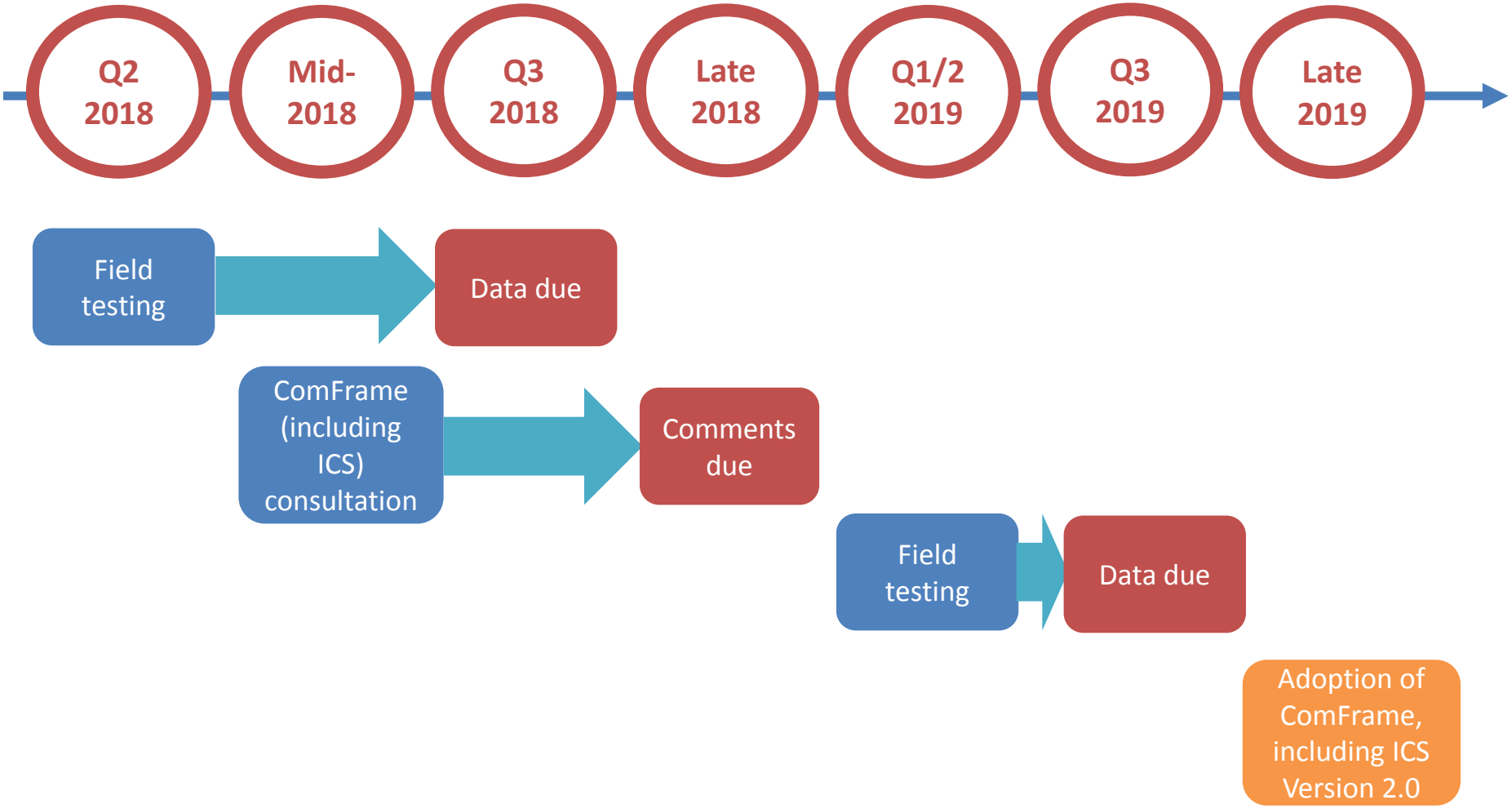
Status of ICS Version 1.0

- Provide **background and rationale** for ICS components
- Design and calibration are **not indicative** of ICS Version 2.0
- Options are **not exhaustive**
- Demonstrate **progress** in narrowing down options for field testing
- Covers only the **insurance component** of the ICS
- Developed as **standard method**

'Extended field testing' means:

- Field testing is extended to all **potential IAIGs** and other **interested groups**
- **Extended data requests** to facilitate resolution of technical and policy issues
  - Test potential impact of different options

The Path Towards ICS Version 2.0



PRESENTATIONS FROM STAKEHOLDERS

General Comments from Stakeholders

- Geneva Association and Institute of International Finance
- Global Federation of Insurance Associations
- The General Insurance Association of Japan
- The Life Insurance Association of Japan
- National Association of Mutual Insurance Companies
- AIA

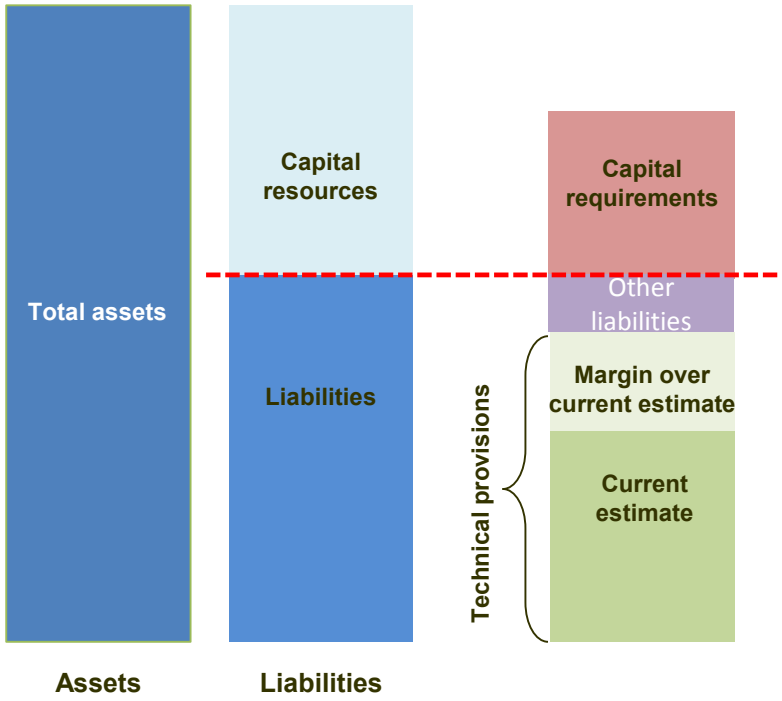
ICS VALUATION BASES

Valuation

- Overall design of ICS - **total balance sheet approach** – ie all assets and liabilities needs to be valued on a consistent basis

- ICS Principles – complementary goals for valuation
  - **Comparability** – ICS Principles 1 and 5
  - Promote **prudentially sound behaviour** while minimising inappropriate procyclical behaviour – ICS Principle 7

- Two approaches currently being tested:
  - **Market–adjusted valuation** and
  - **GAAP with adjustments**



MARKET-ADJUSTED VALUATION APPROACH

(MAV)

Market-Adjusted Valuation Approach (MAV)

- Focus on comparability of assets and liability valuations regardless of location of an IAIG's head office
- Should be transparent and verifiable to supervisors
- Adjust the most significant jurisdictional GAAP/IFRS balance sheet items

Market-Adjusted Valuation Approach (MAV)

Assets

- Fair value of invested assets
- Reinsurance recoverables: consistent basis as insurance liabilities

Technical Provisions

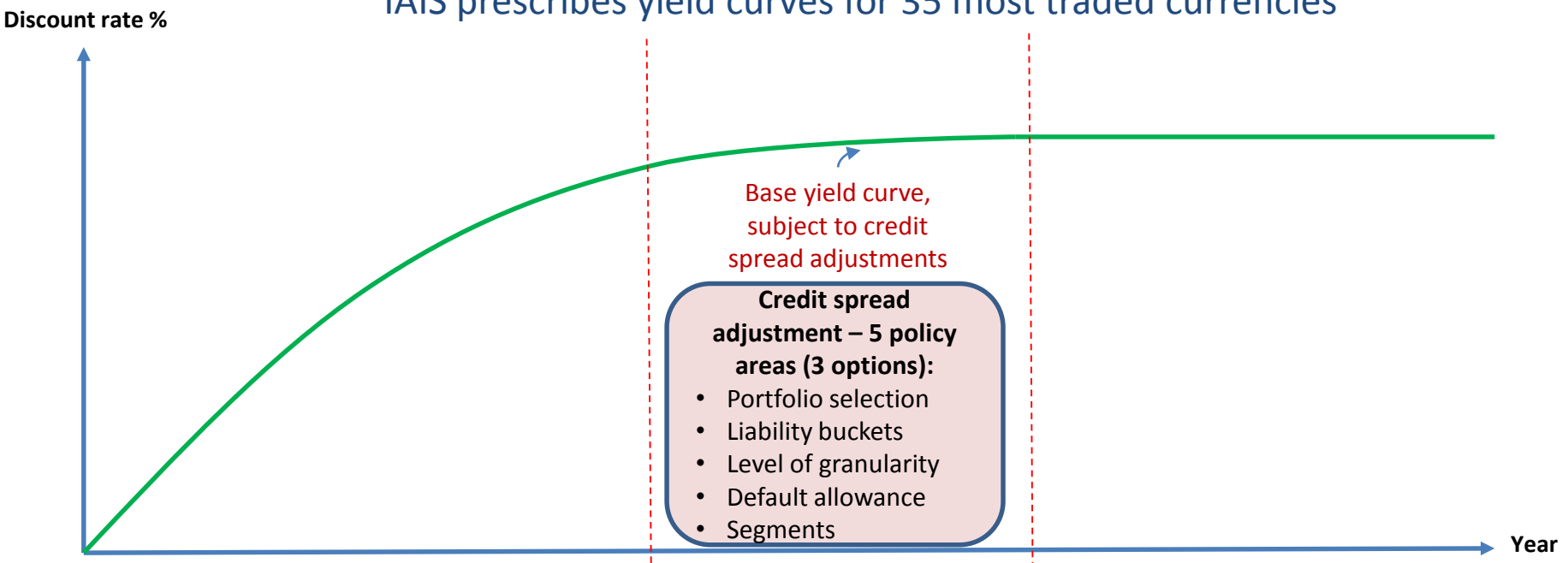
- Current estimate:
  - probability-weighted average of present values of future cash flows
  - based on up-to-date, credible, realistic assumptions
  - IAIS-specified discount curves
- Recognition and derecognition of insurance contracts
- Multiple field-testing to refine discount curve:
  - Reflect long-term nature of insurance liabilities
  - Test design under current and stressed market conditions

Non-insurance liabilities

- Should not take account of changes in credit standing of the IAIG

MAV Discounting Approaches

IAIS prescribes yield curves for 35 most traded currencies



Segment 1

- Liquid segment
- Based on observed market prices of government bonds or swaps (subject to 10 bps credit risk adjustment)

Segment 2

- Extrapolation between segments 1 and 3

Segment 3

- Long Term Forward Rate
- Set at 60 years for all currencies
- Based on long-term expectations of economic growth and inflation in each country (OECD study)

GAAP WITH ADJUSTMENT APPROACH

GAAP+

GAAP with adjustments (GAAP+)

GAAP/IFRS balance sheet

- IAIG starts with audited, consolidated balance sheet
- Based on GAAP or IFRS

Adjustments for GAAP+

- Address only the most significant and material items on insurance liabilities and invested assets
- Adjustments based on amounts from GAAP financial reports; or audited processes/systems

GAAP with adjustments (GAAP+)

- Based on jurisdictional GAAP
- Rationale is because GAAP amounts, processes and/or systems are subject to audit
- Should be transparent and verifiable to supervisors, internal auditors and independent external auditors
- Differences of results between MAV and GAAP Plus are mainly due to the different discounting approaches - 2017 Field Testing will further examine drivers of differences
- There are GAAP Plus-specific risk charges for interest rate and credit risks
- GAAP Plus approach will be reviewed following changes in accounting rules for insurance contracts and financial instruments under IFRS and US GAAP

MARGIN OVER CURRENT ESTIMATE

(MOCE)

Margin Over Current Estimate (MOCE)

- The development of a comparable and consistent MOCE requires few iterations of field testing.

Cost of Capital Approach

- Based on 'arms-length' transfer of liabilities (market value)
- Implemented as measure of cost of capital

Prudence Approach

- Life: percentile of insurance liabilities
- Non-life: avoid recognition of future profits

Consistent and Comparable Margin Over Current Estimate

Item	Cost of Capital MOCE (C-MOCE)	Prudence MOCE (P-MOCE)
Purpose	• Risk-adjusted valuation of insurance liabilities – consistent with valuation of assets • Allow transfer of insurance liabilities to a willing third party • Allow own fulfilment of insurance obligations	• Simple and comparable way to calculate MOCE for policyholder protection • Non-life: avoid recognition of future profits

Interaction between MOCE, capital requirements and capital resources – Options

- Full/partial/no deduction from capital requirement
- Full/partial/no inclusion in capital resources
- MOCE added to capital requirement to determine supervisory action trigger
- Reduce calibration of MOCE

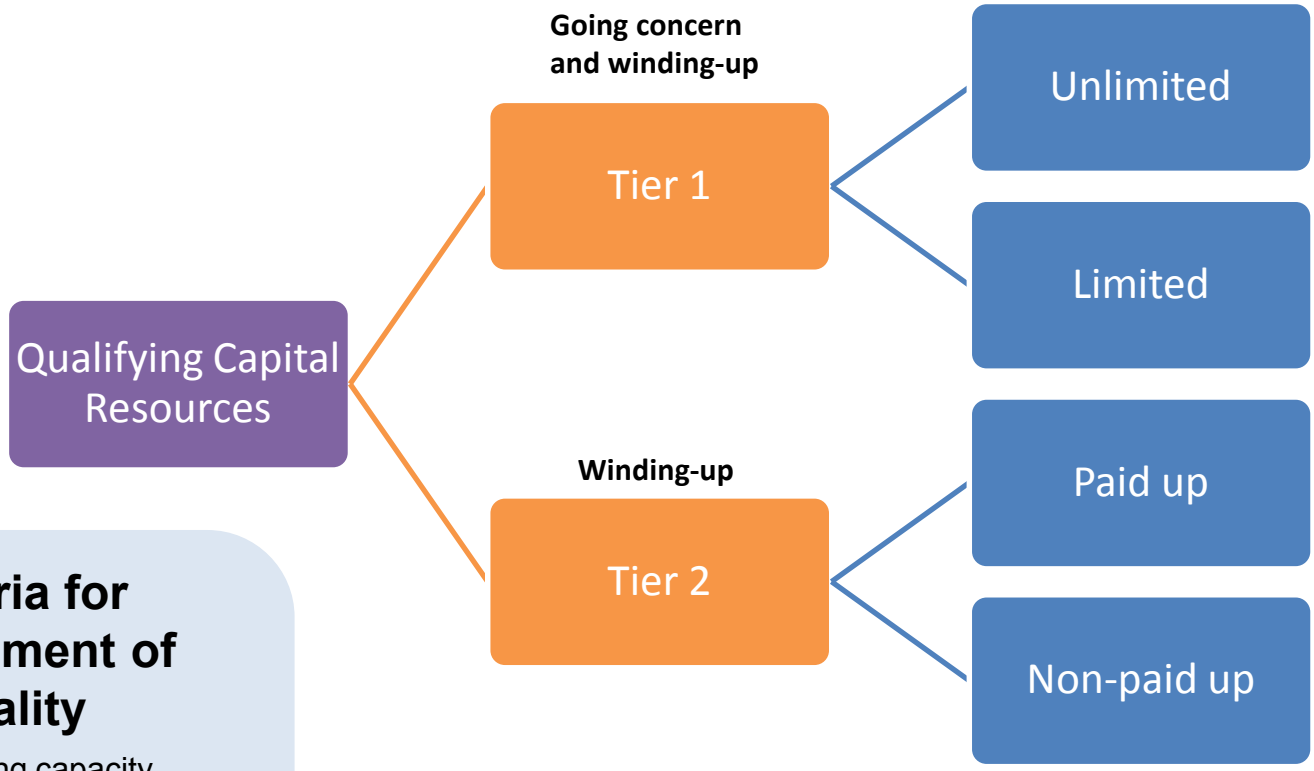
PRESENTATIONS FROM STAKEHOLDERS

Valuation Comments from Stakeholders

- Own Assets with Guardrails Working Group

CAPITAL RESOURCES

Capital Resources



Criteria for Assessment of Quality

- Loss absorbing capacity
- Level of subordination
- Availability to absorb losses
- Permanence
- Absence of encumbrances and mandatory servicing costs

Structural vs Contractual Subordination

Issue: Should the Tier 2 qualifying criteria be modified in order to recognise the characteristics of regulatory regimes that enforce structural subordination?

- 2016 Field Testing: only contractual subordination was recognised
- Result: senior debt not recognised as qualifying capital resources

How could structural subordination be recognised in the ICS?

Possible conditions that the IAIS has identified for potential recognition of structural subordination include:

- The instrument has been issued by a “clean” holding company
- The proceeds from the instrument issuance have been down-streamed into an insurance subsidiary of the holding company that is located in a jurisdiction where there exists a ‘sufficiently high level of regulatory controls’ over distributions from insurance companies
- The IAIG is able to accurately track and report the amount of the instrument issuance proceeds that have been down-streamed into insurance subsidiaries.

2017 Field Testing collected information on these potential conditions

Financial instruments issued by mutual IAIGs

Issue: The recognition of financial instruments issued by mutual IAIGs in Tier 1 capital resources is still under consideration with possible options including a carve-out within Tier 1 capital resources for certain financial instruments issued by mutual IAIGs.

2016 Field Testing: Surplus notes and Kikin were assessed against the same criteria as all other financial instruments

Result: Surplus notes and Kikin qualified as Tier 2 paid-up capital resources

Financial instruments issued by mutual IAIGs

Two views that must be reconciled:

1) All financial instruments should be evaluated in a substance-over-form assessment against the same qualifying criteria, regardless of the type of instrument or issuer; this maintains a level playing field and reduces opportunities for regulatory arbitrage

2) Mutual insurers have an inherent disadvantage in terms of limitations on means to raise capital, as compared to stock companies; mutual insurers should have the ability to raise Tier 1 capital resources in times of stress

ICS CAPITAL REQUIREMENT: THE STANDARD METHOD

Capital Requirement – Overview of Standard Method

Risk	Factor-based	Stress	Other
Insurance risks			
• Mortality		✓	
• Longevity		✓	
• Morbidity/Disability		✓	
• Lapse		✓	
• Expense		✓	
• Premium	✓		
• Claims reserve	✓		
• Catastrophe			✓ (model)
Market risks			
• Interest rate		✓	
• Equity		✓	
• Real estate		✓	
• Currency/FX		✓	
• Asset concentration	✓		
Credit risk	✓		
Operational risk	✓		

Risk knowledge/ development

Insurance product characteristics

Practicality vs. materiality

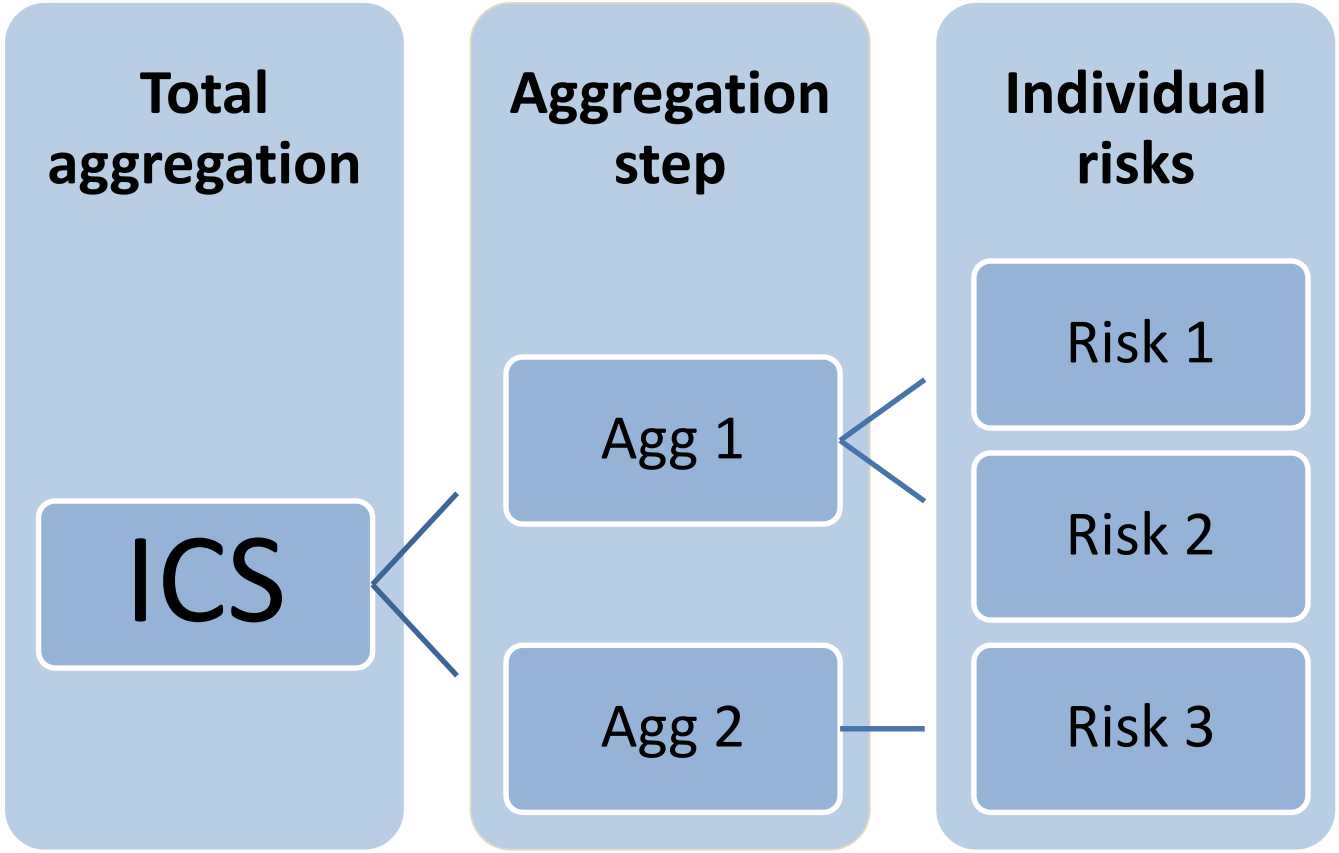
Calibration target = 99.5% 1-year VaR + supervisory judgement

Field Testing

- **2015**: interim calibration – more supervisory judgement
- **2016**: refined calibration based on more data
- **2017**: refine design and calibration based on data + volunteer feedback + improved methodology

Risk aggregation / Diversification

Multiple-step: through different sets of variance/covariance matrices



TAX

Holistic approach to tax under the ICS

- Deferred taxes arise out of the differences in valuation of assets and liabilities and between reported GAAP and taxable income. Differences may arise amongst jurisdictions on account of differences in jurisdictional GAAP and tax rules.

- Deferred taxes impact the ICS across valuation, capital resources and capital requirements. Thus a holistic approach to deferred taxes is required.
  - **Valuation -** As the ICS balance sheet (under MAV or GAAP Plus) is reporting economic value, the amounts are reflected on an after tax basis. Deferred tax amounts must be adjusted to reflect differences in valuation of assets and liabilities between reported GAAP and MAV/GAAP Plus
  - **Capital Resources** – Changes resulting from valuation have an impact on Capital Resources as adjustments flow through retained earnings and an assessment may be required to evaluate the realisability of the deferred tax asset for solvency purposes.
  - **Capital Requirement -** The ICS capital requirement stresses are also calculated on an after tax basis and thus create the need for an additional adjustment to deferred taxes in the context of determining the capital requirement. In 2015 field testing this adjustment was calculated after stress and including the impact of diversification and operational losses

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Thank you