The Geneva Association Response to the Consultation on the IAIS 2013 Common Framework for the Supervision of Internationally Active Insurance Groups

December 2013

The Geneva Association

Geneva | Route de Malagnou 53, CH-1208 Geneva | Tel: +41 22 707 66 00 | Fax: +41 22 736 75 36
Basel | Sternengasse 17, CH-4051 Basel | Phone +41 61 201 35 20 | Fax +41 61 201 35 29

secretariat@genevaassociation.org   *www.genevaassociation.org*

Introduction

The Geneva Association appreciates the opportunity to comment on the International Association of Insurance Supervisors (IAIS) 2013 Draft Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The Geneva Association supports the ComFrame objective of efficient and effective group-wide supervision of internationally active insurance groups (IAIGs).

In April 2013, The Geneva Association contributed to the ComFrame discussion by publishing a survey of chief risk officers (CROs) on group-wide risk and capital management of IAIGs[1]. Therefore, the answer to the consultation focuses primarily on the area of capital adequacy (Module 2, Element 5) in view of the future development of a risk-based global insurance capital standard.

1 https://www.genevaassociation.org/media/463708/ga2013-comframe_survey.pdf

I. General comments on Module 2—The IAIG

The development of ComFrame should recognise that insurers are long-term investors with long-term liabilities and therefore are not exposed to the material risk of being forced to sell assets at a loss. Capital resources and required capital should reflect the degree to which this risk is mitigated. Failure to do this would introduce procyclicality.

Insurance groups should be recognised as a single economic entity with shared risks and capital resources. The role of diversification in risk management should also be recognised.

Additionally, in developing a global insurance capital standard (ICS) within ComFrame, appropriate provisions should be made in order to:

- ensure alignment and compatibility with existing and developing sophisticated risk based local regimes;
- manage the transitional period prior to full ICS implementation;
- avoid inconsistencies emanating from the fact that some jurisdictions might not be willing to transpose ICS provisions in their own regimes.

It should be anticipated that an agreement on ICS can be reached at the IAIS level. It can, however, not be excluded that some jurisdictions might, with reference to the specificities of their local/state regulations and constitutional law, be opposed to an alignment with the standard agreed at an international level. Consequently, regulators should ensure a level playing field overall in all member countries, for IAIGs and between IAIGs and non-IAIGs in their respective jurisdictions, taking existing regimes into account when applying ComFrame.

II. Comments on Module 2, Element 5—Capital adequacy assessment

The principle based approach in determining the capital benchmark allows IAIGs to make appropriate use of scenario-based economic frameworks tailored to their own strategies and risk profiles.

This approach should allow the use of group-specific internal models, which should be fully recognised under ComFrame.

With regard to valuation, the details are still lacking. Before taking a final decision on the chosen valuation basis, practical consequences for IAIG operations in local markets should be considered thoroughly. Should a global valuation regime not exist in the near future, the IAIGs should not have to adapt their group-wide capital and risk management to a valuation basis chosen for ComFrame purposes in addition to the valuation basis used for statutory purposes.

Since the chosen valuation basis is going to determine the elements of "qualifying capital resources", the finalisation of the parameters/guidelines referring to 'qualifying capital resources' should await the outcome of field testing.

M2E5-2-1-1

The allowance for a deduction and aggregation approach and use of sectoral rules for non-insurance business aligns perfectly with the choice for a partly harmonised approach. This approach should also be considered in case local regimes do not adopt ComFrame standards and parameters; in this context, guideline M2E5-2-1-4 requesting the use of a consistent valuation basis should be revisited.

M2E5-4

Overall, The Geneva Association does not agree that the classification of capital resources into (at least) two categories (core and additional capital) is necessary in the case of insurance operations. This would put substantial pressure on IAIGs by narrowing the range of instruments for complying with capital requirements. For example, for mutual companies, very limited options would be available for strengthening their core capital position and other companies would also have to use mainly equity for this purpose.

Furthermore, The Geneva Association sees a disconnection between the tiering system in ComFrame and systems in existing local regimes, which either have (or may have) 1 tier or 3 tiers. In our view it would be sufficient to introduce one concept of "capital" (i.e. no tiering) into international capital standards for insurance. Nevertheless, in the subsequent comments we refer to the terms "core" and "additional" capital as currently used in the ComFrame draft.

M2E5-4-1

Risk margins: in some jurisdictions risk margins are meant to be an additional loss-absorbing prudence incorporated into the technical provisions. Such risk margins should therefore be part of "core" capital.

Equalisation reserves should similarly count as "core" capital. They represent a specific reserve allocation of retained income owned by the equity shareholders. Their function has the attributes of capital in that they provide a stabilising and counter-cyclical buffer to company performance, especially in periods of stress.

M2E5-4-2

Long-term (subordinated) debt: according to the logic of absorbing losses and contributing to the financial strength of an insurer through periods of stress, we note that long-term debt should qualify as "core" capital even if the security itself is not legally stated as "subordinated". This is due to the general laws in effect in most jurisdictions under which policyholders rank before debt holders irrespective of whether the latter are subordinated or not. Accordingly, in those jurisdictions any long-term debt should qualify as capital, provided that either the distributions can be suspended or, alternatively, the instrument, for regulatory purposes, amortises on a straight-line basis in the final five years to maturity (see Guideline M2E5-5-4-1).

In line with IAIS Insurance Core Principle 17 (§ 11.22 regarding the assessment of the permanence of capital elements), subordinated financial instruments with an initial maturity of 5 years or less should also qualify as "core" capital in the case where the provisions of ICP 17.11.22 are met.

M2E5-7-7

Reinsurance assets: reinsurance is a facility "readily available to absorb losses when the insurer is under stress" and therefore qualifies as "core" capital. The introduction of the term "non-qualifying reinsurance" only reflects a special issue of very few jurisdictions that put additional hurdles to the international business model of reinsurers.

Collateral, if any, should only be taken into account for the assessment of the counterparty default risk.

M2E5-7-8 / M2E5-7-8-1

In some reinsurance transactions, collateral is provided even in excess of the relevant reinsurance liabilities in line with local regulatory requirements or client demands. In the case where the full collateral posted has to be deducted from the reinsurer's capital, the transaction costs would increase and could even become prohibitive. Similarly, in derivatives transactions, often a margin is required or the collateral posted exceeds the liability. In a wind-up, such excess collateral is released back to the company. Accordingly, this rule is not warranted and its application will increase costs of risk mitigation tools, both reinsurance and derivative hedging.

For these reasons, Parameter M2E5-7-8 is inappropriate and should be removed. The wording in M2E5-11-4 should correspondingly be expanded to include "Appropriate account should be taken of collateral or other security held by or for the account of the insurer and their associated risks".

M2E5-7-1

Intangibles should be able to be included within "available" capital where the value of assets can be reasonably measured on an ongoing basis.

In our opinion it is not justified to exclude a priori all intangibles from core capital. For example, "trade names" or "distribution channels" might have a positive impact on the operation for continuing its activities during stressful periods and their value could be monetised in a winding-up situation.

We therefore believe that, along with computer software intangibles, the value of these assets should be recognised through capital resources.

Similarly, **deferred tax assets** (DTA) should be part of the "core" capital. Insurers have the capacity to realise the value of DTAs both as "going concern" and even in stress situations—rigorous valuation reviews conducted regularly ensure that DTAs meet the asset recognition criteria. As an example: in a stress situation, a life insurer moderates its new business sales. As a consequence, the expected decrease of capital strain (from first year financing of acquisition costs) would lead to a higher taxable income improving the DTA recoverability.

The Geneva Association remains available to discuss and elaborate on the comments and suggestions contained within this response and would welcome the opportunity to do so.