SOCIETY OF ACTUARIES

Article from

The Financial Reporter

June 2019
Issue 117

Insurance Capital Standards: Changes on the Horizon

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In the wake of the global financial crisis of 2008, the G-20 group of countries established the Financial Stability Board (FSB) at its meeting in April 2009. The FSB is charged with, among other things, assessing the vulnerabilities of the global financial system and identifying the supervisory actions needed to address them. The members of the FSB include regulatory and standard-setting bodies globally. The International Association of Insurance Supervisors (IAIS) is a member.

At the direction of the FSB, the IAIS announced in October 2012 that it would undertake development of a global insurance capital standard (ICS). The ICS is intended to be a group solvency standard rather than one that applies to legal entities. This is different from the system in several major jurisdictions, including notably the United States and Hong Kong, where the supervisor's powers apply only to the insurance legal entities. Because the focus of the ICS is on the global financial system, it applies only to so-called internationally active insurance groups (IAIGs). IAIGs are essentially large, multinational insurance groups.[1]

In this and subsequent articles, we will explore the current state of the ICS and the various issues that the IAIS and IAIGs are working through. At present, there is a wide range of opinions of what form the ICS should take and even what its purpose should be.

The ICS has been undergoing field testing and evolving since 2014. In addition, two major consultations and numerous stakeholder meetings have been held. A reference ICS is scheduled for adoption by the IAIS at its annual meeting in November 2019. Under the terms of the "Kuala Lumpur Agreement" reached at the 2017 IAIS annual meeting, there will be a five-year monitoring period (MP), during which IAIGs will report the ICS to the IAIS and their group supervisors on a confidential basis. During the MP, the ICS will be discussed in the supervisory colleges, but it will not be used as a basis for any regulatory intervention. After the MP, it will be used as a prescribed capital standard (PCR) (i.e., a level below which the group supervisor could intervene on solvency grounds). It is expected that the ICS will continue to evolve during the MP.

HIGH-LEVEL DESCRIPTION OF THE ICS

The scope of the ICS is the consolidated group, and the starting point is the consolidated balance sheet on the group's accounting basis (e.g., IFRS, US GAAP, etc.). Invested assets are revalued to fair value if not already held at fair value. Intangible assets (e.g., DAC, goodwill, software, etc.) are eliminated. Policy liabilities consist of a best estimate liability (BEL) and a margin. The BEL is the discounted value of best estimate future cash flows at rates that are referenced to current market conditions. The time value of options and guarantees is included in the BEL. The margin, referred to as the margin over current estimates (MOCE), is an additional amount held to reflect the uncertainty inherent in the BEL.

Beyond the valuation basis, capital requirements are derived based on a combination of stresses and factors applied to the balance sheet for a range of different risks, including market risk, credit risk, insurance risk and operational risk. These stresses are calibrated to a one-in-200-year shock scenario, as with many other solvency regimes. For example, the charge for interest rate risk is based on shocks to the risk-free curve applied simultaneously to revalue assets and liabilities under the shocked conditions, while the charge for operational risk is based on factors applied to premiums and policy liabilities. The separate risk charges are combined via a correlation matrix.

TOPICS OF DEBATE

There are various highly controversial areas with the ICS. Following is a brief description of what we believe to be the three most consequential ones.

Liability Valuation

In the 2018 field testing, the default method for discounting policy liabilities is the so-called three-bucket approach. This approach seeks to recognize an "illiquidity premium" on the risk-free rate for those portfolios whose assets and liabilities are considered sufficiently well matched. To qualify for the additional spread, the asset-liability portfolio must meet certain criteria intended to ensure that asset-liability risk is mitigated.

The method separates liability portfolios into three "buckets" of decreasing degrees of asset liability matching and consequent recognition of spread. The top bucket uses a spread based on the insurer's own assets, the middle bucket uses IAIS's prescribed spreads applied to the insurer's own assets, and the general bucket uses prescribed spreads based on a reference portfolio. The top bucket uses an application ratio of 100 percent, the

middle bucket 90 percent, and the general bucket 80 percent. The application ratio is applied to the net spread after deduction for credit risk.

The primary points of discussion relate to:

1. The criteria to qualify for the various buckets: The criteria used for the 2018 field testing were highly restrictive. The overwhelming majority of business fell into the general bucket. As of the writing of this article, we understand that the IAIS intends to take a more expansive approach to the 2019 field testing. This will be welcomed by the industry.

2. The definition of "eligible assets": Currently no spread is recognized on equity assets. Some, including us, believe that provided certain guardrails are present, a spread should be recognized on equities that are used to back long-term liabilities. This will be the subject of a subsequent article in this series.

MOCE

The IAIS has not decided how MOCE are to be calculated or what they actually represent. The cost-of-capital MOCE (COC-MOCE) are calculated similar to the risk margin in Solvency 2 (i.e., as the present value using risk-free rates of a cost of capital times future required capital for non-diversifiable risk). The cost of capital rate used in the 2018 field testing was 5 percent. COC-MOCE are based on a transfer value concept. After a shock, the insurer should have enough assets to be able to transfer the business to a third party. Many in the industry object to COC-MOCE on the grounds that insurers do not actually transfer their liabilities but rather fulfil them.

Prudence MOCE (P-MOCE) are based on the difference between a liability calculated using prudent assumptions and the BEL, a concept similar to existing U.S. GAAP for long-duration traditional contracts. Many in the industry believe that P-MOCE represent a double counting and should be deducted from required capital.

Note that the industry views mentioned above are premised on the assumption that after a shock, the insurer should be required to hold only the BEL, as this would be expected to be sufficient to fulfill the liabilities as they fall due.

Capital Resources

The last major area of controversy is capital resources. This centers around what types of financial instruments should be counted as available capital. For example, a debt instrument issued by the non-insurance holding company, the terms of which require that policyholders be paid before the debt holders, is "contractually subordinated" to policyholders. Such debt instruments may be considered a capital resource, provided other criteria are met.

Many in the industry have argued that debt that is "structurally subordinated" to policyholders should also qualify. For example, if the proceeds have been injected into an operating insurance company and money is needed to pay policyholders, they will be paid before the holding company debtholders.

The area is highly complex and technical and beyond the scope of what can be described in this article.

LOOKING TO 2025

The IAIS is a standard-setting body only. For the ICS to become effective in any jurisdiction, it must be adopted locally. Inevitably there will be variations among jurisdictions. The question of what an acceptable implementation of the ICS would be is a critical one that must be answered before the end of the MP. The standard will be that it is "outcome equivalent" to the reference ICS.

Among the options being considered is the aggregation method (AM). The AM is based on two core concepts: the aggregation of local solvency requirements to the group level and the calibration of these requirements via scalars. For example, a scalar of 150 percent might be applied to the local basis PCR of a particular jurisdiction if the jurisdiction's local basis is deemed not strong enough. The AM is still in the initial stages of development. In 2018, an initial data-collection exercise was undertaken. Development is being led by the NAIC, which is the most vocal advocate among regulators of the AM. Other jurisdictions, including Hong Kong, have expressed interest.

The main advantage cited for the AM is the potential to maintain a level, competitive playing field in local markets. The reference ICS, on the other hand, has the potential to distort the level playing field by applying a different, potentially more onerous, standard that non-IAIGs would not be subject to. Under the Kuala Lumpur Agreement, the AM will be evaluated for outcome equivalence by the end of the MP. How exactly this will be done is not yet clear. The IAIS is in the initial stages of developing criteria.

CONCLUSION

While the IAIS has come far in the development of the ICS, it is clear that more work is needed. What is most important in the next few years is to maintain open communication among the industry, supervisors and the IAIS so that an informed and collaborative approach to group-wide supervision can be developed.

Subsequent articles in this series will explore issues around liability valuation in more detail. Aside from the issue of outcome equivalence, this is the single biggest issue that needs to be dealt with before agreement can be reached on the final ICS. ■

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ENDNOTE

1 The exact criteria are that the group must (1) operate in at least three jurisdictions, (2) have assets of not less than $50 billion or premiums of not less than $10 billion, and (3) receive at least 10 percent of its premiums from outside the home jurisdiction.