



EIOPA-IRSG-14-10

**IRSG Response to IAIS Consultation Paper on  
Basic Capital Requirements (BCR) for Global  
Systemically Important Insurers (G-SIIS)**

## **Executive Summary**

The IRSG supports the development of the global capital standards with the purpose to ensure increased resilience of the global financial system. In our view, the Solvency II is the most modern risk-sensitive prudential regime finalized and implemented after the financial crisis and should provide guidance to the development of new global capital requirements.

The IRSG recognizes the considerable challenge facing the IAIS in terms of resolving trade-offs between simplicity, comparability and risk sensitivity in the design of the BCR and subsequently the ICS. We understand that having simplicity as a target for the BCR design has resulted in a decision not to explicitly recognize diversification effects nor the impact of asset-liability matching (the latter being of key importance for life insurers). As a result of this approach, the BCR is not very reflective of the risk profile of any individual G-SII and, as a consequence, the calibration level should be carefully considered. This should be done to avoid interference with sound risk management principles and unfairly discriminate against G-SIIs with substantial operations in both life and non-life insurance.

The IRSG believes that the valuation principles and framework should be finalised as soon as possible given it provides the basis for determining exposure measures for the BCR as well as the qualifying capital resources against which the capital requirement is measured. In our view, it should be made clear, that all companies will be required to apply a consistent valuation approach for assets and liabilities. It should also not be left ambiguous as to whether jurisdictions will be allowed to apply significantly different valuations. Furthermore, the IAIS should clarify that capital charges imposed via national legislation might be above the HLA uplift and therefore enough to mitigate the systemic risk, in which case there would effectively be no capital increase.

The IRSG stands ready to further contribute to IAIS work to develop of the global capital standards and share experience its members have gained throughout the development of the Solvency II framework.

## **Q1 - General comments on IAIS Executive Summary**

The EIOPA Insurance & Reinsurance Stakeholder Group appreciates the opportunity to comment on the IAIS proposal for the Basic Capital Requirements (BCR).

Although the proposal is applicable only to global systemically important insurers (G-SIIs), we believe it is of wider relevance given the BCR is likely to inform the development of the risk based global Insurance Capital Standard (ICS) applicable to Internationally Active Insurance Groups (IAIGs) from 2019. Indeed it is possible that delays in the formulation and agreement of ICS may mean that BCR persists for much longer.

We support the development of the global capital standards with the purpose to ensure increased resilience of the global financial system. Solvency II is the most modern risk-sensitive prudential regime finalized and implemented after the financial crisis and should provide guidance to the development of new global capital requirements.

We recognize the considerable challenge facing the IAIS in terms of resolving trade-offs between simplicity, comparability and risk sensitivity in the design of the BCR and subsequently the ICS.

We understand that having simplicity as a target for the BCR design has resulted in a decision not to explicitly recognize diversification effects nor the impact of asset-liability matching (the latter especially important for life insurers). As a result the BCR is not very reflective of the risk profile of any individual G-SII and the calibration level should be carefully considered. This should be done to avoid interference with sound risk management principles and unfairly discriminate against G-SIIs with substantial operations in both life and non-life insurance.

The proposed valuation approach of combining a market valuation of assets with a simple risk free discount of liabilities (taking into account to some degree the bond spreads) with essentially no link to the asset portfolio has been made to avoid complexity but, as acknowledged in the consultation document, will not correctly reflect the long-term nature of the insurer's business. This can lead to a significant exaggeration of the volatility of balance sheet, and therefore own funds, especially during financial crisis. In particular, the risk mitigation benefits of asset liability matching, profit sharing and diversification are not explicitly reflected in the BCR design. Whether or not this causes problems by resulting in BCR/HLA measures are unmanageable because of high undue volatility resulting in pro-cyclical behaviour will depend on the level of calibration of the BCR and the design of the HLA.

The valuation principles and framework should be finalised as soon as possible given it provides the basis for determining exposure measures for the BCR as well as the qualifying capital resources against which the capital requirement is measured. It should be made clear, that all companies will be required to apply a consistent valuation approach for assets and liabilities. It should not be left ambiguous as to whether jurisdictions will be allowed to apply significantly different valuations.

We are concerned that the principle that "G-SIIs should hold higher levels of capital than would be the case if they were not designated as G-SIIs" could be misunderstood to mean the G-SIIs should always hold more than required under their local requirements. The IAIS should clarify that capital charges imposed via national legislation might be above the HLA uplift and therefore enough to mitigate the systemic risk, in which case there would effectively be no capital increase.

We recommend that the following areas are further considered and clarified:

- The purpose of the BCR and the supervisory action resulting from a breach
- The target level of capitalization i.e. the risk measure underpinning the BCR
- The specification and transparency of the overall level of the BCR (the alpha scalar)
- The valuation principles and framework
- In the BCR formula clarification is required e.g. which assets should be excluded from the asset exposure base in particular for unit linked business and participating life insurance business; treatment of other asset classes than credit and equity
- The qualifying capital resources to cover the BCR, HLA and later ICS
- The concept of the Margin Over Current Estimate, especially its interaction with/how it is embedded in the measurement rules/valuation principles and the treatment of MOCE as qualifying capital resources

- The relationship between the BCR and HLA including the fact that HLA should only be imposed on systemically risky activities (i.e. activities that create additional risk for the global financial system).

Prior to introduction of the BCR, HLA and eventually the ICS it is vital that potential unintended consequences are considered and the capital requirements are properly tested, not only at one point in time, but also in more extreme/ stressed conditions including a recurrence of 2007/2008 and 2011.

## Q2 - Comments on Background & Mandate

11) The paper clarifies that the Basic Capital Requirement will act as a foundation for the Higher Loss Absorbency (HLA) which together will form the consolidated group-wide capital requirements. The target level of capitalization for the BCR and BCR+HLA respectively should be clearly stated to enable comparison by firms with existing regulatory and internal capital measures e.g. Economic Capital and for European players Solvency II. In addition it would be of interest to state the anticipated supervisory action upon a breach of the respective levels.

(12) We welcome the intention for confidential reporting although it is expected that there likely will be pressures on the G-SIIs to disclose their BCR coverage ratio in due course.

(13) We are not convinced that the BCR can inform the development of the more risk sensitive ICS given the BCR is relatively simple and crude e.g. not taking into account diversification effects, not reflecting the impact in the capital requirement of ALM or other risk management/ risk mitigation activities.

## Q3 - Comments on BCR Design

(17) We acknowledge that the BCR will be calculated on a consolidated group-wide basis, its composition of three segments and the use of Basel III measures for the banking component. Capital requirements regarding non-insurance financial activities should be included using the capital requirements as defined under (future) sector specific global requirements. Until those requirements have been developed the final inclusion in the G-SII standards cannot be settled.

(19) We understand that having simplicity as a target for the BCR design has resulted in a decision not to explicitly recognize diversification effects nor the impact of asset-liability matching (the latter especially important for life insurers). As a result the BCR is not very reflective of the risk profile of any individual G-SII and the calibration level should be carefully considered in order to avoid interference with sound risk management principles and unfairly discriminate against G-SIIs with substantial operations in both life and non-life insurance.

(19) It is not sufficiently clear from the Consultation Document in which way the alpha scalar should/will be determined, whereas the process for determining the factors for the segments within the BCR has been described. Given the enormous importance of alpha scalar for the BCR required capital one would expect more transparency on this.

(20) We support the use of ‘current estimates’, which appear to be equivalent to the principles underlying ‘best estimate’ under Solvency II although with a different approach to discounting. We would encourage a consideration of the naming convention i.e. the ‘current estimate’ could be interpreted as current practice whereas it is reflecting an unbiased best estimate. Therefore in discussing methods for valuation of liabilities, the IAIS should separate the two issues – a) the method of projecting liability cash-flows and b) the method of discounting those projected cash-flows into a single valuation figure. We support strongly that the liability cash-flows be projected based on updated (“current”) assumptions and forecasts e.g. the timing, frequency and severity of claims; direct and indirect expenses; inflation, policyholder behaviour. The method for discounting is a more complex discussion because of the challenge of having to design a method that is simple, yet avoids exaggerated exposure to market volatility by capturing the long-term nature of the business and Asset-Liability Matching.

(20-21) We recommend that it is made clear that all companies will be required to apply consistent valuation approach for assets (and liabilities). It should not be left ambiguous as to whether jurisdictions will be allowed to apply significantly different valuation of their balance sheets.

(20-23) The valuation principles and framework should be finalised as soon as possible given it provides the basis for determining exposure measures for the BCR as well as the qualifying capital resources against which the capital requirement is measured.

A simplified valuation approach has been proposed, combining a market valuation of assets with a very simplified method for setting the discount rate, with no link to the asset portfolio for liability valuation. As indicated in the consultation document, this will not correctly reflect the long-term nature of the insurer’s business and ignores the economic benefits of asset liability matching and profit sharing. This will lead to a significant exaggeration of the volatility of balance sheet, and therefore own funds, especially during periods of financial market stress. Whether or not this causes problems by resulting in BCR/HLA measures which are unmanageable because of their high undue volatility resulting in pro-cyclical behaviour will depend on the level of calibration of the BCR and design/calibration of the HLA. While we recognize the aim of keeping the BCR as simple as possible, care must be taken to avoid unintended consequences and we believe further consideration should be given to recognizing profit sharing in the design of the BCR.

(22-23) The goal of adjusting the capital resources is not clear. For example it is not clear what the adjustments are and how sectorial rules may be applied to capital resources which are then added and compared to the total required capital for the group.

#### **Q4 - Comments on Next Steps**

(26) The timetable appears to be ambitious. In order not to constrain the development of the HLA and the ICS it is important to open the BCR for further refinements.

Ideally prior to finalising the BCR but certainly, prior to introduction the BCR, HLA and eventually the ICS, it is vital that potential unintended consequences are considered and the capital requirements are properly tested, not only at one point in time, but also in more extreme/stressed conditions including a recurrence of 2007/2008 and 2011.

## Proposed BCR Approach

### **Q5 - General Comments on Proposed BCR Approach**

(28) It is not clear from the text if the current proposal is exhaustive in covering all on- and off-balance sheet items or inclusion of further risks is to be expected in particular relating to any off-balance sheet items.

(29) We support that the explicit integration of other risk areas such as operational and liquidity risk are not included within the scope of the BCR.

### **Q6 - Comments on Application of BCR**

(30-33) See answers to section 2.1.

### **Q7 - Comments on BCR ratio**

(34) See answers to section 2.2.

### **Q8 - Comments on Required Capital**

(35) See answers to section 2.2.

### **Q9 - Comments on Insurance**

(36-37) Comments on the proposed calibration and categorization:

- It is unclear how unit linked business should be treated
- Clarification is required in the BCR formula on which assets should be excluded from the asset exposure base in particular for participating life insurance business and unit linked business
- Further consideration should be given to the recognition of profit sharing
- Considering that variable annuities include often substantial embedded derivatives, it does not appear suitable to apply simply the double factor compared with participating products, which might often as well include minimum guarantees, but which are usually only in the money in extreme market scenarios
- We question if the non-life classification sufficiently take account of catastrophe elements
- The gap between non-investment grade credit and equity looks wide and could have the effect of distorting asset choices. It would be desirable to explore any potential effects on investment markets

With HLA not defined yet, it is difficult to judge the impact of the overall framework i.e. BCR+HLA as the binding capital requirement.

### **Q10 - Comments on Non-insurance**

(40) We support the use of Basel III measures for BCR in order to create a level playing field with banking groups.

(41) IAIS might wish to consider defining a materiality concept for the inclusion of non-material non-regulated activities in the BCR.

(42) It is important that the future global capital requirements agreed for the asset management sector are reflected in the BCR framework to maintain a level playing field.

### **Q11 - Comments on Indicative capital allocation**

(44) The proportion attributable to assets looks high. The IAIS should look closely at what is driving this at the level of individual firms, including to what degree ALM risk is addressed implicitly.

### **Q12 - Comments on BCR principles**

(45) No comments.

## **Qualifying Capital Resources**

### **Q13 - General Comments on Qualifying Capital Resources**

(46-47) Clarity is needed on what the adjustments are and how sectorial rules may be applied to capital resources for other sectors, which are then added and compared to the total required capital for the group.

### **Q14 - Comments on Tiering of Capital Resources**

(48) We encourage IAIS to consider the tiering of capital together with the different components that it will apply to: BCR, HLA and upcoming ICS requirements.

### **Q15 - Comments on BCR Ratio and HLA requirement**

(49) The tiering of capital used within the Solvency II framework could be considered.

(51) The fact that the HLA and at least 50% of the BCR has to be covered by core capital is reasonable.

### **Q16 - Comments on Further work potentially affecting the current definition of Core Capital**

(52) The Margin Over Current Estimate (MOCE) appear to be a type of “risk margin”, however it is not stated what the overarching principle is i.e. should the current estimate + the MOCE be equivalent to a market consistent value?

General comment for further discussion of the Margin Over Current Estimate (MOCE): What is described here seems to be what is called “risk margin” within the valuation concept of Solvency II as well as in the context of the valuation concept discussed for the final IFRS on insurance contracts. One decisive difference is the fact that no measurement principle is explicitly mentioned as a basis for the MOCE.

If the IAIS require the MOCE to be calculated effort should be made to align with other terms used for example within IFRS to avoid creating additional complexity solely caused by wording.

The concept of the Margin Over Current Estimate should be clarified, especially its interaction with/how it is embedded in the measurement rules/valuation principles and the treatment of MOCE as qualifying capital resources

### **Q17 - Comments on G-SII capital resources**

(53-54) No comments.

## **Market Adjusted Valuation Approach**

### **Q18 - General Comments on Market Adjusted Valuation Approach**

(55) We support the comparability principle across jurisdictions and between the capital requirements and the capital resources. This implies that the valuation rules must be prescribed uniformly as part of the framework.

### **Q19 - Comments on Valuation principles**

(56-60) The valuation principles and framework should be finalised as soon as possible given it provides the basis for determining exposure measures for the BCR as well as the qualifying capital resources against which the capital requirement is measured. Any subsequent change in the valuation framework would require a recalibration of the capital requirement.

For further comments see answers to section 2.2

## **Impact on G-SIIs and potential G-SIIs**

### **Q20 - General Comments on Impact on G-SIIs and potential G-SIIs**

No comment.

### **Q21 - Comments on Calibration Level and Capital Resources**

(62) The calibration level should be carefully considered in order to avoid interference with sound risk management principles and unfairly discriminate against G-SIIs with substantial operations in both life and non-life insurance.

(62, 64) It would be desirable to understand the degree of dispersion about the averages quoted and what might be the reason for such dispersion.

### **Q22 - Comments on Reporting and Applicability**

(66) We welcome the intention for confidential reporting although it is expected that there likely will be pressures on the G-SIIs to disclose their BCR coverage ratio in due course.

We support that the IAIS will review the suitability of the BCR factors over time. Clear governance and targets for the recalibration should be communicated to avoid arbitrary update and unpredictability for the G-SIIs which would make capital management difficult.



## **Q23 - Comments on Implementation of the BCR**

(67) Attention should be made on the enforcement to ensure a level playing field for the G-SIIs.

## **Communication plans and next steps**

### **Q24 - General Comments on Communication plans and next steps**

(68-71) The timetable appears to be ambitious. In order not to constrain the development of the HLA it is important to open the BCR for further refinements.

### **Q25 - Comments on Annex A – BCR Principles**

No comments.

### **Q26 - Comments on Annex B – Glossary**

No comments.

### **Q27 - Comments on Annex C – Insurance Liabilities and Reinsurance Recoverables**

We agree with the “substance over form” approach.

This is a good summary of the principles which should be associated with the calculation of a sound current estimate.

The title ‘Methodology for calculation of current estimate’ could be slightly misleading as it is the principles/ concepts that are described rather than the actual calculation method itself.

We would encourage a consideration of the naming convention to avoid a risk that the ‘current estimate’ is misinterpreted as current practice whereas it is actually reflecting an unbiased best estimate.

Comments re recognition: To recognize an insurance contract when the insurer “becomes party to” it causes a sizeable technical burden as insurers need to investigate when the contract has formally been concluded. The provision differs from the future IFRS Insurance Contracts and may also be different according to local laws.

The definitions of contract boundaries may lead to counterintuitive results for life insurance contracts as they are in principle the same as in Solvency II, however lacking detail and as a consequence different in impact. We would welcome an alignment between the frameworks.

IAIS specified discount curves: The valuation concept described here is not that far away from what is required for the purpose of the Solvency II balance sheet. The question arises why some parameters for the calculation of the current estimate of insurance liabilities are drafted differently, e.g. the discount rates by currency is based on curves (for swaps and government bonds) which are flat after 30 years rather than applying a Ultimate Forward Rate. We would encourage IAIS to use Solvency II, as guidance to the development.

We would encourage the IAIS to analyse the impact of the choice of discount curves on the expected volatility in the balance-sheet and the overall stability of the BCR ratio.

### **Q28 - Comments on Annex D – Qualifying Capital Resources - ComFrame**

No comments.

### **Q29 - Comments on Annex E – Guidance for specific balance sheet items**

Specific balance sheet items are currently foreseen to be recognized using GAAP. We advocate a fair value option for those assets and liabilities. Property should be valued at fair value as it otherwise would be inconsistent with the valuation of invested assets which according to the proposal is based on fair value.

### **Q30 - Comments on Annex F – BCR Formula and Derivation**

See comments under section 2 and 2.2.

### **Q31 - Comments on Annex G – Mapping table: BCR category to field testing data collection**

No comments.

### **Q32 - Comments on Annex H – Sensitivity Analysis**

No comments.