actuarial association of europe
advising · achieving · engaging

ACTUARIAL ASSOCIATION OF EUROPE
ASSOCIATION ACTUARIELLE EUROPÉENNE

1 PLACE DU SAMEDI
B-1000 BRUSSELS, BELGIUM
(+32) 2 201 60 21
INFO@ACTUARY.EU
WWW.ACTUARY.EU

15 August 2022

AAE response to IAIS Public consultation on draft criteria that will be used to assess whether the Aggregation Method provides comparable outcomes to the Insurance Capital Standard

Text entered in response to Q33 General comment on the draft criteria to inform the criteria that will be used to assess whether the Aggregation Method provides comparable outcomes to the ICS.

The Actuarial Association of Europe is thankful for the opportunity to provide comments and remarks to the International Association of Insurance Supervisors (IAIS) on the draft criteria to assess whether the Aggregation Method (AM) provides comparable outcomes to the Insurance Capital Standard (ICS). Our Assessment comes to very similar conclusion than Insurance Europe's. We use similar language to describe our findings.

The Actuarial Association of Europe recognises that IAIS is developing the ICS with the aim of "creating a common language for supervisory discussions" with the "ultimate goal of a single ICS that includes a common methodology by which one ICS achieves comparable – i.e., similar but not identical – outcomes across jurisdictions" and that its objective is "to enhance global convergence among group capital standards".

The Actuarial Association of Europe supports the aim of the proposed High-Level Principles and associated draft assessment criteria to take a quantitative approach to the comparability assessment. A rigorous, quantitative, and robust assessment is essential to avoid that the AM gives raise to two different standards in supervision that appear equivalent by considering the AM equivalent. This could have significant consequences on, for example, any future assessments under the financial sector assessment program (FSAP) with the jurisdictions that ultimately implement the ICS being under a much more demanding set-up and held to much higher standards than those implementing the AM. The risk of having a de facto double standard in the implementation phase needs to be averted by a robust, quantitatively substantiated comparability assessment.

For this to be achieved, the following key elements need be reassessed and potentially rectified before the criteria are finalised and the comparability assessment begins:

1. The AM can only be considered as producing comparable outcomes if any group's prescribed capital requirement (PCR) under the AM would be breached at similar points under all possible financial market and insurance risk scenarios as its PCR under the ICS, leading to much the same supervisory outcomes.
2. All criteria are essential, and all should be sufficiently met to achieve comparability.
3. Short-term market fluctuations are a reality that must be included in the assessment.
4. It is vital to compare outcomes under a suitably wide range of scenarios.
5. A suitable sample of real company data should be included in the study. In addition, it is necessary to apply scenarios to model companies to explore the space of possibility appropriately.

6. The criteria contain language that lends itself to a potentially wide range of interpretations. To facilitate a robust assessment and an objective final conclusion IAIS should clarify in advance what will guide the IAIS when drawing a final conclusion.
7. The potential equivalence of the AM needs to be reassessed on a regular basis to consider changes in the AM, ICS, and the risks for which capital is required.

Comments on criteria for High-Level Principle 1

HLP 1: AM and ICS results are significantly correlated in that they change similarly in response to changing economic and financial market conditions over the business cycle, not short-term market fluctuations, although the quantum of change may differ.

Criterion 1.1 The ICS and AM results are significantly correlated, changing similarly in response to changing economic and financial market conditions over the business cycle (as per the sensitivity analysis referenced in criterion 1.3) excluding short term market fluctuations.

Comments in the explanatory note:

- *With respect to the reference to "significantly correlated", the assessment team will undertake a technical analysis of the degree of correlation between the AM and ICS results; the IAIS will then apply judgment in considering whether the degree of correlation is sufficient to meet the comparability outcomes.*

The Actuarial Association of Europe is concerned about the vague language of "materially correlated". No matter how "materially correlated" is defined, this will not ensure that the PCR under the AM would be breached at similar points under all possible financial market and insurance risk scenarios as its PCR under the ICS. Moreover, short-term market fluctuations are a reality that must be included in the assessment. The term "over the business cycle" seems to aim at some averaging over time. This would not be appropriate. The PCR is either breached nor not breached at a particular point in time.

Criterion 1.2 In assessing whether the results are significantly correlated, correlation of results is analysed over the business cycle, considering both direction and quantum of change, although the quantum of change may differ. The correlation analysis is based on multiple points in time over the business cycle (including the sensitivity analysis referenced in criterion 1.3) to avoid false indications due to short-term market fluctuations, but the results will be assessed over the business cycle as a whole.

a This analysis considers direction and quantum of change together over the business cycle to understand how the ICS and AM respond to changing economic and financial market conditions.

Comments in the explanatory note

- *With respect to references to "the business cycle" and "short-term market fluctuations", this will be an issue that the IAIS will return to after the development of scenarios for the sensitivity analysis, to check whether through the development of the scenarios these concepts are sufficiently clear, or whether further work is needed on definitions.*
- *Regarding "quantum of change", draft criterion 1.2 a. reflects that the analysis considers direction and quantum of change together over the business cycle to understand how the ICS and AM respond to changing economic and financial market conditions.*

The Actuarial Association of Europe is concerned about Criterion 1.2 as it will not ensure that the PCR under the AM would be breached at similar points under all possible financial market and insurance risk scenarios as its PCR under the ICS. It seems a pure co-movement analysis.

Moreover, short-term market fluctuations are a reality that must be included in the assessment. The freedom to choose and exclude points "over the business cycle entails the potential to suppress "short term fluctuations".

Criterion 1.3 Each Volunteer Group in the representative sample conducts sensitivity analysis using the same scenarios (representing different economic and financial market conditions over the business cycle) for both the ICS and AM.

- *a* *For AM, sensitivity analysis is conducted by legal entities representing at least two-thirds of total AM required capital, with legal entities from at least three jurisdictions. In determining the two-thirds level, material legal entities (ie those with the largest total AM required capital) should be included. For the remaining one-third, an approximation or simplified approach may be used to determine the impact of the sensitivity analysis. This allows for a more proportionate approach through the use of a materiality threshold.*
- *b* *For ICS, the sensitivity analysis is conducted on the consolidated group.*
- *c* *In addition to the data on the ICS and the AM based on current market conditions (the "base scenario"), Volunteer Groups in the representative sample provide ICS and AM data for a limited number of additional scenarios representing different points in time, which are intended to help inform the analysis of correlation of results over the business cycle.*
- *d* *These additional scenarios are standardised and differentiated according to business models. For life business, the scenarios include changes to equity values, interest rates, credit spreads, mortality rates and lapse rates. For non-life business, the scenarios include changes appropriate to the nature of the business, like changes on non-life insurance risks.*
- *e* *Volunteer Groups also provide the following information to inform the analysis:*
  - *i.* *a description of an economic and/or underwriting scenario that would cause AM capital resources to become less than AM capital requirement at the group level and an estimate of AM capital resources and capital requirement under this scenario, as well as the corresponding impact on the ICS.*
  - *ii.* *a description of an economic and/or underwriting scenario that would cause ICS capital resources to become less than ICS capital requirement at the group level and an estimate of ICS capital resources and capital requirement under this scenario, as well as the corresponding impact on the AM.*

The Actuarial Association of Europe strongly requires comparing outcomes under a suitably wide range of scenarios. The full range of potential scenarios must be sufficiently sampled. This testing in necessary, and it is different in nature from the "reverse Stress testing" approach in Criterion 1.3.e. If the breach scenarios differ in Nature, i.e., by more than just severity, outcome equivalence seems challenging, if not impossible. If the breach scenarios differ predominantly by severity, there should be a universal mapping of the breach severity under the AM and under the Standard Method to ensure outcome equivalence.

Comments on criteria for High-Level Principle 2

HLP 2: Individual elements of a group solvency approach, ie valuation, capital resources and capital requirement, will be analysed. However, the decision on comparable outcomes will consider the elements in totality.

The following will be assessed in undertaking the analysis of the individual elements:

- *The AM captures the same underlying risks as the ICS, even if this is achieved differently within the quantitative calculation of the group capital requirement. The overall AM capital requirement and ICS capital requirement provide a similar level of solvency protection.*
- *The overall quality and eligibility of capital resources allowed in the AM is similar to the ICS and is assessed based on the same five key principles*

identified for ICS capital resources: loss-absorbing capacity, level of subordination, availability to absorb losses, permanence and absence of encumbrances and mandatory servicing costs.

Criterion 2.1 *When carrying out the analysis of individual elements of a group solvency approach, ie valuation, capital resources and capital requirement, prudence in one element may be used to offset less prudence in another element. The analysis should consider interaction between valuation (eg insurance liabilities), capital resources and capital requirement.*

The Actuarial Association of Europe strongly agrees that the assessment should be done at least on the level of individual elements. While it seems clear what "more or less prudent" means for each individual element in each scenario, it seems very challenging to define "offset" in any other manner than requiring a resulting immaterial impact on required and available capital.

Criterion 2.2 *The AM captures the same underlying risks as the ICS. To this end, an analysis of risks is performed to understand and determine how all of the risks covered in the ICS are captured in the AM calculation. This could be either an explicit risk charge (taking into account different risk groupings), prudence embedded in valuation (ie accounting conservatism) or other such quantitative measures (eg scalars). In addition, any material risks captured in the AM, but not in the ICS, should be disclosed.*

The Actuarial Association of Europe welcomes that the same risk should be covered – it is a necessary precondition of outcome equivalence. We welcome transparency on the risk coverage.

Criterion 2.3 *The analysis includes whether the overall AM capital requirement provides a similar level of solvency protection as the ICS*. As part of this analysis, the proportion of non-risk-based regimes as determined by the AM represents less than 5% of available capital.*

** The ICS has a target calibration of 99.5% Value at Risk over a one-year time horizon. The AM capital requirement is computed as the aggregation of scaled risk-based legal entity capital requirements that have a target calibration of at least a 0.5% probability of default.*

The Actuarial Association of Europe notes a 99.5% VaR Including an end of year MOCE is very much different than a 0.5% probability of default. If would need specific analysis to assess, if this might lead to a similar level of solvency protection.

Criterion 2.4 *The overall quality and eligibility of capital resources allowed in the AM is similar to the ICS for the representative sample. This determination is made by considering the following:*

a. An analysis of capital elements other than financial instruments is performed to determine how the capital resources recognised in the ICS are treated in the AM. Any capital elements recognised in the AM, but not in the ICS, should be disclosed.
b. An analysis of deductions from ICS capital resources is performed to determine how the AM treats such items. This could take the form of non-admitted assets that have already been removed from the entity level balance sheet.
c. The financial instruments recognised in the AM are assessed considering the same five key principles identified for ICS capital resources: loss-absorbing capacity, level of subordination, availability to absorb losses, permanence and absence of encumbrances and mandatory servicing costs.
d. The capital composition limits in the AM are compared to those of the ICS.

The Actuarial Association of Europe agrees on the importance of the recognition of capital instruments. Especially, when it comes to senior debt instruments, the differences between "default" and "solvency", see Criterion 2.3, can be quite pronounced.

Comments on criteria for High-Level Principle 3

HLP 3: The AM could be more but not less prudent than the ICS, which is being developed as a minimum standard.

Criterion 3.1 The AM triggers supervisory action on group capital adequacy grounds under similar conditions over the business cycle as the ICS showing that the level of solvency protection in totality could be more but not less prudent than the ICS.*

** A prescribed capital requirement (PCR) is a solvency control level above which the supervisor does not intervene on capital adequacy grounds, as defined in ICP 17.*

*a. For purposes of the analysis, the AM and ICS solvency ratios for individual IAIGs are used to understand when the AM triggers supervisory action compared to the ICS; however, the assessment will consider the results of the representative sample in totality. Additionally, to support this understanding, the analysis considers movements in capital resources and capital requirement (as well as their difference - ie excess capital) at different points in time to understand the drivers of the movements in solvency ratios. Material differences in these items (between the ICS and AM) are explained**.*

*** The explanation of differences will also take into account any changes made to the ICS in response to the public consultation on the final design of the ICS as a PCR*

The Actuarial Association of Europe stresses that outcome equivalence must entail that in all materially similar situations, materially the same supervisory action should be triggered. We doubt however, that a movement analysis, see Criterion 1.1 is suitable to achieve this goal. Especially the qualifications that come with the wording "over that business cycle" seem difficult to align with triggering supervisory action.

Comments on criteria for High-Level Principle 4

HLP 4: The AM and ICS use the same scope of the group, consistent with that set out in ComFrame.

Criterion 4.1 The scope of the group for the AM is determined as per ICP 23.2, which is the same as that for the ICS. In particular, all entities in the scope of the ICS calculation are also captured in the AM calculation.

The Actuarial Association of Europe stresses that this is a necessary condition to achieve outcome equivalence.

Comments on criteria on High-Level Principle 5

HLP 5: A representative sample of Volunteer Groups, covering a diversity of business models, provide both ICS and AM data under various economic and financial market conditions over the business cycle.

Criterion 5.1 The sample of Volunteer Groups providing both AM and ICS results is representative of the business models and risks of IAIGs headquartered in the US and other interested jurisdictions. Representativeness is determined separately for life and non-life operations (as per criterion 5.2) with composite groups being split between their life and non-life operations.

The Actuarial Association of Europe stresses that using a representative sample is a necessary condition to achieve outcome equivalence. Moreover, it seems necessary, to extent this set by model companies, as some IAIGs can and have changed their business mix substantially. Therefore, it is also necessary to reassess outcome equivalence on a regular basis to consider changes in the AM, ICS, and the risks for which capital is required.

Criterion 5.2 For purposes of the determination of representativeness:

a. *Volunteer Groups provide relevant and sufficient data for both the ICS and AM data collections necessary to assess the criteria.*
b. *Material geographical areas, as determined by the legal entity location, of US (or other interested jurisdictions) IAIGs are included in the representative sample including, as applicable, North America, Europe and South Africa, Japan, Asia and Oceania.*
c. *For life, in recognition of the more heterogenous nature of life operations, a relatively large sample is needed. For purposes of demonstrating representativeness, the analysis will consider the minimum ratio of total AM required capital of US (or other interested jurisdictions) IAIGs participating in both the ICS and AM data collections to the total AM required capital of all US (or other interested jurisdictions) IAIGs.*
d. *For non-life, in recognition of the more homogenous nature of non-life operations in some jurisdictions, a smaller sample is needed. For purposes of demonstrating representativeness, the analysis will consider indicators such as: material lines of business of non-life US (or other interested jurisdictions); similarity of investment portfolios; the correlation between the net loss ratios of the representative sample and the total net loss ratio for all US (or other interested jurisdictions) IAIGs; and the correlation between the solvency ratios of the representative sample and the solvency ratio for all US (or other interested jurisdictions) IAIGs.*
   For non-life, both IAIGs and other Volunteer Groups can contribute to the determination of representativeness (geographical areas and lines of business), when both AM and ICS results are provided.

The Actuarial Association of Europe agrees that these are necessary, yet not sufficient criteria, to achieve a representative sample to achieve outcome equivalence. Particularly the challenge to achieve a sufficient coverage of the entire conceivable space of IAIGs does not seem to be address adequately.

Criterion 5.3 The Volunteer Groups providing both AM and ICS data is stable or increases during the monitoring period.

The Actuarial Association of Europe agrees that this would be helpful to avoid other challenges.

Comments on criteria for High-Level Principle 6

HLP 6: The AM and ICS are similarly transparent in terms of facilitating understanding and comparability, within and across jurisdictions, of the group solvency position through public disclosure and reporting to group-wide supervisors.

Criterion 6.1 When introduced in ComFrame, IAIG capital reporting to group-wide supervisors and public disclosure requirements, including their content, granularity, and frequency, will also apply to the AM.

The Actuarial Association of Europe is not aware that any IAIG public disclosure requirements have yet been decided. We would therefor suggest rewording "If introduced in ComFrame …". We support, that the same requirement will apply to the AM. In case transparency would require, the reporting and potential disclosure requirement could also exceed to requirement for the Standard Method.

Criterion 6.1 The assessment considers preparatory work that shows evidence of a commitment to meet ComFrame public disclosure and supervisory reporting requirements, including, for example, relevant text in the AM Level 1 document.

Comments in the explanatory note:

- *Draft criteria have been developed with the perspective of being applicable to the candidate versions of AM and ICS as a PCR, as available at the time of the comparability assessment. The IAIS plans to discuss actions that could be taken, after the implementation of AM and ICS as a PCR, to ensure continuing comparability.*
- *The draft criteria have been developed with the view of defining representative samples of IAIGs providing both AM and ICS information. Representative samples will be determined so as to deliver robust and credible output.*

Response to consultation questions

Stakeholder feedback is sought on each criterion. (Note: the consultation tool provides a comment box for each individual criterion, as well as a general comment box).

In addition, the IAIS is seeking feedback on some targeted questions related to HLPs 1 and 5.

Please provide any feedback on the design and parameters of scenarios that the IAIS could use to conduct the sensitivity analysis envisaged in criterion 1.3 in order to adequately capture different economic and financial market conditions over the business cycle.

The Actuarial Association of Europe stresses that to ensure that the point in time of breaches and supervisory intervention are analysed, more extreme scenarios are necessary, as it is vital to compare outcomes under a range of scenarios. The additional scenarios mentioned in criterion 1.3 must include a wide range of market and other scenarios covering both periods of contraction and expansion, in particular those that have been experienced, including very high spreads, high and low (negative) interest rates, equity market crashes, pandemic situation, potentially rapid change of climate conditions, cyber-attacks, and potential change in worldwide economic collaboration, etc.