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Emerging Global Capital Standards for Insurance

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In the years following the financial crisis, the International Association of Insurance Supervisors (IAIS), a global standard setting organization, embarked on an effort to develop the first ever global group-wide capital standards for insurers. Given the significant role capital plays in an insurer's activities, from providing solutions to consumers and institutions to attracting and providing returns to investors/owners, to managing risk and investing for growth, it is no surprise that insurers around the globe have been actively following the efforts of the IAIS and engaged in the discussion surrounding the development of the standards.

IAIS BACKGROUND

Established in 1994, the IAIS is comprised of member insurance regulators and supervisors from more than 200 jurisdictions in nearly 140 countries. The IAIS has two stated objectives: to promote effective and globally consistent supervision of the insurance sector and to contribute to financial stability. The IAIS continuously works to develop standards, principles, and guidance papers that address both the qualitative and quantitative aspects of insurance supervision. Although IAIS standards are developed by insurance regulators and supervisors from around the world, the body does not have the authority to enforce the measures it has developed. Implementation and enforcement of all IAIS standards and principles is a local decision that must be made by respective jurisdictional insurance authorities and governments.

Some of the broadest spanning IAIS measures include the *Insurance Core Principles (ICPs)*, a comprehensive globally accepted framework for the supervision of the insurance sector and the soon to be finalized *Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)*, which is built and expands upon the high level requirements and guidance set out in the ICPs. When conducting their Financial Sector Assessment Program (FSAP), the International Monetary Fund (IMF) assesses a country's insurance regulatory practices against those recommended in the ICPs. The ICPs and ComFrame are at varying stages of development and are generally subject to regular review and revision/evolution to ensure they remain relevant and useful to insurance authorities and the dynamics of the industry and insurance markets.

Following the financial crisis, and at the guidance of the Financial Stability Board (FSB), the IAIS developed a methodology for identifying Global Systemically Important Insurers (G-SIIs), whose distress or disorderly failure could cause a significant disruption to the global financial system and real economy. The IAIS later published a set of policy measures applicable to G-SIIs, which are intended to reduce potential moral hazard and risk to the global financial system posed by such firms. Both ComFrame and the G-SII policy measures include capital standards for insurers. The image below illustrates the IAIS capital standards in the context of other standards and policy measures under development.

Figure: 1

<table>
<tr><td rowspan="4">IAIS INSURANCE REGULATORY STANDARDS FRAMEWORK</td><td>Type of Entity</td><td>Legal Entity</td><td>Group</td><td>Internationally Active Insurance Group (IAIG)</td><td>Global Systemically Important Insurere (G-SII)</td></tr>
<tr><td>FIRST TIER
Insurance Core Principles (ICPS)</td><td>ICPs that apply only to legal entities</td><td colspan="3">ICPs that apply to legal entities and groups</td></tr>
<tr><td>SECOND TIER
ComFrame
(including ICS)</td><td colspan="2"></td><td colspan="2">Common Framework (ComFrame) for the Supervision of IAIGs</td></tr>
<tr><td>THIRD TIER
G-SII Package
(including BCR & HLA)</td><td colspan="3"></td><td>G-SII Measures</td></tr>
</table>

*Insurance Capital Standard (ICS), Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA) discussed in the next section

CAPITAL AND THE INSURANCE BUSINESS

Before delving into the proposed capital standards under development by the IAIS, it is helpful to reflect on the role capital plays for an insurer. Capital can be thought of in terms two basic questions: *"How much do I have?"* and *"How much do I need?"* In insurance, the answers to these questions are anything but trivial. They depend upon and are significantly impacted by key aspects of the insurance business model:

- Insurance obligations are tied to coverage for contingent events which are uncertain in their amount and/or timing. Life insurance deals with life contingent events (death, disability, longevity), where claims may occur many years or decades in the future. Property-casualty insurance relates to coverage for non-life risks (weather, catastrophe, workers compensation, etc.) and includes short and longer term exposures. Pooling and diversification across a large number of independent exposures (the Law of Large Numbers) is a core tenet of insurance and allows insurers to develop highly credible estimates of expected claims.

- Insurers perform liability driven investing, carefully managing assets to support liabilities. Risk to an insurer can arise through the liability and asset sides of the balance sheet, as well as from the interaction between assets and liabilities. Since insurance liabilities are not demand deposits, short term fluctuations in the value of assets backing insurance liabilities are generally inconsequential to the ability to meet expected liabilities.

- Insurance around the globe is exceptionally diverse in terms of the risks covered, product designs and contractual terms, policyholders, and geographies.

Capital for insurance actually starts with the liabilities. Available capital ("How much do I have?") is the amount of loss absorbing resources the insurer has available in excess of the assets needed to cover liabilities. Understanding how insurance liabilities are measured then is critical in any measurement of available capital. In a pure economic sense, the value of liabilities is simply what the insurer expects it will need to meet its obligations based on best estimate assumptions (the "best estimate liability"). Reserves established under the rules of GAAP/IFRS accounting and prudential regulatory frameworks often exceed the best estimate liabilities. Since reserves are backed by invested assets, the portion of reserves which exceed the best estimate liabilities is effectively a form of loss absorbing capital. Because of this, different valuation bases can produce different measures of "capital," and best estimate valuations are often used to reveal an insurer's full loss absorption capacity as well as for evaluating risk in economic/internal views.

Required capital (*"How much do I need?"*) is the amount of funds that an insurer must hold in order to be highly confident that it can cover its obligations even if conditions are significantly worse than it expects. Required capital then is based on a quantification of the impact of risks emerging less favorably than assumed. A wide range of practices may be employed to quantify required capital, from model-based approaches using specified scenarios/stresses with correlations to calibrated factor-based approaches which represent the impact of stress. Regardless of the calculation approach, required capital is a *framework* meant to capture the insurer's material risks associated with assets (e.g., default risk), liabilities (e.g., mortality risk, catastrophe risk), the interaction between assets and liabilities (asset-liability mismatch risk) and business/operational risk, reflecting a certain severity level and taking into account diversification.

Capital adequacy is measured as the ratio of available capital to required capital. The target adequacy ratio depends upon the objectives of the required capital framework. Most jurisdictions include "early warning" indicators or triggers that give rise to increasing levels of supervisor intervention as the capital strength of an insurer decreases below required levels. Given the impact that underlying drivers such as the valuation of liabilities and the design and calibration of risk stresses/factors can have on the capital measurements of an insurer, it is critically important to consider how the elements of the framework interact with each other, and to take care that the framework operates to avoid artificially overstating or understating an insurer's capital position.

IAIS CAPITAL STANDARDS

There are three IAIS group capital standards: the International Capital Standard (ICS), the Basic Capital Requirement (BCR), and the Higher Loss Absorbency (HLA) Requirement. Each is at a different stage of development. Although the design and scope of potential applicability of the standards vary, they share a common goal to produce comparable results through the application of a consistent approach or methodology. Development is occurring through a scheduled series of public consultations and accompanying quantitative field tests.

The ICS, which is a component of ComFrame, is intended to serve as a globally consistent capital framework for all internationally active insurance groups (IAIGs).[1] While ICS development is currently in its early stages, the IAIS has established an ambitious timeline for moving the standard forward and is hard at work on the task. The ICS proposed standard method for required capital is a stress-based approach and currently two valuation bases are being explored—market adjusted valuation (MAV) and GAAP with adjustments (GAAP Plus). The MAV approach uses prescribed yield curves developed by the IAIS to value insurance "current estimate liabilities" (analogous to best estimate liabilities), while the GAAP Plus approach leverages existing best estimate constructs in GAAP such as gross premium valuation.

The BCR and HLA standards are components of the IAIS' *G-SII Policy Measures*, which are targeted only at the firms designated as G-SIIs by the FSB. Initial versions of both standards have been approved by the G20; however the IAIS has acknowledged the need to refine the standards over time to reflect related policy developments and the results of ongoing field testing.

The purpose of the BCR is to provide a globally consistent basis for HLA requirements. It is a factor-based formula which applies charges to an insurer's activities broken into categories of traditional and non-traditional insurance, assets, and non-insurance. The HLA is intended to establish a capital "buffer" related to the systemic risk posed by a G-SII. The HLA is determined by a set of increases to the BCR, which are more pronounced for non-traditional and non-insurance exposures and for G-SIIs with higher G-SII assessment scores. Key questions in the discourse on HLA include linkage to systemic risk and calibration. Many stakeholders contend that the HLA does not appropriately align capital to potential systemic impact due to flaws in the underlying frameworks defining non-traditional products/activities and the G-SII assessment methodology upon which HLA relies. Many stakeholders also assert that even the "riskiest" insurers do not pose comparable systemic risk to that of banks and the calibration of the HLA buffer should reflect that.

The IAIS has stated that they intend for the ICS to replace the BCR as the foundation for the HLA requirement in the future. Given the significant differences between the BCR and ICS, such a change will require a review of the calibration and structure of the HLA standard.

LOOKING AHEAD

Few could argue that the IAIS' stated objectives—to promote effective and globally consistent supervision of the insurance sector and to contribute to financial stability—are not noble causes. However, given the heterogeneity of the insurance sector it is easy to see why the undertakings of the IAIS, and in particular their effort to develop globally consistent group capital standards, have elicited significant industry interest with many concerned about how the IAIS standards will or will not align with their jurisdictional capital requirements. The local nature and diversity of insurance markets has given rise to differing opinions regarding the best way forward on many of the key elements of the standards including the appropriateness and structure of the valuation approaches, the design and calibration of stresses, and criteria for determining what capital resources would be eligible to satisfy the capital requirements. Many have argued that group capital standards that do not account for the nuances and jurisdictional nature of insurance markets, including the unique needs of consumers, and only apply to a subset of the industry could have an adverse impact on competition, product offerings, and the role insurers play as a provider of capital to the financial markets.

The IAIS has acknowledged many of the concerns raised by industry and efforts to refine the IAIS' group capital standards are underway. Recurring field tests and public consultations through 2019, the scheduled date for IAIS adoption of the ICS and application of the BCR and HLA to G-SIIs, will help inform development of the standards.

The efforts of the IAIS are important and positive steps forward in increasing supervisory cooperation and the global discourse on issues related to risk, capital and supervision of insurance. Ultimately it is up to policymakers and insurance supervisors to determine the extent to which the IAIS' proposed standards apply to the insurers they supervise—and therefore the impact they have on insurance markets and consumers in their respective jurisdictions—as they will need to consider the standards within their jurisdictional rulemaking processes in order for them to apply. Actuaries in both the industry and regulatory arenas have played and will continue to play a key role in the ongoing dialogue on these important global developments for insurance. ■

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ENDNOTES

[1] Identification as an IAIG is to be carried out by the firm's supervisors based on proposed criteria for "international activity" and "size."