3 February 2014

GFIA response to the IAIS Basic Capital Requirement consultation

Response structured according to the IAIS web input tool.

Chapter 2: Executive Summary
General comments on Executive Summary

- The GFIA welcomes the opportunity to take part in this public consultation on the Basic Capital Requirement (BCR).
- GFIA aims to contribute constructively to meeting the goals and time-table but would like to emphasise that the time-table set is very ambitious and care should be taken to ensure that it does not compromise arriving at a system that works well enough in practice to achieve its aims.
- In particular it is important that any proposed capital adequacy standard, including the BCR is not overly volatile and does not create pro-cyclical behaviour.
- Given the very limited time-table and therefore the simplicity required for the BCR, we believe it should be a temporary measure. This is in line with the mandate set by the FSB that the BCR is needed in the absence of a comparable global capital standard on which to set the HLA for G-SIIs.
- We have based our submission on this assumption, and on the assumption that the BCR will apply only to G-SIIs. If however the BCR is intended as a long-term measure and/or to apply more widely then this could significantly alter our views, and for example, a less granular BCR may no longer be appropriate.
- Given both the limited time-table and the temporary nature**, GFIA supports a factor based approach as the basis for the BCR.** A key challenge will however be to find a reasonable trade-off between simplicity and accuracy in order to serve as an appropriate basis for the HLA. The reasonable level of balance to be achieved should be considered through the field testing process.
- We support the approach to assess overall BCR at single, consolidated group level.
- We can support economic valuation **as defined in ICP14**, which recognises that this covers both the use of market valuation and amortised cost valuation. We emphasise, that any valuation approach must look at assets and liabilities together, making sure that long-term and illiquid characteristics of both assets and liabilities are appropriately reflected in the measurement approach and therefore the measurement system does not introduce artificial volatility into the BCR measures.
- Although not explicitly addressed in the proposal, challenges remain on a range of valuation and capital issues.
- As a general comment, we believe that it's vital that principles of proportionality and materiality are embedded in the framework. Thus, it should be acceptable that companies apply simplifications to the methodology, such as excluding business units and/or risks that would create significant costs and have a non-material impact on the total measurement.
- The limited scope for impact testing of the BCR would suggest that a phase-in period would be appropriate, as supervisors monitor the measure's usefulness and performance. This is important to assess whether it is sufficiently risk sensitive, and to limit the uncertainty it will impose on the markets. This also means that it would be appropriate for supervisors to have some flexibility to determine how they respond to movement that impacts a company's ability to meet the BCR.

Comments on Overview (para 8-12)

- We welcome the recognition that the BCR has a different role and characteristics compared to the Basel III leverage ratio, as explained in **paragraph 9**.

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Comments on Approach (para 13-20)

- We support the approach to assess overall BCR at single, consolidated group level.
- Given both the limited time-table and the temporary nature**, GFIA supports a factor based approach as the basis for the BCR.** A key challenge will however be to find a reasonable trade-off between simplicity and accuracy in order to serve as an appropriate basis for the HLA..The reasonable level of the balance to be achieved should be considered through the field testing process.If however the BCR is intended as a long-term measure and/or to apply more widely then this could significantly alter our views, and for example, a less granular BCR may no longer be appropriate.

Comments on Generic Example (para 21-23)

- It is difficult to judge if the proposed generic example will work in practice until the measures for the Liability, Asset, NTNI and Other categories are determined. Alongside this approach, we believe that other approaches should also be considered. For example, some GFIA members believe it may be possible to base a simple BCR on a system where the total liabilities are split into segments, with factors applied to the liabilities in each segment. The factors applied to the liabilities would be calibrated to implicitly or explicitly reflect liability and asset risks, and also ALM. Such an approach would need more granularity than simply life/non-life liabilities to work, and would need to take diversification and risk mitigation into account. Other GFIA members believe that the framework could be based on asset and liability factors, as the Generic Example suggests.

Comments on key Risks Addressed (para 24-28)

- We agree that liability and asset risks, and also ALM should somehow be incorporated into the factors/framework.
- The impact on overall risk profile of key risk mitigation mechanisms such as asset-liability management, profit sharing, participation features, hedging and re-insurance should also be recognised in the framework. Without such reflection, an accurate and/or comparable view of risk cannot be achieved.

Comments on Other considerations (para 29-34)

- We welcome the recognition in **paragraph 29** of the fact that the Basel III leverage ratio is not appropriate for G-SIIs.
- We believe limiting the number of risk measures and factors as mentioned in **paragraph 30** is premature; the field test exercise will reveal which level of granularity is needed to ensure a comprehensive assessment of the risk profile.
- Care should therefore be taken when trying to apply pre-calibrated factors from the Basel III framework, as suggested in **paragraph 31**. We would strongly argue against such an approach as the insurance business model is significantly different from the banking business model and therefore risk indicators should be tailored and calibrated to appropriately reflect this difference.
- Diversification should be accounted for implicitly or explicitly, in order to ensure the BCR appropriately captures the risks that the insurance company is exposed to on a consolidated basis.

Comment on Conclusion and next steps (para 35-38)

Chapter 3: Context
General comments on Context
No comments

Comments on background (para 39-43)
No comments

Comments on The BCR mandate (para 44-47)
No comments

Comments on Scope of application (para 48-49)

- Off-Balance Sheet exposures, as indicated in **paragraph 48**, should be considered only if material. At the consolidated level we do not expect many cases where these will be material. Where off-balance sheet exposures are included then associated off-balance sheet assets merit equivalent consideration.

Comments on Principles (para 50-53)

- We generally agree with the principles outlined in this sub-section and support the IAIS' aim to strike a balance between the various (and often conflicting) objectives. We believe that the approach taken can achieve the objectives of simplicity and comparability, whilst greater risk-sensitivity could be ensured through sufficient granularity of the factors. However, we continue to stress that it is important for a globally consistent methodology to reflect local jurisdictional risk characteristics and operating environments.

Comments on Role of a "basic" BCR (para 54-61)

- Where **Paragraph 58** mentions internal models, there is an implication that they increase complexity and make supervision more challenging. This runs contrary to the view of many in the industry, that internal models can be proper tools for measurement of insurers' risk exposures when appropriately designed and supervised.
- **Paragraph 58** notes that a straightforward backstop is "inherently less reflective of risk profile differences between G-SIIs […] given that the G-SII population is not as diverse as the whole insurance sector, it is not anticipated this will be an issue." In this context the GFIA notes that the diversity and complexity that will need to be captured by the ICS is significantly higher.
- Though we understand that this will be examined during field testing, we hope that the IAIS takes into consideration that calibration of the BCR factors at an inappropriately high level could have a knock on impact on policyholders by requiring higher capital, and may distort the principle of a level playing field.

Comments on Qualifying capital resources (para 62-64)

- As indicated in **paragraphs 62 and 63**, further guidance on capital resources to serve the BCR purpose is given under ComFrame - Module 2. However, as highlighted in our response to the ComFrame consultation in December 2013, we have strong concerns around the definitions of core capital and additional capital, which we find as being far too strict. We continue to believe that tiering of capital is inappropriate at this stage. The focus for the BCR should instead be on total capital resources. Moreover, the IAIS itself considers Module 2 Element 5 as preliminary. We expect that it will be subject to major revisions as a result of the field test. This process is unlikely to be finalized until after adoption and implementation of the BCR.

Comments on Non-insurance activities (para 65)
No comments

Chapter 4: Comparability of valuations
General comments on Comparability of valuations (para 66-71)

- We can support economic valuation **as defined in ICP14**, which recognises that this covers both the use of market valuation and amortised cost valuation. We emphasise, that any valuation approach must look at assets and liabilities together, making sure that long-term and illiquid characteristics of both assets and liabilities are appropriately reflected in the measurement approach and therefore the measurement system does not introduce artificial volatility into BCR measures.
- The BCR framework should acknowledge the loss absorbing capacity (risk mitigating features) of certain products, like adjustable products and participating policies, as well as reinsurance.

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Comments on Valuation of liabilities – current estimates (para 72-76)

- Although discounting is not explicitly addressed in the BCR proposal, if discounting is part of the final standards, it is crucial that the discount rate used to determine the (present) value of technical provisions reflects the illiquidity (and often long-term) characteristics of insurance liabilities, as well as the consequent reduced risk of losses from forced sales of corresponding assets. In this regard, when determining discount rates used for measurement of liabilities, due consideration should also be given to the specific context in each jurisdiction, potentially requiring the introduction of additional adjustments on interest rates or extrapolation measures.
- Equally, both top-down, as well as bottom-up approaches for deriving best estimates should be possible, in order to ensure that the valuation methodology correctly reflects the overall balance sheet and does not create artificial volatility or pro-cyclical behaviour.
- The BCR framework, in the valuation of liabilities, should take into account the impact of key management actions, such as discretionary payments and other profit sharing features which absorb losses
- As indicated under **paragraph 75**, risk margins, when calculated, should be treated as a component of capital resources for BCR purposes.

Comments on Valuation of assets (para 77-81)

- Where an economic balance sheet is taken as the basis for deriving the BCR, there should be no exclusion of assets (as suggested in **paragraph 81**) nor adjustments to best estimates instead of technical provisions (as suggested in **paragraph 105**).

Chapter 5: Factor-based approach
General Comments on Factor-based approach

- Given both the limited time-table and the temporary nature**, GFIA supports a factor based approach as the basis for the BCR.** A key challenge will however be to find a reasonable trade-off between simplicity and accuracy in order to serve as an appropriate basis for the HLA. The reasonable level of the balance to be achieved should be considered through the field testing process.

Comments on Context (para 82-95)

- We agree, as highlighted in **Paragraph 90** with the importance of aligning “incentives to G-SIIs consistent with their risk management activities and decisions.” However, risk management activities and decisions are strongly influenced by internal policies and existing regulatory valuation and capital requirements. Given the intended simplicity and aim of the BCR to be a “basic “ capital measure, it should be ensured that the BCR does not act as a driver on risk management, incentivise poor risk management, or send misleading signals to the market. As indicated in **paragraph 91**, implicit allowances for diversification benefits would be reflected in the calibration of factors.

Comments on Major risks (para 96-103)

- Our comments here largely reiterate our comments on paragraph 24-28.
- We agree that liability and asset risk, and also ALM should be incorporated into the factors/framework.
- The impact on overall risk profile of key risk mitigation mechanisms such as asset-liability management, profit sharing, participation features, hedging and re-insurance should also be recognised in the framework. Without such reflection, an accurate and/or comparable view of risk cannot be achieved.
- As mentioned in **paragraph 100**, proxies for current estimate calculations should indeed be considered in the field testing.

Comments on Factor-based approach calculation (para 104-107)

- Where an economic balance sheet is taken as basis for deriving the BCR, there should be no exclusion of assets (as suggested in **paragraph 81**), nor adjustments to current estimates instead of technical provisions (as suggested in **paragraph 105**).

Comments on level of granularity (para 108-111)
No comments

Comments on Generic example (para 112-115)

- Our comments here reiterate our comments on paragraph 21-23.
- It is difficult to judge if the proposed generic example will work in practice until measures for the Liability, Asset, NTNI and Other categories are determined. Alongside this approach, some GFIA members believe that other approaches to the one proposed in the generic example should also be considered. For example it may be possible to base a simple BCR on a system where the total liabilities are split into segments, with factors applied to the liabilities in each segment. The factors applied to the liabilities would be calibrated to implicitly or explicitly reflect liability and asset risks, and also ALM. Such an approach would need more granularity than simply life/non-life liabilities to work, and would need to take diversification and risk mitigation into account. Other GFIA members believe that the framework could be based on asset and liability factors, as the Generic Example suggests.

Comments on Field testing process (para 116-123)

- We believe the field-testing should allow for the greatest possible diversity of participation and seek to limit the workload on participating companies by allowing estimations, proxies and generally accept a best efforts approach. This includes for example allowing, insurers to report their undiscounted central estimates for claim liabilities as reported under national GAAP or equivalent, rather than best estimates.
- The field test design needs to be sufficiently flexible with regard to the granularity of segmentation to allow the testing of different approaches as indicated in our comments on the Generic Example. In particular this means gathering data on liability segments more granular than life/non-life.
- The inclusion of ComFrame within the field testing risks insufficient attention being given to the development of the BCR and its valuation basis. Given the limited timeframe to complete the BCR, we recommend that the IAIS focus only on this during the initial field testing.
- The GFIA urges the IAIS to organise the field testing in a way which allows for firms to assess the quantitative impact of the BCR, and consequently allow for further refinement and testing. This would require going beyond data collection exercises, and would include testing of at least one of the models. This would help ensure that the balance between simplicity and accuracy is appropriately struck.

Comments on Next steps (para 124-126)
No comments