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February, 2014

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Re: IAIS Basic Capital Requirements Consultation from December 16, 2013

The Institute of International Finance and the Geneva Association are pleased to provide comments on the IAIS document on the Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs) of Dec 16, 2013. These have been produced by the Joint IIF/GA BCR Task Force.

IIF and GA members look forward to continuing the open and constructive dialogue they have had so far with the IAIS and to working constructively with the IAIS on important technical issues.

General comments

Overall, we believe that in a number of areas the consultation paper constitutes a good basis for further work on the BCR and aims at a good balance between the various (and at times conflicting) objectives.

In particular, in line with our previous discussions with the IAIS, we welcome a factor-based approach for the BCR and its proposed valuation approach for assessment of available capital and current best estimate value of liabilities (BEL).

However, concerns remain regarding the timetable for completion of the BCR and the lack of details concerning its specific structure and calibration. Until this is available, it is not possible to draw any final conclusions on the appropriateness of the BCR as described in this consultation document.

The very limited time left also raises questions on whether and how the industry will be further involved in the process (e.g. discussing essential elements such as BCR structure and BCR field testing) going forward. It is of major importance that the final BCR approach is sufficiently and appropriately tested before its implementation.

We feel strongly that the field testing should not be reduced to a simple data-gathering exercise whereby companies would only submit their data without any indication as to the BCR design and calibration options being tested. We would support a reiterative process of result analysis combined with an open exchange with the industry on results.

Our views are set out under the assumption that the BCR is, as initially indicated by the FSB, a foundation for the application of Higher Loss Absorbency (HLA) requirements to G-SIIs in the absence of a global capital standard, and is therefore a temporary measure until the global insurance capital standard (ICS) is developed. It is important to note that what may be viewed as appropriate for the BCR as a temporary measure may not be appropriate for the ICS.

The BCR should, where relevant, endeavor to draw on information provided by existing or future prudential or accounting regimes and by companies' own models when these are in line with IAIS Insurance Core Principles (ICP) principles. The BCR's valuation basis and the BCR itself should not duplicate nor conflict with existing or future national and regional requirements.

The effort to achieve comparability should be proportionate to the materiality of the various items on the firms' balance sheets and consider the constraints imposed by the target timelines. Proxies and simplifications should be allowed commensurate to the scale, nature and complexity of the risks being assessed.

Where risk-based regulatory systems already exist, efforts should be made to assess whether such regimes are already in line with BCR objectives and principles. If this is deemed to be the case, existing measures should be considered equivalent to fulfil BCR needs and no additional work should be required from insurance companies.

We welcome the focus on simplicity. However, it is important that the BCR remains both simple and risk-sensitive at the same time. It needs to be as simple as possible while capturing key features of insurers' risk profile.

Key features of insurers' business model that need to be recognized by the BCR and its valuation basis, include:

- Insurers' reduced exposure to losses from forced asset sales
    - Insurer's exposure to the risk of losses from forced sales is reduced because of the illiquid nature of their liabilities or where part or all of the exposure to market risk has been transferred to policyholders through market value adjustment mechanisms or, for example, in the case of unit-linked and separate account type products.
    - Even in recovery and resolution situations insurers under financial stress have many tools available to them which are effective in creating an orderly resolution. Critically, the long term nature of insurance allows time for stabilising actions to be taken over a number of years.
- Diversification
- Other risk mitigation techniques such as reinsurance and hedging

A factor-based approach for the BCR should be based on applying factors to exposure measures such as BEL segments. One alternative is to cover market and credit default implicitly through the calibration of the factors applied to each BEL segment. Another alternative is to cover these risks explicitly by introducing separate factors and exposure measures. There is currently no industry consensus as to whether there should be an explicit factor on assets or not. The joint IIF GA BCR Task Force is currently considering a number of options and may follow up with further input at a later stage.

Whichever option is selected, it is crucial that the link between insurance liabilities and assets is appropriately taken into account and in particular the reduced exposure to the risk of losses from forced sales of assets. This may require further segmentation of the BEL according to their degree of illiquidity and the extent to which market risk is borne by policyholders or otherwise hedged.

Diversification, which is at the heart of insurers' business model, needs to be appropriately recognized. It could be taken into account implicitly or explicitly. A number of members very much prefer to reflect diversification explicitly.

Reinsurance needs to be given due recognition. One simple approach is to apply the factors to the BEL net of reinsurance. Reinsurance is one of the main insurance risk mitigation techniques available to insurers and failing to recognize it would result in the BCR being insufficiently risk-based.

The structure and segmentation of the BCR should be sufficiently granular to ensure that non-traditional (NT) activities that are materially systemically risky can be subsequently separately identified to facilitate the targeting of HLA. Risks from non-insurance (NI) activities should be covered using sectoral rules.

We welcome the overall direction taken by the IAIS on valuation which is in most aspects consistent with a principles based, economic, risk-based, globally comparable basis for valuation, whilst remaining inclusive enough to be workable for all – e.g. through the use of local GAAP or the valuation component of their internal capital models to the extent possible to determine available capital, adjusted as appropriate to ensure alignment with the valuation principles. Clearly though there remain a number of points on which further work is required (e.g. contract boundaries, yield curve definition, need for regular updating, treatment of options and guarantees).

As indicated in our comments on Module 2 Element 5 of the latest ComFrame draft, we believe that the restrictions on qualifying capital are potentially problematic. The long-term nature of insurance needs to be duly considered when defining qualifying capital. Notably because of the illiquid nature of their liabilities, insurers, unlike banks, generally cannot be forced into an accelerated liquidation of their balance sheet.

We welcome the recognition of the fact that BCR has a different role and characteristics compared to the Basel III Leverage Ratio [§10]. Undue spill-overs from regulation originally designed for banks may result in insurers being driven away from their core business model of providing protection and diversifying risks.

We welcome that the IAIS intends to develop the technical specifications for field testing in cooperation with the volunteering firms [§69]. However, the discussion on technical specifications will be key to the success of the field test, and further interaction with the volunteering firms should be actively fostered by the IAIS.

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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.

Annex:

<u>Specific comments</u>

Executive summary

Overview

§2 and §11: The overall timeline for the BCR is extremely ambitious. The IAIS should therefore concentrate its efforts on the BCR development and its field testing in order to deliver answers to outstanding features of the BCR as soon as possible and well in advance of the second consultation period. The IAIS should also assess the risk of inability to deliver on time or just with 'an 80% developed BCR'.

The overall IAIS timetable for the ICS to be delivered at the end of 2016 is also very ambitious. The development of the BCR and ICS should not be confused. To address the complexities which are very likely to surface when details of the ICS are discussed, more time is needed. It is not compatible with the short timeline for finalizing the details of the BCR, which is the object of the current consultation.

The current BCR timeline is unachievable if ICS and BCR are both being tackled simultaneously. The risk is that the BCR will not be sufficiently tested and could potentially become a 'risk insensitive' blunt tool. Members are concerned that the IAIS is not allocating sufficient time to field test the BCR if metrics are only to be supplied to companies in July.

Approach

We agree with IAIS's support of "a simple structure in the sense of having few factors" for BCR. The 2014 timeline for the BCR is short. It is doable only if the BCR requirements are principles-based and if companies are allowed to use proxies and simplifications and can, as much as possible, rely on existing approaches and models.

It is important that the BCR strikes the right balance between simplicity and risk sensitivity. It needs to be as simple as possible capturing key features of insurers' risk profile. These key features include:

- Insurers' reduced exposure to losses from forced asset sales Insurer's exposure to the risk of losses from forced sales is reduced because of the illiquid nature of their liabilities or where part or all of the exposure to market risk has been transferred to policyholders through market value adjustment mechanisms or, for example, in the case of unit-linked and separate account type products
- Diversification
- Other risk mitigation techniques such as reinsurance and hedging.

§14: [Same comment as for §50]: It is unclear what is meant by "the BCR has resilience to stress"? The IAIS should clarify whether this is intended to refer to the capital ratio, surplus or required capital?

§18: We welcome the statement that the potential integration of other risk areas, such as operational and liquidity risk is beyond the scope of the BCR.

§19 (same comments as for §48 and §86): We agree with the IAIS' view that off-balance sheet exposures should generally be considered for determining the BCR. If off-balance sheet items are considered to be immaterial, these can be excluded from the BCR calculation. The materiality should be addressed in a transparent manner to ensure comparability. When off-balance sheet items are considered, they need to be treated symmetrically. If off-balance sheet liabilities are taken into account then the value of off-balance sheet assets should also be considered.

Generic Example

§ 21: We disagree with Footnote 6 "the benchmark [for the BCR Adequacy Ratio] need not be set at 100% but could be set at a different level, if so desired." This caveat can create confusion. The IAIS should be very clear on the action required where the BCR is not met and should not introduce ambiguity. Further, the benchmark should be applied consistently to all G-SIIs to ensure a level playing field. If the benchmark is set at other than 100%, then in essence that alternative level of BCR is actually required, and the factors should just be modified accordingly.

§ 22: The approach needs to distinguish between risks that can be addressed through appropriate segmentation and risks that need to be addressed in the calculation of the factor(s) applied. A factor-based approach for the BCR should be based on applying factors to exposure measures such as BEL segments. One alternative is to cover market and credit risks implicitly through the calibration of the factors applied to each BEL segment. Another alternative is to cover these risks explicitly by introducing separate factors and exposure measures. There is currently no industry consensus as to whether there should be an explicit factor on assets or not. The joint IIF GA BCR Task Force is currently considering a number of options and may follow up with further input at a later stage.

Key risks addressed

§ 24: We agree that insurance is a liability-driven business. Investments in assets are driven by the nature and duration of liabilities.

§ 25: BEL should be segmented into homogenous major insurance risk groups. For simplicity and practicability reasons, it would be useful if insurance liabilities are segmented in a manner that is consistent with that used for existing purposes – e.g. accounting or regulatory purposes – for calculation of best estimate.

The more granular the segmentation is, the more accurate and hence comparable and risk sensitive the BCR will be. Increasing the granularity does not necessarily add complexity and is likely to increase comparability of results across jurisdictions and companies. We acknowledge the IAIS' desire to have fewer factors to keep the BCR simple. However, we would suggest that the field testing should consider more granularity as this would aid decision making regarding the final recommendations. The IAIS will have the opportunity to refine the granularity based on the results of the field testing, but this will only be effective if enough different factors are initially available.

Whether or not all risks are explicitly or implicitly taken into account in the factor applied to the BEL segments it is crucial that the link between insurance liabilities and assets is appropriately taken into account and in particular the reduced exposure to the risk of losses from forced sales of assets. This may require to further segment the BEL according to their degree of illiquidity, the extent to which market risk is bore by policyholders. Typically, Unit Linked and Separate Account liabilities should be considered separately from other BEL when the investment risk is borne by policyholders. Similarly, illiquid liabilities, such as those originating from guaranteed life products where policyholders have no or limited options to lapse (e.g. annuities and similar liabilities), backed by assets with a shorter or similar maturity should also be dealt separately to the extent that the risk of losses from the forced sale or reinvestment of these assets is significantly reduced.

We have previously proposed 14 BEL segments as set out below and are currently further developing our thinking in this area.

- Life: 1. Protection – life; 2. Protection – health; 3. Protection – other; 4. Savings without (material) guarantee; 5. Annuities; 6. Savings with guarantees; 7. VA with Living Benefits; 8. Other
- Non-Life: 1. Motor (including motor TPL); 2. Property damage; 3. Asbestos, Pollution and Health Hazard (APH); 4. Other liability; 5. MAT; 6. Other

§ 26: If financial market risks have to be assessed separately, it should be assessed by differentiating between category of assets and between assets covering insurance liabilities and other assets. However, we believe that financial market risks should also be assessed by differentiating between assets backing illiquid liabilities, assets backing liabilities originating from products where policyholders bear the risk, products where financial market risk has otherwise been mitigated by ALM, and other products. This split is essential to recognise the reduced exposure to losses from forced sales from which insurers typically benefit. It will also ensure that the BCR does not provide pro-cyclical behavioural incentives.

Although the list of NT products is likely to evolve over time, the segmentation should be sufficiently granular to ensure that insurance business that may be considered NT can be separately identified to facilitate the targeting of HLA.

According to §102, "NI risks will be addressed by taking the respective sectoral capital requirement". The industry agrees with this statement. Risks from NI activities should be addressed under relevant sectoral rules. As an example, for a non-insurance subsidiary concentrating on banking activities, Basel III rules should be used.

§ 28: In general, the fact that insurance companies hold assets to match liabilities should be reflected in the design of the BCR.

Other considerations

§ 29-34: There is no reference to diversification in the executive summary although diversification is at the heart of the insurance business model and risk management. It could be taken into account implicitly or explicitly. A number of members very much prefer to reflect diversification explicitly.

The IAIS should be aware of the incentives that the BCR will create relative to risk management and potential consequences on the wider financial system. In particular, it is possible that a simple factor-based approach may perversely discourage risk reduction through reinsurance and hedging. In addition, the industry agrees with the fact that the use of the Basel III Leverage Ratio for G-SIIs is not appropriate.

§ 30: We acknowledge the IAIS' desirability of having fewer factors to keep the BCR simple. However, we would suggest that the field testing should consider more granularity as this would aid decision making regarding the final recommendations. The IAIS will have the opportunity to refine the granularity based on the results of the field testing, but this will only be effective if enough different factors are initially available. Increasing granularity does not necessarily add complexity in a factor based approach and is likely to increase comparability of results across jurisdictions and companies. As noted in our answer to question 5 above, we have previously proposed 14 BEL segments and are currently further developing our thinking in this area.

§ 31: Calibration of the BCR within the timescales available will be very challenging. We expect the BCR to be calibrated in a way that its level is below ultimate threshold for which supervisory actions would be triggered. We strongly recommend that available standards (e.g. Solvency II MCR) are considered to benchmark the BCR capital requirement. We recommend that the IAIS communicates before the field testing their intent of a target level. The Solvency II MCR is a simple factor based approach, based on a similar valuation framework that has been tested. In addition, the MCR is designed to be a minimum capital requirement and therefore is a suitable base for HLA.

§ 33: It is important to note that the BCR should also not intervene in or confuse effective risk management. If the BCR is excessively simplistic and fails to capture the nature of the insurance business model it must not be perceived as being very informative on proper incentives for ALM and risk management.

Context

Scope of application

§48 (same comments as for §19 and §86): We would welcome clarity as to what the IAIS considers "off-balance sheet exposure". There does not appear to be a consistent understanding of off-balance sheet exposures. It is the opinion of the IIF and GA that off-balance sheet items should generally not be material and therefore BCR scope must be restricted to on-balance sheet items. If there are any material off-balance sheet items then these should be disclosed in the consolidated financial statements. Furthermore, when off-balance sheet items are considered they need to be treated symmetrically. If off-balance sheet liabilities are taken into account then the value of off-balance sheet assets should also be taken into account.

Principles

§53: We support the objective to ensure, in the development of capital requirements and measures for G-SIIs, that opportunity for regulatory arbitrage between the banking and insurance sectors are not increased.

Role of a "basic" BCR

§56: The IAIS should state specifically and clearly what the implications are for a breach in the BCR and whether a breach of the BCR would mean in any case a breach of the HLA considering the different scope of application for BCR and HLA.

§57: The BCR calibration should be aligned towards the minimum capital requirement ensuring policyholders protection in going and gone concern situations. We agree that BCR should inform the ICS and represent a stepping stone towards a global capital standard. However, as mentioned earlier the major focus needs to be given at the moment to the BCR given the November 2014 deadline.

Qualifying capital resources

§62 & §63: The restrictions around qualifying capital in the latest ComFrame draft are concerning. In our view:

- The prescription of 'a priori' deductions from qualifying capital should be avoided.
- Tiering is a concept designed for banks and may therefore not be appropriate for insurers.
- The proposed criteria for qualifying capital are unjustifiably restrictive.

However, as the valuation basis has yet to be determined for ComFrame and BCR it would be premature to draw conclusions on aspects related to qualifying capital at this time. This is because the details around the valuation basis have implications both for capital resources and requirements. In particular, whether the tiering or capital deductions proposed in ComFrame are needed or appropriate for ComFrame or the BCR will depend on the final valuation basis and the calibration and design of the ComFrame capital benchmark and of the BCR.

It is essential that the valuation basis and subsequent qualifying capital reflect insurers' reduced exposure to losses from forced asset sales. By doing so, market volatility to which insurers are typically less exposed to will not unduly flow into the balance sheet and therefore affect qualifying capital. Failing to recognize the long term nature of insurance business appropriately will introduce incentives for pro-cyclical behaviors in times of stress.

Elements of capital, such as those known as retained earnings/reconciliation reserves, prudential margins, the value in force, goodwill, intangible assets and deferred taxes and others should not be a priori subject to tiering or deducted from qualifying capital resources when the risk that they may not be fully available in times of stress or during winding-up is already captured through required capital.

In particular, long-term debt is available to absorb losses and contributes to the financial strength of an insurer through periods of stress. Therefore, long-term debt should qualify as capital where it is de facto subordinated to policyholders, even if the security itself is not legally stated as ”subordinated”.

The appropriateness of tiering for insurers needs to be re-considered. It is a concept that is inspired from banking regulation and it may therefore not be appropriate for insurers given the distinct features of their business model. In general, unlike banks, insurers cannot be forced into an accelerated liquidation of their balance sheet.

Non-insurance activities

§65: We agree that insurance entities should be reflected in the BCR, and that non-insurance financial entities should be covered by sectoral rules. In addition, we agree that material non-insurance, non-financial entities should be in scope of the BCR. However, further guidance should be given on what the IAIS considers as material NI, NF entities and on how such activities should be tackled within the BCR.

Comparability of valuations

General comments

§66: We believe that the following general valuation principles should apply in order to ensure the necessary degree of comparability of valuations which should be the starting point for a simple factor-based approach:

1. The insurance liabilities should be valued on a best estimate basis;
2. Available capital should be determined as the value of assets minus the sum of the best estimate of insurance liabilities and other unsubordinated liabilities;
3. For the purposes of the determination of available capital, investment assets should be fair-valued;
4. In accordance with BCR principles existing accounting or regulatory prudential margins should be included in available capital, and not in the current best estimate of insurance liabilities.

§67 to §71: The overall direction taken by the IAIS on valuation is in most aspects consistent with a principles based, economic, risk-based, globally comparable basis for valuation, whilst at the same time remaining inclusive enough to be workable for all – e.g. through the use of local GAAP or the valuation component of their internal capital models to the extent possible to determine available capital, adjusted as appropriate to ensure alignment with the valuation principles. Clearly though there remain a number of points on which further work is required (e.g. contract boundaries, yield curve definition, need for regular updating, treatment of options and guarantees).

Contract Boundaries:
We suggest that the IAIS relies on the practice of the G-SIIs supervisors and companies experience. For the purpose of BCR calculation, firms' existing approaches should be used. Model changes needed to adjust this fundament aspect of the valuation approach have in the past taken many months if not years. IAIS should request that firms explain how insurance contract boundaries are treated.

Going forward we would hope that there is accounting and regulatory convergence towards an economically based approach in order to be consistent with the principles of a best estimate calculation and the way that firm's manage their business. It is important to note that an economic approach is based on best estimate assumptions of expected future premiums and associated cash-flows based on past experience.

Yield curve definition:
A principles based approach should be adopted allowing both top-down and bottom-up approaches to be used for the definition of the discount rate curve.

Economic assumptions used in the best estimate calculation should be consistent with observable market information where such information is reliable, relevant and based on active markets. Where policyholder benefits are a function of the investment return on a designated pool of assets, the discount rate used to determine the present value of those policy benefits should be consistent with the investment return used to determine those policy benefits. The discount rate used to determine the present value of the policy benefits should take into account the liquidity characteristics of the insurance liabilities and the consequent reduced risk of losses from forced sales.

We would not recommend IAIS specify yield curves as it will be practically difficult for IAIS to specify and firms to implement in context of a field test. Nevertheless testing of a single sensitivity to a prescribed yield curve would be less onerous if sufficient additional time was available, though may still not be feasible for all firms.

IAIS can request firms to submit curves used and explanation as to how they were derived to be able to assess comparability of yield curves in a transparent manner.

Options and Guarantees:
The technical specifications should make clear that approximations and deterministic calculations for best estimates can be used, particularly where the time value of options and guarantees (TVOG) is not material relative to their intrinsic value.
Guidance for specific products such as Variable Annuities (VA) where TVOG for Living Benefits will be material would also be helpful. The IIF/GA BCR Task Force is in the process of finalizing further input in this regard that will be shared with the IAIS in forthcoming weeks, including:

- Approach to determine the best estimate of liabilities in instances where the TVOG is material (e.g., use of a stochastic valuation method)
- Appetite and/or intent to:

- Apply a capital factor distinct from other life insurance liabilities for VA Living Benefits
- Distinguish capital requirements for variable annuities with significant guarantees like Living Benefits and those with no or minimal guarantees
- Reflect the impact of hedging programs for material TVOG on capital requirements under the BCR.

§69: We welcome that IAIS intends to develop the technical specifications for field testing in co-operation with the volunteer IAIGs and G-SIIs.

Valuation of liabilities – current estimates

§72 to §76: The following principles should apply to the calculation of Best Estimate of Insurance Liabilities (in conjunction with general valuation principles listed in our comments to §66):

1. The best estimate should be calculated as the expected present value of future cash-flows.

a. The best estimate calculation should be based on up-to date and credible information;
b. The best estimate calculation should be performed using adequate, applicable and relevant actuarial and statistical methods;
c. The non-economic assumptions in the best estimate calculation should target mean values and include no allowance for margins for adverse deviation;
d. The best estimate calculation should take into account all the cash-in and cash out-flows required to settle the insurance obligations;
e. The best estimate calculation should take into account all expenses that will be incurred in servicing and settling the insurance contracts as well as inflation;
f. The best estimate calculation should take into account all payments to policyholders, including any future discretionary payments that are expected;
g. The best estimate calculation should take into account financial guarantees and contractual options;
h. The best estimate should make full allowance for expected future premiums and associated future cash-flows;

2. Generally, the best estimate calculation described in principle 6 should be calculated deterministically. Firms may though choose on their own initiative to calculate the best estimate stochastically, if the time value of the options and guarantees is material relative to their intrinsic value.

3. Insurance obligations should be segmented into homogenous risk groups when calculating the best estimate.

a. P&C only - The best estimate calculation for provisions for claims outstanding and premiums should be calculated separately;
b. P&C only - Insurance liabilities should be segmented by line of business in a manner that is consistent with that used for existing purposes – e.g. accounting or regulatory purposes – and as a minimum sufficiently granular to support the application of the prescribed BCR best estimate of insurance liabilities risk factors;

c. Life only – Insurance liabilities should be segmented by product type in a manner consistent with that used for existing purposes - e.g. accounting or regulatory purposes – and as a minimum sufficiently granular to support the application of the prescribed BCR best estimate of insurance liabilities risk factors.

4. Economic assumptions used in the best estimate calculation should be consistent with observable market information where such information is reliable, relevant and based on active markets.

a. Where policyholder benefits are a function of the investment return on a designated pool of assets, the discount rate used to determine the present value of those policy benefits should be consistent with the investment return used to determine those policy benefits;
b. The discount rate used to determine the present value of the policy benefits should take into account the liquidity characteristics of the insurance liabilities and the consequent reduced risk of losses from forced sales.

Where sufficient relevant and reliable market observable information is not available in active markets, other methods should be retained for the assumptions and further described to the IAIS.

5. The best estimate calculated for amounts recoverable from reinsurance contracts should be calculated in accordance with the principles above.

a. When calculating best estimate for amounts recoverable from reinsurance contracts timing differences between recoveries and direct payments should be taken into account, if material;
b. The result from the calculation shall be adjusted to take account of the best estimate of expected losses due to default of the counterparty, if material.

6. Proportionate simplifications should be allowed in the calculation of the best estimate.

§75: The Solvency II Risk Margin (RM) is not part of the BEL but is an element of the Technical Provisions (TP). We agree that reserves such as risk margins or equalization reserves which may be required under certain local regimes to cover losses from unexpected events should fully count as qualifying capital as they serve the same purpose and provide the same protection against unexpected risks as does capital.

Valuation of assets

§77 to §81: For the purposes of the determination of available capital, investment assets should be fair-valued.

§79&80 (same comments as for §22): BCR consultation suggests that the BCR field testing will focus on a total balance sheet approach. As a total balance sheet approach is commonly understood, capital requirements are based on the combined impact of specific stresses to assets and liabilities. However, paragraph 22 refers to separate factors applied to assets and liabilities. This seems contradictory to a total balance sheet approach. Accordingly, it is not clear what the IAIS means by a "total balance sheet approach." Applying separate factors to both assets and liabilities (and also NTNI risks) seems to inherently conflict with the total balance sheet approach, which should show the effects of natural risk offsets and explicit hedging. The proposed approach may still be acceptable, but only if the BCR is calibrated as a minimum.

Factor-based approach

Context

A factor-based approach for the BCR should be based on applying factors to exposure measures such as BEL segments. One alternative is to cover market and credit risks implicitly through the calibration of the factors applied to each BEL segment. Another alternative is to cover these risks explicitly by introducing separate factors and exposure measures. There is currently no industry consensus as to whether there should be an explicit factor on assets or not. The joint IIF / GA BCR Task Force is currently considering a number of options and may follow up with further input at a later stage.

Whichever option is selected it is crucial that the link between insurance liabilities and assets is adequately considered and in particular the reduced exposure to the risk of losses from the forced sales of assets. This may require to further segment the BEL according to their degree of illiquidity, the extent to which market risk is borne by or otherwise hedged.
As noted in our answer to question 1, the structure and segmentation of the BCR should be sufficiently granular to ensure that NT activities that are materially systemically risky can be separately identified to facilitate the targeting of HLA.

Risks from NI activities should be addressed under relevant sectoral rules, should be reflected in a net adjustment to available capital, (available capital minus required capital determined according to relevant sectoral rules), and not in the BCR.

§85: We welcome the focus on simplicity. However, it is important that the BCR strikes the right balance between simplicity and risk sensitivity. It needs to be as simple as possible while capturing key features of insurers' risk profile.

§91: Diversification is at the heart of the Insurance business model and risk management. It could be taken into account implicitly or explicitly. A number of members very much prefer to reflect diversification explicitly.

Major risks

§ 102: As noted in our answer to question 1, the structure and segmentation of the BCR should be sufficiently granular to ensure that NT that is materially systemically risky can be separately identified to facilitate the targeting of HLA. Risks from NI activities should be covered using sectoral rules. It would not be appropriate to address NTNI through the use the risk weighted assets (RWA) or the total exposure of the leverage ratio of Basel III, other than where those measures would already apply to non-insurance activities. It would also be inappropriate to reflect NTNI risks through factors akin to the G-SII methodology as this would be too complex given that the BCR is intended to be straightforward. Rather consideration should be given to ensuring the segmentation of the BCR takes into account the three NTNI principles set out in the IAIS's Global Systemically Important Insurers Policy Measures paper of July 2013. In this respect, Principles 1 and 2are aligned with the segmentation proposed and the treatment of NI. Principle 1 would require the inclusion of a credit guarantee insurance segment. This is something we should explore further in our engagement.

§103: In general, the fact that insurance companies hold assets to match liabilities should be reflected in the design of the BCR.

Factor-based approach calculation

§105: Bullet point 6 creates a lot of confusion: It should be made clear that the starting point for qualifying capital is the fair value of assets minus the sum of the best (current) estimate of insurance liabilities and other de facto unsubordinated liabilities.

Generic example

As noted in our answer to question 6, calibration of the BCR within the timescales available will be very challenging. We therefore recommend that available standards (e.g. Solvency II MCR) are used to benchmark the BCR capital requirement. The Solvency II MCR is a simple factor based approach, based on a similar valuation framework that has been tested. In addition the MCR is designed to be a minimum capital requirement and therefore is a suitable base for HLA.

Given that there is a trade-off between simplicity and risk sensitivity the benchmark for the BCR should be set as a minimum capital requirement, and avoid becoming a blunt front stop to ensure that it does not conflict with risk management incentives.

In order for companies to implement BCR in systems and processes an indication of the expected reporting frequency would be helpful.

Field testing process

Combining BCR and ComFrame/ICS development within the field testing risks that insufficient focus is given to the development of the BCR. Given that the BCR needs to be completed within a number of months the field testing should have a strong focus on the BCR.

The testing of the BCR should be sufficient to allow G-SIIs to assess the structure of the BCR and also to assess its quantitative impact allowing time for further refinement and testing in order to deliver an appropriate and workable measure.

The timescales for this development are exceedingly challenging and we would urge the IAIS to seek agreement with the FSB that delivery of a framework approach by November with further development of the calibration during 2015 would be an appropriate outcome.

General Questions

1. Is the purpose of the BCR clear enough?

The purpose of the BCR as initially set out by the FSB is clear: the BCR is a foundation for HLA requirements for G-SIIs in the absence of a global capital standard, and therefore it is a temporary measure until the ICS is developed.

However, the IAIS has indicated that they have yet to decide whether it should be extended to non-G-SIIs and that it will be used to inform the development of the ICS. This indecision makes it difficult for the industry to confirm the scope for the BCR. Other items which need further clarification are whether the BCR will be a target or minimum capital requirement and whether it will be a temporary or permanent measure.

There should be no extension to the initial aims of the BCR it should remain a temporary measure to provide a foundation for HLA requirements until the ICS is developed.

The IAIS should clarify its statement that the BCR has to be reported in 2015 to the supervisor. It should also elaborate on how the BCR will be further developed up through 2019 when HLA and ICS is planned to come into force. We propose that the BCR data are kept confidential during the period 2015-2018.

2. At what level should the BCR be calibrated compared to existing national benchmarks?

As noted in our answer to question 24, given that there is a trade-off between simplicity and risk sensitivity the benchmark for the BCR should be set more toward a minimum capital requirement (e.g. similar to the Solvency II MCR), and should avoid becoming a blunt front stop. This will ensure that it does not conflict with risk management incentives. In addition, the BCR should not conflict with the outcome of a more refined framework.

3. Is the BCR expected to be a temporary measure, until the risk-based group-wide global insurance capital standards (ICS) is in place, or will it continue to apply?

While it is premature to answer this question, it is clear that the initial aims as communicated by the FSB are that this is a temporary measure.

Given that ICS and ComFrame are being developed as a comprehensive framework building on the ICPs, and that the ICPs envisage both a front stop (PCR) and backstop (MCR) capital requirement there is no rationale for retaining a separate BCR once the new capital framework is in place.

4. Should a backstop capital measure be introduced to complement the proposed ICS, in addition to or instead of the BCR? If so what should the purpose of such a backstop capital measure be, compared to the BCR?

We do not see a reason to have both a backstop and a basic capital requirement in addition to a comprehensive ICS. In developing an ICS that builds on the ICPs the BCR and MCR effectively should serve the same purpose. Therefore once the new capital framework has been developed there will be no rationale need for a separate BCR and MCR.

5. Will the proposed approach to valuation of assets and liabilities provide sufficient global comparability?

This question is premature to answer at this stage as the consultation is not specific enough on IAIS approach to valuation of assets and liabilities.

The IAIS will need to be pragmatic in what is specified and what reliance is placed on existing practice in order to deliver a workable solution within the timeframe required. We think some sacrifice of comparability should be made for operational purposes achieving the goal to deliver a BCR by November 2014. In addition, comparability is linked to the existing frameworks that companies need to manage to and therefore the extent to which the valuation basis developed by the IAIS reflects the actual risk management choices of companies. Accordingly, IAIS valuation should be generally linked to economic and IFRS approaches and avoid unnecessary prudence or the prescription of yield curves to which companies do not currently manage.

6. Can a reasonable balance of risk sensitivity and simplicity be achieved using a factor based approach?

The level at which the BCR is calibrated is key in this respect, as noted in our answers to question 24 and 28, given that there is a tradeoff between simplicity and risk sensitivity the benchmark for the BCR should be calibrated as a minimum capital requirement, and avoid becoming a blunt front stop to ensure that it does not conflict with risk management incentives. We suspect that more than ten factors will be needed to capture risk sensitivity.

7. How should the BCR be integrated into national or regional frameworks which are in the process of being implemented or modified?

In principle, insurers should not be subject to multiple overlapping and potentially conflicting capital standards and regimes. For the sake of an efficient G-SII supervision, consistency of purpose must be ensured between the BCR and minimum capital requirements in local/regional existing regime. To deal with contradictory prudential references would introduce confusion in insurance supervision. The concept of BCR must be aligned with the various statutory obligations currently in place.

8. How should supervisors enforce the BCR in a consistent manner across jurisdictions?

Appropriate provisions should be made for supervisors in order to ensure BCR alignment and compatibility with risk based local regimes.

Supervisors must also be very attentive to inconsistencies potentially emanating from the fact that some jurisdictions might not be willing to transpose BCR provisions in their own regimes. It should be anticipated that an agreement on BCR can be reached at the IAIS level while some jurisdictions, with reference to the specificities of their local/state regulations and constitutional law, would oppose to an alignment with the standard agreed at an international level. Consequently, supervisors should ensure a level playing field overall in all member countries, for G-SIIs in their respective jurisdictions, taking existing regimes into account when applying BCR. In addition, consistent reporting and supervision regime would need to be established. This should not be a significant issue if limited to G-SIIs, but the answer also depends on whether the BCR is integrated within local regulations and applied to a broader scope of companies.

Given that the BCR is a temporary foundation as a base for the application of HLA for G-SIIs, The calibration of the BCR and the HLA will inform the level of capital required from 2019 onwards.

Therefore, necessary legal and regulatory changes will need to be implemented within each relevant jurisdiction so that supervisors are able to require G-SIIs to hold the required level of capital to meet HLA requirements from 2019 onwards.