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August 8, 2014

John Maroney
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International Association of Insurance Supervisors (IAIS)

**Re: IAIS Basic Capital Requirements Consultation from July 9, 2014**

Dear John:

The joint IIF/GA BCR Task Force would like to thank the IAIS for the opportunity to provide feedback on the latest Basic Capital Requirement ('BCR') Consultation Document ('CD'). We very much appreciate the ongoing dialogue which we have been afforded. Our joint Task Force comprises a broad range of insurance companies including both G-SII and non G-SII members. Our comments emphasize the concerns of the G-SIIs who are immediately subject to the BCR, but input was received from non G-SIIs. The application of the IAIS's proposals will give rise to specific considerations, which may be addressed through individual responses.

## <u>General comments</u>

We have aimed to engage constructively with the IAIS throughout the development of the BCR and are pleased that some of our points have been considered, including the allowance for the risk mitigating effect of reinsurance through the use of net technical provisions and the principles for valuation that we shared in February 2014.

We welcome the increased clarity provided by the CD. It confirms that the BCR will be calculated on a consolidated group wide basis, developed to reflect major categories of risk impacting G-SIIs consisting of three basic components (insurance, banking and non-insurance), and calculated using 15 factors applying to specific segments of insurance activities. This is in line with our previous discussions and expectations.

We recognise that the BCR is being developed with the aim of establishing a simple and comparable basis that will serve as the foundation for the Higher Loss Absorbency ('HLA'). As a result, the BCR is by design a more simplified tool that will not fully reflect the complexities of the insurance business model such as diversification and asset-liability management which will not be explicitly factored into the BCR.

Since the CD has been developed under an ambitious timetable, it leaves a number of areas unclear or unresolved. These areas include the treatment of Margin Over Current Estimate ('MOCE'), the classification of assets and liabilities into segments, the determination of current estimates for certain products, the definition of non-qualifying reinsurance, the final level of the alpha scalar factor and the tiering of available capital into core and additional. Additional time and further discussions are needed to obtain more clarity on these and other issues in order to achieve sufficient comparability, a level playing field among G-SIIs and ultimately consistent application of the BCR.

Moreover, these unresolved areas are critical in determining the impact of the BCR on G-SIIs' capital requirements and thus we are unable to fully assess the overall appropriateness of the BCR in its current form.

The appropriateness and impact of the BCR cannot be fully assessed without consideration of the HLA, which remains a key missing piece of the quantitative measures identified by the FSB for G-SIIs alongside enhanced supervision and recovery & resolution planning requirements.

Beyond simplicity, the IAIS objective was to have a BCR that would be comparable across jurisdictions. Such an objective is a must in the prospect of setting up an even basis for HLA and dealing with level playing field issues across jurisdictions. It also means that any new regulation covering G-SIIs would ultimately need to apply and be implemented in a manner which achieves reasonable comparability across G-SIIs to ensure a level playing field while recognising that national policy makers and supervisors may use discretion when implementing the BCR and HLA to make certain that the standards meet jurisdictional requirements and market concerns. We would suggest that such a critical and key objective be explicitly stated in any final standard issued by the IAIS, with the recognition of the need for political agreement to ensure implementation.

Introducing new rules specific to G-SIIs for comparability purposes might have severe distortion effects compared to non-G-SIIs, who will not be subjected to the same rules. In addition, it must be recognized that to the extent that the design of the BCR differs from an existing or emerging framework applicable to G-SIIs, changes to national law may be required for the BCR to be implemented.

We welcome the confirmation that BCR will be reported to supervisors confidentially until 2019. We would strongly recommend that this be made clear in the final BCR proposal to manage market expectations alongside a clear explanation of the purpose of this private reporting to supervisors during that period. We would also recommend that the BCR reporting occur on an annual basis with appropriate reporting deadlines. We fully expect that during this confidential reporting period, the IAIS will engage with industry/G-SIIs and consider ways to resolve the shortcomings of the BCR, especially those aspects which will be carried forward into the HLA and ICS.

In the context of field testing, we would also note that a full bottom-up implementation of the BCR proposal for Q2 2015 for all volunteers will be significant challenge, if not a near impossibility, even if the requirements were already finalized. Thus, to make future field testing meaningful, we would request that discussions regarding the specifications for next year begin as soon as possible.

We have a number of specific comments on the design and calibration of the BCR as proposed in the CD provided in the detailed comments section of our response. However, we would like to specifically highlight the following key concerns:

**Financial resources available to cover BCR requirement & tiering** – we have concerns with the definition of and restrictions applied to capital resources including the proposed tiering. For member firms, compatibility with existing regimes is important. If change to national regimes were deemed necessary, then transitional provisions should be introduced in order to allow firms to adapt their capital base over an appropriate period of time without creating market distortions.

- **Clarity of the purpose and level of the alpha scalar factor –** we note that the final level of the alpha scalar may be subject to ongoing discussions. However, the rationale for this factor and whether there is underlying overall calibration target for the BCR are unclear.

- **MOCE** – we would be concerned should any part of MOCE be re-introduced as part of insurance liabilities as it would be a step backward in comparability. We strongly believe that the entire MOCE should be included in Core capital, reflecting the ability of that margin to absorb unexpected losses.

- **Contracts with Participating and Other Risk Mitigating Features –** we have concerns with a 100% charge being applied to assets backing participating contracts in addition to a capital charge on liabilities resulting from these contracts. This would result in double counting of risk and in an undue capital charge for market risk when the downside risk can be contractually passed to policyholders. We support further IAIS consideration as to how the loss absorbing capacity of such contracts can be taken into account. Similar concerns apply to a range of contracts that have profit sharing or risk mitigating features embedded in their product structures.

- **Financial activities which are subjected to neither banking nor insurance regulation -** We believe that the same treatment should apply for all participants in any given market to ensure a level playing field, regardless of the ultimate owner. For insurance-owned non-bank non-insurance (NBNI) activities we therefore strongly oppose the application of a 25bp charge on AUM for G-SIIs. Such a measure would significantly alter the playing field not only between G-SIIs and non-G-SIIs, but also G-SIIs and other participants in these businesses.

- **Property Valuation** – since valuations may differ under different accounting regimes it is important that insurers have the ability to value at market value both investment and owner occupied property to ensure consistency.

- **Unrated/Internal/ Local rated assets** – we do not agree with treating all but global rated assets as sub-investment grade. This is overly conservative, given the significant expertise and sophisticated techniques that G-SIIs have for assessing the credit quality of exposures and is inconsistent with the FSB's commitment to reduce reliance on external credit ratings. The lack of a global investment grade rating does not necessarily mean the asset is sub-investment grade. Further, we do not agree with the treatment of policy loans as non-investment grade. In the event of default of the borrower these loans would be directly offset against liabilities towards policyholders and as such do not pose risk to the insurer in the event of default.

- **Long term nature of insurance and the yield curve –** The proposed BCR construction is likely to generate results that are very volatile. The long term and illiquid nature of some insurance liabilities makes insurance undertakings less exposed to losses from the forced sale of assets. This key feature needs to be appropriately reflected in the way the BCR available and required capital are calculated, to avoid incentivizing pro-cyclical behaviours in times of stress. We will monitor with interest the ongoing deliberations of the IAIS in relation to developing yield curves to mitigate volatility and pro-cyclicality, including use of the longest tenor of observed rates and to extend the yield curve, which in our view needs to be more stable with long term parameters by being based more on historical data in the absence of credible market information.

- **Minority Interest –** the treatment of minority interest is currently not clear, in both the calculation of BCR and Qualifying Capital Resources the treatment should be consistent. Based on our preliminary discussions with the IAIS we understand that this is an issue that the IAIS intends to address.

**Contract Boundaries -** The stated basis for the BCR is that it should be an economic view of our businesses, based on realistic, best estimate assumptions and observable data. The basis for the liabilities is to be without conservatism or margins (explicit or implicit). Furthermore, the BCR CD stresses the importance of substance over form. A major deviation from this desired approach for the BCR is the requirement that we apply a strict legal definition to the contract boundaries of products. Instead, as for all other assumptions used for the calculation of insurance liabilities, contract boundaries should be established on a best estimate basis.

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We hope these comments are useful as the IAIS considers the way forward in this area. Given the complexity of these issues, we believe direct dialogue with the industry is essential and appreciate the IAIS's willingness to engage in that dialogue. The IIF and GA stand ready to provide additional views or clarifications.

Should you have any questions on the issues raised in this letter, please contact Andres Portilla (aportilla@iif.com), Yannis Pitaras (ypitaras@iif.com), Felipe Valdez (fvaldez@iif.com), or Kathrin Hoppe (kathrin_hoppe@genevaassociation.org).

Very truly yours,

Kevin Nixon

Kathrin Hoppe

CC: Peter Braumueller, Julian Adams, Michael McRaith, Paolo Cadoni, Yoshi Kawai and Catherine Lezon

**Annex:**

**<u>Specific comments</u>**

Subject to the general comments above, we would like to raise the following more detailed points based on the CD dated July 9, 2014:

### *Section 2.1 Question 2, (Paragraph 13 page 7)*

Paragraph 13 notes that ultimately the ICS will become the foundation for the HLA at which point the role of the BCR will be reassessed. We believe it to be **premature** to discuss the ICS and its relationship to the BCR and urge the IAIS to focus on refinement of the BCR and development of the HLA.

### *Section 3.5 Question 10, (Page 14)*

**IAIS suggests in paragraph 42 that a capital charge might apply to "financial activities which are subjected to neither banking nor insurance regulation"** by referring to the use of existing capital requirements for NBNI activities. In addition however, the CD proposes the application of a 25bp charge for such activities owned by a G-SII. As long as the level playing field issue referred to in our general comments above is not appropriately addressed, such reference is not acceptable to us and we oppose this alternative proposed by the IAIS. Further, with reference to footnote 9 on page 14, it should be clarified that third party asset management will only be considered to the extent that group-external funds are managed[1]. In addition, introducing this type of capital charge for comparability purposes among G-SIIs would severely distort competition between G-SIIs and non-G-SIIs, could lead to sales of operations, reducing scale in investments, and an increase in costs to insurance companies and consumers, without any specific benefit to financial stability.

### *Section 3.5 Question 10, (Paragraphs 40 and 41 page 14)*

We would be concerned with an approach to non-insurance that applies the higher of the Basel III leverage ratio and the Basel III RWA as this could result in a disproportionately high measure for NI activity. The IAIS should provide further guidance on how the Basel III leverage ratio will be used to determine capital requirements for non-regulated banking activities.

### *(Paragraph 41 page 14)*

When does the IAIS expect **to clarify the treatment for non-regulated banking activities**? An element of materiality/proportionality should be applied. For groups, where the non-regulated banking entities are not material in the overall context of the Group, capital calculations on simplified bases should be allowed.

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[1] More widely, it appears to us that assets managed in the insurance operations by captive asset managers are already captured in the asset factor and this would result in a double-counting effect.

**Comparability with banking rules** should also apply when considering the capital requirements for NBNI financial activities (i.e. comparability with capital required for such activities if carried out by banking groups).

### *Section 3.5 Question 10, (Paragraph 43 page 14)*

In the same vein and for the same reason concerning severe distortion of competition, we are unclear as well on the meaning of paragraph 43 concerning "non-financial activities" and related risks: what are the nature and consequences of the "qualitative risk assessment" referred to in this paragraph and if as stated at the beginning of this paragraph capital requirements do not capture the kind of risks arising from such activities **what is the logic for referring to "operational risks" borne by NBNI activities**. We would suggest that this category of risks is certainly marginal compared to the major risk categories identified by the IAIS through the field test and should not be accounted for BCR purposes.

### *Section 4.1 Question 14, (Paragraph 48 page 17)*

***Tiering of Capital Resources* -** The CD is uncertain on the approach to tiering of capital indicating that capital resources may be classified as either core or additional, and that at least 50% of the BCR and 100% of HLA should be made up of core capital.

It is unclear what this would mean in respect to the level of total capital. Our assumption would be that the IAIS would envisage that core capital should be no lower than the value of HLA + 50% of BCR. However, the IAIS should clarify their intentions in this respect. We would recommend, however, that BCR capital resource definitions be compatible with existing or emerging national/regional prudential frameworks.

We understand that the banking concept of going and gone concern capital and of bail-inable instruments is influencing the IAIS's thinking on core and additional capital. We see no relevance of going and gone concern capital for insurers given how the characteristics of insurance differ from banking. Insurers hold technical provisions for their expected liabilities, with assets typically being matched to their expected duration. Capital is held in addition to this against the risk of variation in those future liabilities and the assets backing them. As capital provides a risk margin above technical provisions, the nature of capital is less relevant for insurers than for banks.

If a gone concern situation for an insurer equates to breaching the regulatory minimum capital requirement, at this stage the insurer will still be solvent as the MCR is set at a level above the technical provisions. In such situations the long term nature of insurance allows time to address the risk capital shortfall, for example through restructuring the insurers risk profile, sale of business, closure to new business, transfer of portfolios etc.

Insurers asset liability matching will ensure that there are liquid assets available to meet policy claims/maturities. Given that banks engage in maturity transformation where there assets are generally long term and their liabilities short/callable on demand, a failing bank is more susceptible to a run that would pose an immediate capital strain as its assets are not immediately available to meet repayments to its creditors. In such a situation 'gone concern' capital may have a role to mitigate the risk that governments may be called on to provide support. However, this risk is unlikely to be present in insurance as insurers are able to manage the duration of their assets held as technical provisions against their claims/maturities. Therefore, going concern is of most relevance in an insurance context and insurance financial resources should be considered in this light.

### *Section 4.3 Question 16, (Paragraph 52 (b))*

**Consideration of amendment to definition of non-qualifying reinsurance.** While not completely clear, the approach suggested is inconsistent with the principles-based approach suggested in Annex C. We would propose instead that as long as there is risk transfer under a legally binding contract with an expectation of performance, the reinsurance agreement should qualify as an asset. If the IAIS decides to extend the definition of non-qualifying reinsurance, it should clearly explain the rationale for such an extension.

### *Section 4.3 Question 16, (Paragraph 53 page 18)*

***MOCE*** - The IAIS notes in paragraph 52 that consideration is being given to applying a notional percentage uplift to technical provisions as the removal of margin from the liabilities indicates that many of the G-SIIs are well capitalised. We strongly oppose the proposal to consider introduction of MOCE as part of the Technical Provisions. This would be a significant step backwards in comparability. While there is an inherent risk relating to future cash flows, the capital requirements (BCR/HLA) are expected to absorb this risk. Re-introducing a MOCE would in effect be an additional provision for the same risks that the capital requirements are intended to cover.

Moreover, this is not consistent with the aim of increasing resilience as a going-concern (as per Para 50). In the context of the development of ICS as a global capital standard, the IAIS may potentially give further consideration to introducing a risk margin over Current Estimate, which had not been contemplated until now in the BCR, and which is conceptually and economically different from MOCE as defined above. We strongly consider that the MOCE as currently defined should be core capital and not be subject to arbitrary adjustment in the context of the BCR.

Any other approach retrieving even partially MOCE from core capital would have negative and unintended consequences on current provisioning practices which might in turn weaken policyholders' protection. We would further note that the introduction of MOCE for the BCR would be inconsistent with the principles the IAIS has set out for a comparable approach based on best estimates of insurance liabilities. We support the idea that the concept of MOCE should be part of the core capital as referred to in para 6 of Annex D

### *Section 5, Question 19, (Paragraph 57)*

Basis for the market adjusted balance sheet: The use of readily available information should be encouraged where relevant for valuation purposes. For instance, companies should be allowed to use readily available financial statements including statutory accounts for the purpose of arriving at the BCR balance sheet.

### *Section 6.1, Question 21, (Paragraph 62 page 20)*

Paragraph 62 sets the example of the average percentage of PCR that the BCR will be where **the alpha scalar** of 100% is applied, but does not indicate how certain this level is, whether this may change, or the circumstances in which it may change. The **lack of clarity** on these points makes meaningful impact assessment impossible.

It is noted in paragraph 10 that the alpha scalar in the formula can be adjusted to target a specified confidence level. Given that the factor values for the proxy measures of risk exposures have been calibrated to achieve a certain level, and presumably may be adjusted in arriving at final recommendations, or subsequently depending on HLA requirements as indicated in paragraph 4, it is unclear what purpose alpha scalar serves. **We would recommend that the alpha scalar is removed from the formula once the calibration of the initial factor values has been concluded.**

### *Section 6.2 Question 22, (Page 20)*

**BCR reporting -** We welcome the confirmation that BCR will remain confidential reporting to supervisors until 2019 and would strongly suggest this is made clear in the final proposals to manage market expectations in this regard. We would suggest an annual frequency of BCR reporting.

We would also note that a full bottom-up implementation of the BCR proposals would not be possible for Q2 2015 for all insurers even if the requirements were already finalized. Thus, to make future field testing meaningful, we would request that discussions regarding the specifications for next year begin as soon as possible.

### *Section 6.3 Question 23, (page 20)*

A primary objective for the BCR is to provide a basis for comparability among G-SIIs and across jurisdictions. We support comparability to the extent it can be achieved and contributes to a level playing field. However, we would suggest that one key element to achievement is consistent implementation across the globe and would further suggest that this key objective be referred to in any final standard issued by the IAIS. What is more, we believe it is important to recognize that the BCR must be implemented by competent authorities in relevant jurisdictions, and that to the extent the BCR differs from existing prudential frameworks, changes in law that require legislative action and which would thereby draw political scrutiny may be required.

A further competitive issue is that introducing new rules specific to G-SIIs (e.g. capital charge on financial and non-financial services referred to para 42 and 43 of the consultation) might severely distort competition with non-G-SIIs who will not be subject to the same rules.

If the intention is for the BCR to be incorporated into national prudential regimes through legislative amendments, it would be helpful if the IAIS could further clarify:

- Whether it has sought political agreement, at least in the jurisdictions of the nine G-SIIs on the implementation of the proposals; and
- Whether it has agreed a coordinated implementation timetable has been agreed amongst the regulators of the 9 G-SIIs to ensure a comparable and level playing field

We recognise the challenges of developing a globally aligned capital standard and the fact that this cannot realistically be achieved in a single step.

## *Section 7 Question 24, (Page 21)*

a) In light of the compressed timetable even for the HLA, we wonder whether the IAIS has already given **some thought to the overall calibration of the BCR+HLA**. We have a question mark with the understanding of the statement in paragraph 4 of section 1.1 of the consultation: "*From 2019, G-SIIs will be required to hold capital in excess of the BCR plus HLA*". We would appreciate that IAIS confirms that this sentence merely states that the Available Resources are not under the BCR+HLA threshold

b) We fundamentally disagree with the statement in paragraph 3 of section 1.1: "*The key principle is that G-SIIs should be required by their group wide supervisor to hold higher levels of regulatory capital than would be the case if they were not designated G-SIIs".* We continue to maintain that our industry is well capitalised and that the addition of capital is purely punitive of size and geographical scope and affords little if any additional protection to markets or policyholders. Our thoughts on this are well-documented.

c) While we appreciate that the design of the HLA might still require some work and that the consultation scheduled by year-end will provide additional insight, we were expecting some preliminary views from the IAIS on the consequences of the **classification of the liabilities or certain off balance sheet items in "traditional" and "non-traditional" clusters**. For example, the CD is silent on derivatives, repurchase agreements and securities lending. To the extent they are considered as traditional, will they be taken into account implicitly in the calibration of the BCR? We also note that the stated aim of HLA referred to in paragraph 50 (page 17) of the CD seems to put emphasis on only part of the purpose of HLA, (i.e. focus on reduction of probability of failure) as set out in the policy measures paper of 2013. We are concerned that other aims should not be over-looked, in particular the primary focus to apply HLA to surgically identified systemic activities not to traditional insurance business (i.e. link between HLA and NTNI).

## *Annex C Question 27, (Paragraph 16 page 26)*

**Application of Contract Boundaries to Renewable Products.** The application of a strict legal definition of the contract boundaries to renewable products is a major deviation from the BCR approach and Basic Principle 5 – Internal consistency.

Applying the strict legal interpretation of a contract boundary to renewable products will result in assumptions that all short-term, renewable business (1 – 3 years usually) lapses at the next policy anniversary/renewal date. We maintain that this requirement results in assumptions that are:

- Extremely unlikely to ever occur in practice.
- Inconsistent with an economic view of insurers business.
- Inconsistent with best estimate assumptions and observable data.
- Inherently conservative, with substantial implicit margin.
- Consistent with the legal form of the contracts in question, but inconsistent with the substance.

Conservatism in a prudential context is appropriate. However, in this economic view it is inappropriate and introduces more conservatism on some businesses (e.g. renewable contracts) than on others (long term contracts).

### *Annex C Question 27, (Paragraph 44 page 31)*

**IAIS Specified Discount Curves** are based on risk adjusted liquid interest rate swaps or government bonds and some adjustment on corporate bond indices. Paragraph 49 notes that only 40% of the actual corporate bond spread is used for the adjustment. This is not necessarily representative of an insurer's portfolio of assets.

We welcome the recognition by the IAIS of the importance of developing yield curves to mitigate volatility and pro-cyclicality. However, we are particularly concerned if spreads were to widen considerably. We believe it may not allow for sufficient dampening effect of exaggerations of bond spreads. It would also be helpful if the IAIS could provide more clarity on how volatility may be addressed in the calculation of the yield curves going forward.

The CD also notes in respect to the yield curve that future development of alternative comparable approaches that better reflect the long term nature of insurance liabilities could eventually be used.

We believe the basis for valuation should be objective, transparent, and give materially comparable results between undertakings. As such, it is important for the yield curves for liability valuation to reflect the nature of the liabilities. Therefore, it may be more appropriate for liabilities across insurers to be valued at different yield curves in order to capture differences in the nature of liabilities even within a single currency.

We note that reference to yield curves for "discounting" may lead to confusion. As previously discussed with the IAIS, to avoid creating implied arbitrage opportunities, there should be a consistency between the yield curves used both for projecting and discounting cash flows. To mitigate the risk of confusion, it may be simpler to refer to "spot rates for valuation".

We support the steps that the IAIS has taken to achieve consistency by establishing principles for yield curves, although we would suggest there is more work to be done in this regard. It would be helpful if the IAIS could further clarify how the approach to yield curves for valuation may develop in the run up to 2019.

We also believe that the current method of applying adjustments based on the 10 year spread is artificial. This would create a basis risk between asset and liability values as asset values will reflect changes in spreads at different term periods. The implication of using the prescribed curves in different market conditions is currently unclear, and may result in inappropriate volatility. IAIS should clarify how it intends to address volatility in this respect.

This is even more important when considering how to extend the yield curve beyond the tenor of information available from deep and liquid markets. In particular we would propose that as a general principle of valuation, in the absence of relevant and credible market data, long term assumptions should be kept stable, and as such the ultimate forward rate used for the Smith-Wilson technique should be kept relatively stable over time. A consideration in setting the ultimate forward rate for each currency should be the expected investment performance of a representative asset portfolio that insurers use to match long duration liabilities.

### *Annex D Question 28, (Pages 34, 35 & 36)*

***Qualifying Capital Resources* -** The proposal indicates that the ComFrame definitions of qualifying capital resources will be used for the BCR. We have previously raised our significant concerns with these definitions in the context of our response to the Com-Frame consultation which we do not consider appropriate. The ComFrame definitions of qualifying capital resources differ in many respects from requirements G-SIIs must meet in existing regimes but should be aligned.  It is therefore difficult to evaluate the implications of these proposals in isolation of the final design and calibration of HLA. For these reasons we believe the BCR should require meeting capital resource requirements in substance as opposed to form.  A principled, rather than prescriptive approach to capital resources should allow comparability without introducing unnecessary and unjustified change to local or regional regimes[2]. Fungibility of surplus capital in the regulated banking sector should be ensured and recognized as capital resources.

In most jurisdictions, policyholders are ranked senior to debt holders – unlike bank depositors, who rank pari passu with senior creditors. Accordingly, in jurisdictions where policyholders rank ahead of debt holders, any debt (inclusive of senior debt, not just subordinated debt) should qualify as additional capital, provided that distributions could be suspended or amortized within 5 years of ultimate maturity. This would align with Guideline M2E5-5-4-1, which should be modified so that distributions that require prior regulatory approval qualify as core capital (i.e., surplus notes). In these jurisdictions (where policyholders rank ahead of debt holders) traditional debentures should qualify as capital since it meets the subordination requirement in form and substance (Parameter M2E5-5-1).

### *Annex D – Question 28, (Points 6 & 7 page 35)*

***The treatment of minority interest is ambiguous.*** In annex D, point 6 & 7, it is unclear whether minority interests are excluded from qualifying capital resources, as they are not explicitly defined as part of core capital and they are not added back as additional capital. The proxy measures for risk exposures are not explicitly defined as net of minorities. Consequently, BCR could be calculated on gross of minority exposures while capital resources are net of minorities. It is important that the two measures are consistently defined and calculated, otherwise the ratio between BCR and capital resources could be a non-sense.

### *Annex D Question 28, (Paragraph 7 (h) and (i) page 36 and Paragraph 8)*

**Exclusions from core capital -** Annex D include a list of items that are excluded from core capital. The exclusion of controlling holdings in banks' core or additional capital is not an appropriate adjustment to group capital resources where the start point is a consolidated balance sheet. As regards point (i) excess secured or encumbered assets, we believe these items fully merit inclusion in core capital. Specifically, a reduction in core capital is not appropriate where excess collateral can be withdrawn and recovery on pledged assets is limited to the amount of any liability.

The proposed deduction of the excess encumbered assets will have punitive impacts on hedging, securities lending and reinsurance activities that are fundamental to insurance risk management and funding

First, the proposed capital deduction could have a very punitive impact on derivative hedging activities. When companies post an initial margin for exchange traded and cleared swaps, and there is no associated liability on their books to net this collateral against, the full amount would be deducted from collateral. The proposed BCR wording would also deduct from core capital the typical haircuts on posted collateral for OTC derivatives. In these situations, the pledged assets could be sold to settle the derivative liability and the excess would be freely available to the insurer. Similarly, posted collateral for cleared derivatives would be released to the insurer once a derivative is unwound. Deducting these temporary encumbrances is excessively conservative and will inhibit the use of derivatives for risk management purposes.

Secondly, to avoid inconsistent treatment of the off-balance sheet transactions, such as securities lending, there should be an appropriate recognition of collateral received in the form of other securities, which are not recognized on-balance sheet due to respective accounting rules.

The proposed deduction would also impair the use of reinsurance for divestitures of insurance blocks. If the ceding company forced to post more collateral than the assuming reinsurer reports as liability, due to local collateral requirements or conservative reserving practices, the excess becomes a deduction to the reinsurer, which will add cost to the transaction and inhibit the use of reinsurance as a risk management tool.

### *Annex D Question 28, (Point 7 (e) & (f) page 35)*

On item e) and f), there is some confusion on whether or not this would apply to BCR or if it is only an ICS issue (cf. bottom of paragraph 52, "The IAIS intends to review both of these issues with the context of developing the ICS").

### *Annex E – Question 29 Guidance for specific balance sheet items (Paragraph 2 page 37)*

Paragraph 2 states that property valuations should be based on the G-SIIs reported IFRS or GAAP valuations. However, property valuations under IFRS are not based on Market Values. This introduces inconsistency in the framework relative to other asset classes (as well as many existing and envisaged solvency regimes) for which market values are used and especially it introduces inconsistency in the comparability principle as property valuations may differ under different accounting regimes and other territories/Groups account properties to their market values. It would therefore be helpful if the IAIS can confirm that market values can be used in the valuation of property. However the principle of proportionality should prevent this from requiring costly valuation procedures to be instigated where use of market valuation would not be materially more insightful.

### *Annex F Question 30, (Paragraph 35 page 45)*

Given the comment that "Current estimate liabilities were considered, but were not chosen as the exposure base because they may be negative" we understand that current estimate liabilities in respect of Variable Annuities would not include the value of the separate account. Is it the intention of the IAIS that when considering the BCR capital requirement the current estimate liabilities for unit linked business should in the same way exclude the value of the unit fund?"

### *Annex F Question 30*

We acknowledge that the IAIS has decided to retain a simple approach for developing the BCR in its given timeframe. We can understand the rationale and think that it should allow the IAIS to close the open issues flagged in our response in a timely manner. We also note that while this approach can make sense in this context, it will create **a gap between the BCR/HLA on the one hand and existing solvency regimes on the other hand with potentially conflicting rules or behaviours between the various standards** (in particular with those that are the most risk-based). This is particularly true since the IAIS has decided not to take explicitly into account diversification, asset-liability management or risk mitigation tools such as non-proportional reinsurance. Also, while we can apply the yield curves established by the IAIS, they may not be totally consistent with yield curves applied pursuant to existing regimes. We are of the opinion that these elements should be carefully considered when calibrating the BCR and also the BCR plus HLA.

### *(Paragraph 43 page 47)*

**Diversification** - The bluntness of the BCR may lead to some anomalous results given that the benefits of diversification from well diversified composite insurers may be effectively shared with less well diversified firms as a result of the calibration of the factors. It is also unclear how the response of the BCR to adverse scenarios will mirror the true circumstances of well diversified firms. Therefore it is important that the BCR only serves as a reference for dialogue and should not become a trigger for supervisory action.

### *Annex F Question 30, (Paragraph 41 page 46)*

Regarding **assets supporting liabilities**, in Annex F paragraph 41, we understand that assets backing pure unit-linked and separate account products are excluded from the asset charge for BCR purposes, as the investment performance is passed through to the policyholder. Since the **assets backing participating products** with participating features would similarly share the risks with the policyholders, we would appreciate it if the IAIS could clarify whether **assets backing liabilities with participating features will be excluded from the exposure measure for assets**.

**We suggest assets backing with-profits products should be excluded from asset charges** as the liabilities have loss absorbency and are therefore less risky than the assets backing non-par business, considering also that with-profits products are already subjected to liability charge.

If such approach is not retained by the IAIS, when will the further guidance referred to by the IAIS in the consultation be made available and its impact taken into account?

**Credit Investment and non-investment grade assets**. We would welcome confirmation that internally rated assets can be classified as investment grade. For the field test, the IAIS had considered assets not rated by rating agencies as below investment grade. The treatment of internally rated assets does not give due recognition to the sophisticated techniques that G-SIIs have for assessing the credit quality of their exposure and is inconsistent with the FSB's commitment to reduce reliance on external credit ratings.

We do not agree with the below investment grade classification of policy loans.

### *"Annex G, Question 31, (Page 50)*

An additional asset class - Other receivables - should be included under Credit investment grade. Typically, insurers' "Other investment assets" would consist of a large majority of "Other receivables" such as bank certificates of deposit. As such, applying a factor of 8.4%, which corresponds to "Other investment assets", to "Other receivables" is excessively punitive. Instead, it would be more appropriate if "Other receivables" were classified under "Credit – investment grade" with a corresponding factor of 0.69%.

### *Annex G, Question 31, (Page 49)*

In any rare cases where due to the relative immateriality of guarantees relative to separate account values, the capital requirement for a group's variable annuity (with living benefits) business calculated as the factor for "Variable annuities" applied to the notional value of guarantees is lower than the capital requirement that would apply if the business was treated as traditional unit-linked business (i.e. calculated by multiplying the factor for "Other Life" applied to the total current estimate liabilities (including separate account)), we believe that the variable annuity business should be apportioned to "Other life". We would request that the IAIS confirm more explicitly if this is the intention.