

Mr. Jonathan Dixon
Secretary General
Dr. Victoria Saporta
Chairperson
International Association of Insurance Supervisors (IAIS)
Centralbahnplatz 2
CH-4051 Basel
Switzerland

October 30, 2018

Re: IAIS public consultation on Risk-based Global Insurance Capital Standard Version 2.0

Dear Mr. Dixon and Dr. Saporta,

The Institute of International Finance (IIF) and the Geneva Association (GA) would like to thank you for the opportunity to provide comments on the ICS version 2.0 and the Overall ComFrame. We have made separate responses for the two consultations.

Considering the importance and potential impact of the ICS, we would like to request the IAIS to consider our comments below on the ICS in the broader context of the IAIS global insurance regulatory initiatives, including the ICPs and ComFrame, as well as some FSB initiatives, such as the effects of reform of infrastructure finance and insurers' important contribution to economic growth as well as the ability of insurers to play a significant role in meeting future retirement needs. In relation to our response to the Overall ComFrame consultation we have also, where possible, responded to the specific questions raised in the consultation documents. As to our response to the ICS consultation, we have not found it meaningful to try to segregate our response letter into answers to the specific questions raised by the IAIS.

General

We are concerned with the IAIS intention to adopt ICS 2.0 at the November 2019 annual meeting and to restrict the Monitoring Period to "possible clarifications/refinements and correction of major flaws or unintended consequences".

The ICS has been under development through field testing and consultation for only 4 – 5 years. The monitoring period is currently scheduled to start early 2020 with a number of unresolved issues, including insufficient testing and the use of placeholder solutions. Hence, it is important that the Monitoring Period allows for testing and for taking proper account of such testing.

Given the magnitude of the undertaking, it is understandable that key elements remain unresolved and that the IAIS has been obliged to insert "placeholders" for certain elements as yet under construction. These include discounting options, overall calibration of what is intended to be a PCR, resolution of MOCE and the development of the tax treatment. For the ICS to be the common reference point for assessment against existing or new jurisdictional solvency frameworks all key elements and options need to be fully tested, understood and agreed.

It is unsettling to consider moving forward into a restricted Monitoring Period under these conditions given the impact that these important elements will have on the viability and credibility of the framework as a whole. Indeed, the IAIS introduced two entirely new elements into 2018 field testing that have a significant impact on ratios – the non-default spread risk charge and the three bucket liability discounting options.

Consequently, we seek assurance from the IAIS that the Monitoring Period will serve to finalize outstanding items through a well-governed and transparent process that will include full testing and discussion and involve volunteer companies alongside their supervisors and the IAIS.

We further substantiate our request below.

A commitment to this full testing and completion of outstanding and new items from the IAIS will benefit ICS outcomes.

In its current form, the ICS represents a potentially misleading and distorted view of group risk capital. In going from multiple options to one option, options have been picked that have not been thoroughly tested, potentially giving a false sense of reaching the finishing line. The Field Test exercise during 2018 has shown that the ICS in its current design, i.e. after the limitation on the number of options, still needs to be adjusted on a range of technical issues and specifications. Within the current design there are a number of technical specifications which basically are not in line with the overall goals of the ICS. This must be corrected in order for the ICS to provide any utility as a “common language” of risk capital across jurisdictional supervisors.

Moreover, we have strong concerns that the design and calibration of the ICS will impact negatively on the possibility of insurers to continue to provide especially a range of long term products and product features in certain jurisdictions, not least concerning guaranteed products which are at the core of long term insurance business.

For meaningful reporting that achieves the basic objectives of the Monitoring Period, all placeholder solutions and new, previously untested options and risk charges must be given proper attention and consideration. It is difficult to understand how this can occur in one final 2019 Field Test. In addition, the results of the ICS calculation exercise during the Monitoring Period must be carefully understood and interpreted by volunteers and their group-wide or lead supervisors to avoid the ICS having unintended and undesired real effects on companies resulting from mis-interpretation of data generated under an incomplete and untested framework.

The Field Test exercise during 2018 has shown that the ICS in its current design, i.e. after the limitation on the number of options, still needs to be adjusted on a range of technical issues and specifications.

We have on earlier occasions noted that the introduction of the ICS may well impact the development of local and regional solvency regulations. This has proven to be the case as a number of jurisdictions are currently contemplating using the ICS as a basis for an overhaul of their local, legal entity insurance solvency regulation. This underlines the need to correct some of the flaws that still exist in the current ICS design (see detailed comments below) and for the IAIS to be prepared to adjust the ICS design during the Monitoring Period.

We have also previously expressed support for the ICS not being a PCR during the Monitoring Period. In this respect, we have pointed to the need for full confidentiality about ICS outcomes during the Monitoring Period. While the IAIS does state that such confidentiality will be secured during the

Monitoring Period, it is still not fully clear whether the proposed governance structure can secure this important aim.

Next to this aspect of confidentiality, it is vital that during the Monitoring Period, the ICS should not serve as a measure by which the soundness and solidity of an insurance company should be measured. After all, and as stated in the consultation document, the ICS does not serve as a PCR during the Monitoring Period. For this reason, the ICS should only be reported to group-wide supervisors, not to the supervisory college. We would appreciate to have a confirmation on this point from the IAIS. If appropriate confidentiality protections are in place, we would support sharing results with a select set of involved/host supervisors or even an entire supervisory college, subject to prior consent of the IAIG.

Detailed comments

In the following we identify a number of the most important topics relative to the ICS design and the Monitoring Period which we believe are of utmost important to resolve expeditiously. We would be interested in entering into a dialogue with the IAIS on the issues in order to find suitable solutions. Resolution of these issues would help ensure that the ICS can become a meaningful indicator of the capital position at group level.

The issues below are stated in a non-prioritized order.

1. Margin Over Current Estimate, MOCE

The CD recommends the use of a MOCE on top of best estimate liabilities in order to reflect their risk adjusted valuation. According to the CD, this would assist in ensuring consistency in the liability valuation. In our view, the inclusion of a MOCE would not achieve this objective and is very problematic for reasons set out below. The inclusion of a MOCE in the ICS would result in double counting and, hence, the ICS would be calibrated at a level significantly higher than the intended 1-in-200 level. In addition a coherent rationale for the role of MOCE as a consolidated group capital requirement has not been articulated. In the absence of this we therefore urge that the MOCE should not be included in the ICS 2.0. We see several fundamental issues regarding the treatment of MOCE that remain uncertain and still need resolution, including: the concept or purpose of a MOCE; the quantification methodology; and MOCE's role within the ICS calculations of available and/or required capital. Given these fundamental uncertainties and their potentially significant implications on ICS ratios, we view the resolution of the MOCE issue as a priority for the IAIS.

Concept or purpose is ambiguous

As a first step the role and purpose of MOCE should be clearly articulated before a decision can be made on whether a MOCE is required or not. Adopting a cost of capital MOCE which represents a transfer concept makes little sense for a group capital requirement as transfers would likely be at an entity level. Additionally, a "liability transfer" MOCE would be duplicative of the recovery and resolution planning elements of ComFrame. On the other hand, using a prudence based MOCE which is a quantitative measure of unexpected losses would result in double counting with the risk-based capital requirement.

Put simply, we do not see the prudential utility of the MOCE as an explicit additional liability within the ICS, particularly if ComFrame already provides a set of supervisory tools and mechanisms for addressing on going risk management and recovery and resolution.

MOCE's role within the ICS calculations of available and/or required capital

Risk margins, as a construct, are evident in US statutory accounting, US GAAP and Solvency II, and, in some cases, in insurers' internal economic capital approaches. However, risk margins represent a layer above best estimate expectations and therefore can distort risk-based solvency assessments, which should consider all loss absorbing resources available to support an insurer's risk exposures.

In addition to the lack of clarity over the purpose of the MOCE within the overall construct of the ICS, we are concerned that, to date, the IAIS has developed MOCE in isolation from the design and calibration of Valuation, Capital Resources, and Capital Requirements – despite the critical interactions between MOCE and these other elements. We note with concern that the inclusion of MOCE within ICS liabilities would, without question, result in an ICS standard that is calibrated at a level significantly higher than the intended 1-in-200 level.

Neutralization of the quantitative impact to the ICS of a MOCE developed in isolation would require adding MOCE to Capital Resources, deducting MOCE from required capital, or undertaking a fundamental reassessment and recalibration of ICS Capital Requirements. Such a recalibration effort would likely involve multiple rounds of future field testing, to ensure that the resulting ICS is consistent with the stated 1-in-200 calibration target.

Clearly, at this late stage in the ICS policy process, and with several other technical issues still unresolved, the inclusion of MOCE within Capital Resources (i.e. excluding MOCE from liabilities) would obviate the considerable effort needed to recalibrate the rest of the ICS framework if a coherent rationale for MOCE within the overall construct of the ICS can be articulated.

2. MAV with a single discounting approach

The approach of the IAIS to the MAV discounting is an important area where the range of options has been limited to just one. This makes it imperative that the methodology chosen is consistent with economic reality and will actually serve its purpose and align with insurers' internal disciplines for asset and liability management (ALM). We recognize that the IAIS is aware of the need to mitigate potential excessive volatility in capital resources. However, in its current design, the Three-Bucket Approach fails to sufficiently achieve such mitigation. Volatility and pro-cyclical effects are not properly addressed.

We continue to believe that of the valuation approaches tested so far, the OAG approach is the most appropriate for many insurance liabilities. While we recognize that some aspects of an own assets approach have been adopted for the Top Bucket and a variation of the own assets approach for the Middle bucket, we believe the criteria to qualify for these buckets are far too strict. The Top bucket requires very strict cash flow matching, while the Middle bucket requires a high degree of cash flow matching, even under a stress event that by definition is unlikely to occur. We think the underlying premise – that more cash flow matching is always better than less – is misguided and in fact contrary to the way most insurers manage their assets and liabilities and to ICP 15, which states (15.4.2): “This requirement to take into account the characteristics of the liabilities does not necessarily place a requirement on the insurer to employ an investment strategy which matches the assets and the liabilities as closely as possible.”

The differences between the Top bucket and the Middle bucket relate to both the qualification criteria and the determination of the discount rate itself. We comment first on the determination of the discount rate, then on the qualification criteria.

There are two main differences in the determination of the discount rate between the Top and Middle buckets. Firstly, the gross spreads (before application of the risk charge) for the Top bucket are based on the spreads actually earned by the IAIG, whereas for the Middle bucket they are based on average spreads by asset class and risk rating as determined by the IAIS. We see no good reason for the latter approach. Spreads within a given asset class and risk rating can vary substantially - by detailed rating (e.g. BBB-, BBB, BBB+), tenor, market segment, etc. The use of average spreads distorts this and has the potential to introduce basis risk. Second, the application ratio is 100% for the top bucket and 90% for the Middle bucket. The use of an application ratio less than 100% reflects the false premise that more cash flow matching is always better than less. The application ratio in the Middle bucket should be 100%.

In brief, we think the approach used for the Top bucket is the proper approach for the Middle bucket, but with less stringent requirements to qualify. Were the Middle bucket to be preserved, it should at least be modified so that spreads vary by tenor as well as rating.

Both the Top and Middle buckets suffer from the non-recognition of internal ratings where external ratings are not available.

The use of internal ratings is permissible under the Basel framework, IFRS and Solvency II. It is essential that insurers should be able to use internal ratings to enable them to play their role as long term investors in the economy and in particular to support infrastructure projects and sustainable growth. This is also important to ensure that insurers can play their role in helping the G20 achieve its growth objective. The IAIS should ensure that its policy proposals are consistent with G20 aims.

The 2018 technical specifications continue to recognize no spread on equity investments. While we fully agree that equities are not an appropriate investment to back short term liabilities, this is not the case for long term liabilities, especially those where the policyholder participates in investment return upside. In many jurisdictions, participating products with a substantial proportion of supporting assets invested in equities are common. One of the potential unintended consequences of a valuation approach that does not recognize the higher expected long term return on equities could be to make these products uneconomical.

The equity risk premium (ERP) is generally accepted as an established fact, although there is debate over its quantum. We recommend that a conservative ERP be recognized when equities back long term liabilities. The OAG technical specifications have a suggestion for a potential guardrail that would restrict recognition of any assumed ERP to long term liabilities only.

We turn now to a discussion of the qualification criteria.

The qualification requirements for the Middle bucket are far too strict. This has resulted in the middle bucket not being adequately tested as most business is unlikely to qualify under the 2018 field testing specifications. We have the following recommendations:

- The requirement that there be no future premiums or only fixed premiums is not justified. The whole premise of the ICS policy liability is that it is based on best estimate cash flows. We do not believe that future premiums should be treated differently from future benefits. Companies estimate future premiums in the same way as they estimate any other cash flows, i.e. based on a combination of experience studies, consideration of policy provisions and the way the product is sold, professional judgment, etc.

- The lapse sensitivity test is inappropriate. While we can accept a requirement for a degree of cash flow matching under best estimate assumptions, we also believe that the discount rate for best estimate cash flows should not depend on what might happen under a one-in-200 tail event (This is certainly an example of a tail wagging a dog).
- The cash flow matching criteria are too strict and alternatives should be tested and explored. Cumulative cash flows are not considered and therefore the approach does not allow carry forward of excess asset cash flows in the early years to offset deficits in later years. ALM strategies where excess early years cash flows are used to support later year liability cash flows should be recognized as well within the qualifying criteria. More testing will be needed to ensure this will be sufficient to achieve the goals of the MAV approach.

It is essential that the discounting approach adopted recognizes and incentivizes prudent ALM. In doing so, the IAIS should ensure that it does not create incentives that would deter insurers from investing in assets, such as equity and infrastructure assets, that are appropriate to hold within a portfolio to match the liabilities.

Regarding the General bucket, we suggest that the application of a term structure to spread adjustment would be more appropriate for long-term business. But more importantly, the general bucket is not suitable for wide application to all liabilities on the balance sheet, particularly where an insurance group with a global approach to ALM wishes to apply a single valuation approach for all liabilities rather than an artificial bucketing approach that is inconsistent with their ALM. To achieve this there would need to be an alternative option for such insurance groups to the bucketing approach -this would also need to be a function of the asset portfolio as proposed for the Top and Middle buckets in the bucketing approach without restrictions to avoid undue basis risk and unsound incentives for investments.

Finally, we would like to point out that the change in the LTFR methodology results in all developed markets being grouped together (e.g. EU, Japan, Korea and US) and inconsistent LTFRs for economies within this group. We suggest adjusting the LTFR methodology so that each jurisdiction should calibrate jurisdiction-specific LTFR based on economy-specific data. The IAIS should also ensure consistency of relative differences between calibrated LTFRs with the economic fundamentals of economies.

3. Deferred Taxes (DTA): Role in Available Capital and treatment in tax-effecting Required Capital

Many companies that participated in the Field Test have encountered severe problems with the approach taken to the treatment of deferred taxes. The ICS is premised on forward-looking risk assessment; yet in the area of DTA loss absorption capacity, the framework relies on simplistic constraints and rules-of-thumb, rather than allowing for economic assessments of expected monetization over a future horizon. We see these constraints applied to two fundamental aspects of DTA recognition: the amount of DTA includible in current Available Capital and the approach to tax-effecting Required Capital (which is essentially a reflection of the degree to which the prospective DTAs generated in an ICS loss scenario would be recognized as loss absorbing).

The treatment of deferred taxes has been an outstanding issue during the ICS Field Testing for a number of years. We believe the IAIS has this time merely introduced a placeholder solution, which appears to be aligned from a conceptual standpoint to the rationale applied under the Basel Accord for banks. While Basel restricts DTA (based on temporary differences) to 10% of a bank's Tier 1 common equity capital, the IAIS is proposing a roughly comparable 10% limit of the ICS capital

requirement as part of the “Tier 2 basket”. It is unclear to us how this 10% cap was calibrated, other than as a simple placeholder and its potential relation to the Basel framework. Furthermore, the IAIS acknowledges that further analysis is required since “DTAs for most Volunteer Groups are near historic lows and thus, this analysis may not be reflective of the impact of limits in a less favorable environment where DTAs could be much higher”. (Source: March 2018 Field Testing Workshop Presentation). However, the potential realization of DTA under conditions of economic stress could differ for an insurance group with diversified financial and non-financial risks, relative to a banking organization concentrated in financial risk whose earnings might, in turn, be more volatile under stress.

The valuation of deferred taxes should build on the same principles as the valuation of other assets, i.e. it should be based on an economic valuation on a going concern basis, taking into account the loss absorbing capacity of this particular asset.

Insurance Groups will already have detailed approaches and information regarding tax included in GAAP and existing regulatory reporting or well defined internal capital frameworks. The ICS tax treatment should build as far as possible on these existing approaches and information and should not require new and different approaches.

The limit on tax relief on the capital requirement should not be more prudent than the limit allowed by existing regulators. The proposed limit is the net DTL in the group accounts. However, this does not account for the ability to carry back losses (and hence generate a repayment of tax) that exists in territories such as Canada, the UK and Ireland. It also does not account for the ability to generate future profits that have been accepted as a valid basis for recognizing tax relief by other regulators (including the European Commission).

Furthermore, the Field Test restriction of only permitting the tax-effecting of required capital to the extent that the insurer is in a net DTL position would, in a practical sense, not provide recognition for DTA loss absorption on a go-forward basis after a stress event. While we recognize that DTA should not constitute a disproportionate share of a group’s Available Capital, we are also concerned that a crude, overly restrictive limitation could potentially be pro-cyclical, as companies emerging from a stress event would be artificially constrained in recognizing the monetization potential (and ultimate loss absorption capacity) of DTAs.

This restriction also would not reflect that deferred taxes arise for non-life insurance mainly as a consequence of large events (for example related to CAT risk), which are uncorrelated with financial risk factors that typify stress events. Therefore, non-life companies would be artificially limited, relative to life companies, in their ability to recognize the potential DTAs generated in a stress event (as proxied by ICS required capital).

Further work is needed on this important issue and we are ready to work with the IAIS on it. The treatment of deferred taxes is complicated and it may not be possible to fully resolve all issues before entering into the Monitoring Period. If this were to be the case, this would be one of the “fatal flaw issues” under the Monitoring Period to which we must urgently find an appropriate solution. We should also allow for jurisdictional discretion, while at the same time ensure sufficiently similar approaches.

4. Capital Requirements under the standard method

A range of issues have been raised as part of the Field Testing exercise in relation to the specification and calibration of capital requirements under the standard formula. These must be addressed in order to:

- avoid unintended effects such as double counting and excessive requirements which could have negative impacts on economic growth,
- secure an economically sound approach to some stresses.

It is important to recognize that IAIG's are likely to be large and diversified by their nature, and that the diversity of differing business models may be difficult to fully capture within a single approach.

True comparability of outcomes should mean that regulatory capital is aligned to the actual risk profile of insurers.

As an alternative to the standard method, Internal Models facilitate a risk sensitive approach to supervisory and insurers' internal assessment of capital adequacy by considering an insurer's idiosyncratic risk profile, and provide transparent insights into the risk management practices of insurers that are helpful to supervisors. ICP17.12.7 notes that effective use of internal models by insurers for regulatory capital purposes leads to better alignment of risk and capital management providing incentives for insurers to adopt better risk management procedures. They produce regulatory capital requirements that are more risk sensitive and better reflect the supervisors' target criteria, and assist the integration of the internal model fully into insurers' strategic, operational and governance processes, systems and controls.

We therefore welcome inclusion of internal models in the ICS framework during the Monitoring Period and strongly support their eventual acceptance as a means of calculating the ICS capital requirement.

In this context, the process by which the IAIS will reach a decision on the use of internal models in the ICS requires clarification. We note that the IAIS proposes to reach this decision by the end of the Monitoring Period. Its decision-making process should be open and transparent, and informed by contributions from stakeholders through public consultation, in accordance with IAIS procedures on stakeholder engagement. The IAIS should take full account of experience in those regions where internal models are already part of regulatory capital-setting processes.

In relation to the standard method it is important that the following issues are satisfactorily resolved:

- Lapse risks
 - The proposed lapse shock of retail policies (for example: a mass lapse shock which assumes the immediate surrender of 30%) is simply unreasonable for many products (including individual life insurance).
 - Noting that the current proposal is to apply lapse risk stresses to all kind of policyholder options (as per the consultation proposals), appropriate consideration should to be given to calibration of non-standard policyholder options (such as utilisation rate for VAs) as the current calibration is only valid for standard lapses and mass lapses.
 - The applications of homogenous risk groups within the lapse stress is unjustifiably onerous. It is too onerous to assume that all policyholders can assess the money-ness of their individual contracts (using a valuation basis such as ICS) from the insurers' perspective and always act in ways that are most onerous to the insurer rather than adhering to their own needs or circumstances.

- Credit risk
 - The IAIS should permit the use of internal ratings, as long as the internal rating process is well governed. It helps to reduce reliance on external rating agencies (which reduces potential for systemic risk), supports the development of robust internal risk management processes and promotes investment in emerging economies and in certain sectors (e.g. infrastructure projects) where ECAI ratings are not available.
 - There is an excessive commercial mortgage loan (CML) credit risk charge.
 - Given that the IAIS recognizes rating agency credit ratings (which are designed and intended for investors and not for regulatory purposes), it is therefore logical to also recognize assessments developed by supervisory organizations, such as the NAIC, expressly for the purpose of providing a prudential view of an obligation's credit risk. Exclusion of jurisdictional credit assessment processes would have impacts on: 1) Loan and Asset Backed Securities: requires use of rating agencies' evaluations of credit loss on loan-backed and asset-backed securities which overstate the extent of credit loss (RMBS, ABS, CMBS), and 2) Bond Ratings/Private Placement Bonds: Currently treated as non-investment grade as not rated by ICS admitted rating agencies. Recognition of NAIC designations and all SEC approved NRSROs would enhance the risk-sensitivity of the ICS both by (i) extending coverage to holdings such as private placements that are not ordinarily assigned rating agency credit ratings and (ii) providing a more comprehensive credit risk assessment of securitization exposures, since rating agency ratings are typically designed to capture default risk but not the potentially significant expected recovery (and, in some cases, the discounted purchase price and embedded loss buffer) on thicker tranches.

- Interest Rate risk
 - The current interest rate risk charge is considered excessive based on data implied calibrations using realistic interest rate models. At a simplistic level the calibration of the interest rate shocks looks to be derived using a symmetrical distribution which is not reflective of the reality as it seems to imply that the interest rates can go boundlessly negative. Based on data implied calibrations the chosen ICS calibrations understate the upward stress and significantly overstates the downward stress for a number of key global currencies.
 - The interest rate risk charges for each currency are aggregated using a correlation matrix, using a 75% correlation between each pair of currencies that have net long or net short duration in both currencies, and a negative 75% correlation in each pair of currencies for which one of the durations is net long and the other is net short. We believe that this method is not appropriate as correlations between interest rates in different economies will not be dependent on any insurance groups' net long or short position in that currency. Any correlation should be based on observed market data, independent of insurance groups' exposures. Market data suggest that the correlation for interest rate between currencies is low.

- Equity risk
 - Regarding equity volatility, given the long term nature of guarantees offered by life insurers, the cost of guarantees will depend on the realized volatility rather than implied volatility over a long term. The current stress to equity implied volatility is also believed to be significantly more onerous compared to market data implied

calibrations. This is also not in line (more onerous) with some local jurisdictional requirements, for example the Solvency II standard formula does not include equity volatility. In addition, a permanent change assumed under stress to equity volatility is not an appropriate treatment since volatility shows strong mean reverting properties. A permanent stress implies sustained high levels of cost of capital and equity risk premium which is not realistic. Therefore, we propose that the mean reversion of equity volatility be recognized, and the calibration to reflect either realized volatility or market consistent levels.

- Intra-risk diversifications and interactions should be taken into consideration while calibrating the overall risk charge. This includes capturing interaction between the level and volatility drivers when calculating the stress impact.
 - Regarding the treatment of hedges, we believe the current restrictions, particularly the 20% haircut, do not appropriately reflect the risks associated with the hedging programme especially in developed economies with high level of market liquidity for certain market instruments. For example, the S&P 500 futures market remained deep and liquid with only minor increases in trading cost during the 2008 crisis, therefore the haircut is not justified in this context. The current approach of applying an arbitrary haircut creates inappropriate risk management incentives and is inconsistent with ICS principle 6 of promoting “sound risk management” and including “an explicit recognition of appropriate and effective risk mitigation techniques”.
- Spread risk

The IAIS’ introduction of a new, previously untested risk charge for non-default spread risk is problematic in several respects. First, this charge is largely duplicative of the existing ICS risk charge for fundamental credit and market risk, which is designed and calibrated to address all dimensions of credit risk (default, recovery, and migration risk). Importantly, the ICS applies a maturity adjustment, which according to the Basel Committee “can be interpreted as anticipations of additional capital requirements due to downgrades. Economically, maturity adjustments may also be explained as a consequence of mark-to-market (MtM) valuation of credits. The maturity effect would relate to potential down-grades and loss of market value of loans” (source: <https://www.bis.org/bcbs/irbriskweight.pdf>).

Additionally, volatility in credit spreads should not impact an insurer’s capital, if the insurer adheres to prudent ALM and liquidity management. In a volatile credit spread scenario, the movements in spread are “noise” that ultimately do not impact the insurer’s financial performance on a fundamental cash flow basis. However, it appears that the ICS non-default spread charge, as currently formulated, could result in sizable capital requirements even for a perfectly matched book of business due to the asymmetric stress applied to assets and liabilities. We view this as another area where the ICS is attempting to address potential risks which are more effectively and directly addressed through ComFrame. Namely, the ComFrame criteria for prudent ALM should better mitigate potential exposure to spread volatility than an explicit capital charge through the ICS.

- Currency risk (FX translation)
 - The IAIS should exempt the portion of the currency risk charge relating to currency translation, as currency translation does not have any impact of the Group’s ability to meet policyholder liabilities e.g. if the Group has sufficient capital to meet both local and ICS requirements within each currency, the translation of surplus to the reporting

currency (while it may alter the Group surplus) has no bearing on the Group's ability to meet policyholder liabilities in those countries.

- Requiring capital for translation risk will reduce comparability across IAIGs, as the capital requirement will depend on each Group's reporting currency. i.e. two IAIGs with exactly the same business and balance sheet would have different ICS requirements, depending on their reporting currency.
- Morbidity/Disability risk
 - The current calibration levels are overly excessive and must be lowered to reflect real world experiences. For example, the stresses applied to the long-term contract bucket for "lump sum" type products appear to ignore the fact that for the long-term contracts, these stresses are being applied over the entire life of the contract that may exceed upward of 80 years, while the calculation is essentially using volatility to estimate a one-year shock. Such stresses are not simply viable. This is further reinforced by public cancer incidence data that is available in major developed countries. Given this, the IIF and GA urge the IAIS to lower the shock levels for long-term contracts considerably.
- Dynamic hedging
 - The IAIS is collecting information on how dynamic hedging is currently used for the recognition of economic capital. In our view, dynamic hedging serves an important function as a risk mitigating tool and should be recognized as such within the ICS. This issue represents another area of a "fatal flaw issue" which could be carried into the ICS in the Monitoring Period. It is very important to recognize this as an issue to resolve even after entering into the Monitoring Period.
- Geographical diversification
 - There is a lack of recognition of diversification effects, in particular no geographical diversification for equity, lapse, mortality, morbidity, expense and operational risk. We would suggest adopting a more granular approach to geographical diversification across and within risk types.

5. Management actions

Premium adjustments, dynamic investment strategy and changes to market value adjustor should all be permitted within ICS as management actions under base as well as stressed positions, as long as it reflects product features and current practice; so that undue prudence is avoided and actual business realities are taken into account.

6. Capital resources

The ICS will result in requirements on capital resources that differ from existing national requirements. It is therefore essential that implementation of the ICS is subject to an appropriate transitional period. In this respect the ICS should stipulate a ten-year transitional period to comply with the capital resources requirements from the date that they are implemented at a national level. We welcome the IAIS giving consideration to transitional arrangements to assist with implementation of the ICS as a PCR, as discussed in paragraph 76. This will help firms to manage the cost of adopting the ICS as a PCR. We welcome further consultations on this in the future.

There is an overarching problem as to how capital resources have been developed. Capital resources should ultimately be an assessment of economic loss absorbency of certain components of capital under stress.

The proposed capital composition implies that Tier 1 capital resources will be limited to 10% of the ICS capital requirement. This is too onerous. We consider that Tier 1 Limited capital resources being limited to 20% of unlimited capital resources would be more appropriate.

The proposal to restrict the recognition of Tier 2 non-paid-up capital to mutual IAIGs is inappropriate. It is incorrect to say that mutual IAIGs are the only insurers that have access to non-paid-up capital that is external to the group. Other insurers also have access to external non-paid-up capital, such as letters of credit.

Nevertheless, we welcome the IAIS's recognition that external non-paid-up capital should be included in qualifying ICS capital resources, even if its reasoning for the restriction to mutuals is based on an inaccurate premise. All IAIGs should be permitted to use such items as part of their Tier 2 capital resources. Consequently, the capital composition limits for mutual and non-mutual IAIGs currently set out in paragraphs 199 and 200 should be the same for both sets.

Furthermore, we believe that a 10% limit on Tier 2 non-paid-up capital resources is too restrictive. We note that Solvency II permits the use of ancillary own funds as Tier 2 items up to 50% of the SCR without any apparent diminution in policyholder protection.

In addition, we suggest exempting assets from the encumbered assets capital deduction where a counterparty does not have rights to the excess collateral in default or foreclosure (e.g. Federal Home Loan Bank).

With regard to surplus notes we note the following:

- Surplus notes and senior debt should not be treated differently – both should be tier-1
- Surplus notes should not be limited to mutual insurers
- Tracing exercise is problematic in practice

We appreciate that the proposed criteria in the consultation document have enabled mutual groups to have the opportunities to raise Tier 1 capital resources from external bodies. It should be noted, however, that in order to be qualified as Tier 1, an instrument needs to have an initial maturity of at least ten years. Since the maturity of most of the Kikin issued in Japan in the past is about five years and there are almost no experiences of issuing the Kikin with ten years or longer, it is likely that fund-raising by mutuals would become extremely difficult with virtually no investors to purchase the Kikin bonds (i.e., unintended consequences due to unacceptable funding costs). We propose that certain discretion is given to the supervisor in each jurisdiction in setting the minimum maturity, taking into account the requirements or constraints under local supervisory regimes.

7. Monitoring Period

We have already briefly touched upon the Monitoring Period in the general comments above. We appreciate that the IAIS has begun to outline the high level parameters of the Monitoring Period in the CD – it is a positive first step to a robust and well-governed process. The Monitoring Period will be a very important frontrunner to the introduction of the ICS as a PCR, hence it is vital that the Monitoring Period is used to gain insight for all stakeholders involved, and to adapt or revise the ICS where “fatal flaws” are identified. As noted earlier, we have the concern that certain material

unresolved issues in ICS Version 2.0 may well become fatal flaws in the MAV reference method during the Monitoring Period. It is of utmost importance that these issues will be given high priority by the IAIS.

We acknowledge and appreciate that the CD recognizes the Monitoring Period as a means to get “possible clarifications/ refinements and corrections of major flaws or unintended consequences”. We ask the IAIS to formalize the process through which changes to ICS 2.0 are considered. As a start, the IAIS should clearly define “major flaws” and “unintended consequences” to allow for a common understanding and align expectations among stakeholders. We also ask the IAIS to formalize the process through which broad stakeholder feedback (including IAIGs, non-IAIG insurers, regulators and other interested parties) is received, and changes made to the ICS 2.0. Items that should be addressed include:

- Clearly stating that the ICS will not be a PCR during the Monitoring Period, moreover the Monitoring Period is designed to facilitate the further development of ICS - all results and information reported to supervisors are for informational purposes only and is not actionable in any way;
- Establishing a strong and transparent governance framework/process for administering the Monitoring Period, including a Monitoring Period guidance paper, creation of a Monitoring Period governance committee, a process for reporting and analyzing annual results, making modifications to the ICS, etc.;
- Recurring workshops where quantitative and qualitative aspects of the ICS are discussed among the IAIS and insurance groups and supervisors that provide data;
- More substantive engagement on the appropriateness of the ICS framework/results from senior levels of the IAIS and jurisdictional supervisors; and
- Defined process for conducting impact analysis to identify flaws and unintended consequences the ICS could have on insurance markets and products at a jurisdictional level.
- Reporting of ICS results to group-wide supervisors only, with sharing with supervisory colleges subject to prior consent of the IAIG

Following are more detailed recommendations for the Monitoring Period that build on the high level suggestions listed above.

a. Impact Analysis

We would like to stress the importance of implementing a formal impact analysis process with the aim of identifying any negative side-effects the ICS will have on: IAIG product offerings and insurance markets. Impacts and consequences may vary significantly from market to market and jurisdiction-to-jurisdiction, the impact analysis should account for this.

This impact analysis process should be transparent to Group Wide Supervisors, individual industry participants, to promote a clear understanding of the flaws and unintended consequences across markets and globally. We suggest that the IAIS leverage the workshops identified in Paragraph 69 to examine and assess flaws and potential unintended consequences as well as recommended corrections with industry.

To be meaningful, impact analyses should be conducted on a regular basis, ideally on an annual basis but at least several times throughout the Monitoring Period. Group Wide Supervisors in coordination

with the IAIS should organize jurisdiction specific sensitivity testing and impact analysis that would be reported alongside annual MAV reference method results. Group wide supervisors should submit the results of this analysis to the IAIS for discussion and consideration within the IAIS Executive Committee and other working groups so that senior level officials and supervisors understand the real world impacts of the ICS.

Group Wide Supervisors and jurisdictional authorities should develop the specifications for all sensitivity and impact assessments/analysis so that they appropriately reflect risks in individual insurance markets. Jurisdictional authorities should conduct a limited set of sensitivities that remain consistent year over year plus another limited set of analysis that is changeable during the Monitoring Period. These specific parameters should be shared and discussed through the forum that is proposed in Paragraph 71. It is quite possible that participating companies will run sensitivities relevant to jurisdictions outside of the home jurisdiction depending on their presence in host countries.

The IAIS should also consult with the FSB on an annual basis to detail identified material flaws in the ICS or unintended consequences and to discuss potential corrections to the reference method. These FSB interactions should primarily address the impact of the ICS on socially desirable products, local insurance markets and economies including the provision of long duration products/long term capital investment. In addition, the results of these impact analyses should be shared publicly in the aggregate (to protect company-specific information) so that the broader set of stakeholders, especially those not privy to the Monitoring Period outcomes can assess the appropriateness of the ICS. Any unintended consequences or effects identified in the impact analysis should be addressed and resolved by the IAIS and Group Wide Supervisors through various senior level committees of the IAIS including the Forum of Supervisors and publicly. Clear governance and transparent procedures around the resolution of outcomes of the impact analysis are essential.

b. Confidentiality

We appreciate that the CD stresses confidentiality of the Monitoring Period. However the CD does not specifically establish a process through which confidentiality will be guaranteed – a pre-requisite for industry participation in the Monitoring Period. While the confidentiality measures in place for the multi-year field-testing process have been effective, the Monitoring Period will have greater weight and more meaning, which will require additional structures and protections to prevent results and information from being released to the public. In this vein, we recommend that the IAIS develops a confidentiality framework to be employed by supervisors to prohibit the release of any Monitoring Period-related information to the public. Group wide or lead supervisors should stipulate to IAIGs that they are prohibited from making public disclosure of Monitoring Period related data including ICS reference method ratios. Such an approach has been used previously in other jurisdictions to manage market expectations around non-disclosure.

This prohibition (possibly through non-disclosure agreements) should apply equally to supervisors (group-wide and involved), the IAIS and involved insurers. Given the non-binding, unaudited and tentative nature of the results, public release of ICS reference method ratios has the potential to impact market positions of the industry and individual insurers. The IAIS should take all steps necessary to protect insurance markets from being disrupted by any intentional or unintentional release of the information.

Therefore, it is important that the IAIS and supervisors communicate with relevant stakeholders such as rating agencies and industry analysts to explicitly state that firms are prohibited from releasing any data related to the Monitoring Period. They should explain the confidential nature of the ICS and that

a breach of the ICS cannot trigger any regulatory action during the Monitoring Period. Lastly, the IAIS must confirm that publicly listed and traded insurers participating in the Monitoring Period would not be required to release Monitoring Period data, for example by accounting boards and/or other non-insurance regulators. If any one firm or a number of insurers can be compelled to produce data, the IAIS and group wide supervisors must seek appropriate exemptions from non-insurance authorities to guarantee the confidentiality of Monitoring Period data before impacted firms can participate.

c. Involvement of supervisory colleges

Paragraph 37 of the consultation document states that the reference ICS will “provide a basis for comparison across IAIGs, and over time, during the Monitoring Period.” Between 2020 and 2025 the ICS will not be a legally binding, legislated or audited capital requirement. Therefore, during the Monitoring Period insurers cannot be required or expected to manage their business according to the ICS, which will be calculated on a somewhat approximate and unaudited basis. Moreover, at present supervisory colleges vary in terms of their functioning and importance, although these differences may narrow over time following the implementation of ComFrame. Accordingly, the reference ICS is not suitable for assessment in a formal supervisory college setting. The ICS should only be reported to group-wide supervisors, not to the supervisory college.

Hence, we can only support the current process employed in field-testing where results are only reported to group supervisors. If appropriate confidentiality protections are in place, we would support sharing results with a select set of involved/host supervisors or even an entire supervisory college, subject to prior consent of the IAIG.

d. Stakeholder involvement

Industry involvement throughout the Monitoring Period is vital for the success of the ICS. We urge the IAIS to, during the Monitoring Period, establish a formal role for the industry, similar to the way the CD proposes roles for other stakeholders. This role should include opportunities for engagement such as stakeholder sessions or recurring workshops in which quantitative and qualitative aspects of the ICS are discussed by supervisors and insurance groups.

e. Guidance paper

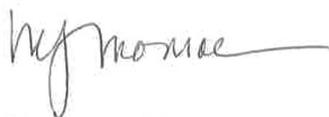
The Monitoring Period needs to be guided by clear, transparent processes and governance procedures. We suggest the IAIS develop a Monitoring Period Guidance paper, laying out and formalizing the governance structure, providing guidance and clarity to all involved stakeholders potentially impacted by the ICS (including but not limited to those participating in the Monitoring Period exercise). Such a guidance paper needs to establish the governance surrounding processes and procedures during the Monitoring Period.

f. Senior level committee

We recommend the creation of a senior level “ICS Monitoring Period Governance Committee” to replace the ICS Task Force senior level committee that consists of members of the Executive Committee, Policy Development Committee, Capital and Solvency Working Group, and select group wide supervisors. This group would be in place for the Monitoring Period and have a charge of coordinating all IAIS Monitoring Period activities, overseeing the Monitoring Period process, assessing flaws and recommending corrections to the ICS. Consideration should be given to having direct industry engagement in this group.

The IIF and the GA will continue to engage constructively with the IAIS on the development of the ICS. We look forward to continue a good dialogue with the IAIS and we would be pleased to elaborate further on our comments. Should you have any questions on the issues raised in this letter, please contact Mary Frances Monroe (mmonroe@iif.com); Ningxin Su (nsu@iif.com); Peter Skjoedt (peter_skjoedt@genevaassociation.org), or Dennis Noordhoek (dennis_noordhoek@genevaassociation.org).

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