Consultation on Insurance Capital Standard as a Prescribed Capital Requirement

Survey response 1

Information

Please provide your information:
Name: - Monique Schuilenburg E-mail address: - moniques@actuary.eu Name of jurisdiction: - Europe Name of organisation: - Actuarial Association of Europe

Do you agree with your responses being made public on the IAIS website?
Yes

Section 3 - General Guiding Principles

1. Do you have comments regarding the general guiding principles of the ICS?
The ICS as a Standard and the corresponding Implementation Assessment must be considered and decided at the same point in time -The AAE appreciates the effort of the IAIS and its collaborators to develop and agree a complete modern, economic, risk-based solvency Standard. -Without the process and criteria that will be used to assess implementations of the Standard, it is impossible to form a view if the lack of rigor and consistency that are currently part of the candidate ICS standard will be harmfully constrain reasonable implementations of the ICS, like Solvency II, Solvency UK, or the Swiss Solvency Test SST. -We ask the IAIS to allow reassessing of the ICS Standard in light of the to-be-defined implementation Assessment. The current candidate ICS is materially lacking rigor and consistency The AAE appreciates the effort of the IAIS and its collaborators to develop and agree a complete modern, economic, risk-based solvency Standard. We note that a bespoke market-adjusted valuation standard has been defined. It only partly follows the only known consistent extension of the market valuation to insurance liabilities, i.e., replicate the insurance cash-flows to the extent possible by existing investment instruments with reliable market prices, cover the residual risky cashflow on a company level by capital resources to reach a desired safety level, and allocate the costs for the capital resources needed to secure the fulfilment of the liabilities during their lifetime back to the corresponding liabilities. However, -The cost of holding capital is not appropriately reflected in the MOCE. The MOCE is entirely ill-defined to an extent that it cannot even be rightsized by any calibration measure. -The duration of the liabilities is naturally an important determinant of the aggregated cost of capital – and it is not even among the parameters of the MOCE. -The definition of the MOCE tends to systematically underestimate the cost to produce long term commitments. This leads to premature transfer of policyholder funds to shareholders. It may lead to significant problems in winding-up -We note that the proposed MAV allows discounting at a rate above the risk-free market rate, i.e., at a spread. We note that the actuarial community is divided over the question, of whether it is possible to earn a risk-free return above the risk-free market rate, or if the so-called liquidity premium is a charge for the lack of diversification of credit defaults in a structural crisis. The latter implies that this choice of discounting exposes the sector to systematic risk in structural crisis. While there is some evidence for this view in the previous crisis situations, there is no final decisive proof. -We insist that reviewability clauses in life insurance contracts are a contractual right of the insurer and therefore increase the value of the contract on the insurers balance sheet (in case the net position is a liability: decrease the liability amount). Moreover, the risk reducing quality of this contractual right must be fully recognizable when determining the capital requirement. -We are missing clarity regarding going-concern versus winding-up valuation. We are missing an assessment if a winding-up gap could occur that is not covered by Tier 2 instruments. We applaud the total consolidated MAV balance sheet approach. In our view this is a valid complement to legal entity and branch supervision. However -While down-streaming of senior bond proceeds from holding company parent entities in the form of equity or structurally subordinated loans contributes to the insurance subsidiary's capital resources, it does not benefit the entire group, as the group internal equity contribution cancels out on a group basis. The externally raised funding (senior bond) is unable to absorb losses for purposes of the group. -While we recognize the importance of fungibility constraints for liquidity risk management, such constraints do not affect the consolidated group balance sheet. We therefore request to delete the exclusion of encumbered assets from T1 capital resources (L-1-60 lit b)). The distinguishing feature of T1 and T2 capital resources is its loss absorbency in a going-concern (T1) and the additional absorbency in winding up (T2). Encumbered assets are clearly loss absorbing in going concern. There may be a timing issue when they will become available. However, this is a liquidity restriction and not a capital restriction. It must be addressed in liquidity regulation – not in capital regulation. The current draft might not be implementable in many countries as it lacks inner logic and appropriateness. We are unable to comment in any detail on the calculation of capital requirements according to the standard method, as the calibration data and processes are not transparent to us. Moreover, we note the challenge that the risk profiles of IAIGs are intrinsically complex and bespoke, so that a general approach seems overly ambitious. However, -We have the impression that some calibrations, e.g., mortality and lapse, are on the conservative side, while others (market and credit) seem optimistic. -We see inconsistencies for equities and infrastructure investments that are valued at market prices, but that are not entering fully into the calculation of the capital requirement. This seems an instance of financial repression, which might lead to investment herding and destruction of diversification by sector wide asset concentration -We ask to consider that an IAIGs' Currency Risk must be measured against the basket of currencies in which the extreme loss is expected to occur. This is the only definition that incentivizes the IAIG to invest its capital resources in those currencies that are going to be needed to cover extreme losses, i.e., the use they are held for. The current method (measuring against the IAIG's reportion currency) incentivizes IAIGs to hold all capital resources in reporting currency. This jeopardizes policyholder protection systematically. -The Actuarial Association of Europe encourages the IAIS to provide greater transparency on the calibration of diversification in the candidate ICS and to seek comments on key aspects of the calibration prior to finalizing the ICS. There has been insufficient detail provided on the calibration of several risk factors, most notably the interest rate risk charge. The ICS was calibrated in a 'low for long' interest rate environment that has now radically changed in nearly all of the markets in which insurers conduct their activities. Generally, we believe that there has been insufficient consultation, discussion, and transparency into the ICS

calibration process. We urge the IAIS to offer opportunities for stakeholder discussion and feedback on the IAIS's calibration methods.
-The Actuarial Association of Europe refers to the results of the International Association of Actuaries "Working Party on Risk Aggregation with Correlation Matrices". They show clearly that dependent on marginal distributions and copulas involved, the linear correlations to be put into the standard methods' correlation matrix may differ by a factor 2.
-More specifically, 25% correlation for normal margins and copula produces the same effect as 12% correlation for more extreme (skewed) margins and copulas (more tail dependence). This indicates that applying a one size fits all correlation approach is materially inappropriate in the context of insurers risk absorbing the tail risks on this planet.
-The Actuarial Association of Europe urges the IAIS to fully consider the result of the International Association of Actuaries "Working Party on Risk Aggregation with Correlation Matrices".

Internal Models (full and partial) must be an integral part of the ISC Standard
-We welcome the proposal to allow firms to use internal models to identify their capital requirement subject to suitable controls.
-Internal models are indispensable to realistically reflect the risk profile of many IAIGs. Generally, insurance undertakings or groups applying for an internal model must prove that their risk profile cannot be realistically covered using the standard method, at least partly. In allowing and providing approval for using internal models, supervisory authorities implicitly confirm the inadequacy of the standard method for the undertaking/group. Therefore, the option to use internal models must be an integral part of ICS as it is indispensable to realistically reflect the IAIG's risk profile.
-To the extent they are used to determine the capital requirement, internal models must be eligible for valuation purposes, too. It is important to maintain consistency between valuation and risk measurement.
-Moreover, group wide supervisors should not "benchmark" internal model results against standard method results. Such comparisons are misleading, as the standard method does not realistically reflect the risk profile of the IAIG. Especially, corresponding capital floors must not apply as the standard method does not realistically reflect the risk profile of the IAIG.
-Finally, IAIGs that use an internal model should not report standard method results. Such a reporting would be misleading for report users, because the standard method does not realistically reflect the IAIG's risk profile. IAIGs should be allowed to use their own risk reporting granularity and structure as these are best suited to foster a meaningful dialogue about their risk situation.

An economically sound and actuarially rigid approach to the MOCE must be (re-) established
-The cost of capital is the only known economically sound and actuarially rigid approach to value insurance liabilities that is not in contradiction to market values.
-It accounts for the entire cost of the capital to be held during the lifetime of the liability ensuring that the liability is met with a defined and prescribed degree of certainty.
-The definition "A margin that reflects the inherent uncertainty in the current estimate." (ICP14 Glossary) resembles a 1960's loading concept. This is an outdated, obsolete concept. For 50+ years, modern financial theory has taken a "cost to produce or transfer" approach, which leads to the cost of capital approach for insurance business.
-The long-term commitment character of insurance, esp. life insurance, can only be properly reflected using a cost of capital approach that enables either solvent run-off or transfer to a solvent insurer. The currently proposed technical provisions with the ill-defined MOCE are insufficient to protect policy holders.
-The MOCE definition might even incentivise to set up insurers as Ponzi schemes, as the definition my make insurers unable to go out of business without causing material harm to their policyholders.

Section 4 - Perimeter of the ICS Calculation

2. Do you have comments regarding the perimeter of the ICS calculation?

Section 5 - Market-Adjusted Valuation

3. Do you have comments on the introduction of a term structure of credit spreads for discounting?
The Actuarial Association of Europe takes note of the introduction of a term structure of credit spreads for discounting. We refer to the various paper dealing with the consequences of discounting with a spread in market-based valuation systems, e.g., https://www.iaisweb.org/uploads/2022/01/171205-Market-Adjusted-Valuation-with-Cost-of-Capital-MOCE.pdf

4. Do you have comments on the revised eligibility criteria for the Middle Bucket?

5. Do you have comments on the introduction of a modulation factor?

6. Do you have other comments regarding the Market-Adjusted Valuation?
An economically sound and actuarially rigid approach to the MOCE must be (re-) established -The cost of capital is the only known economically sound and actuarially rigid approach to value insurance liabilities that is not in contradiction to market values. -It accounts for the entire cost of the capital to be held during the lifetime of the liability ensuring that the liability is met with a defined and prescribed degree of certainty. -The definition "A margin that reflects the inherent uncertainty in the current estimate." (ICP14 Glossary) resembles a 1960's loading concept. This is an outdated, obsolete concept. For 50+ years, modern financial theory has taken a "cost to produce or transfer" approach, which leads to the cost of capital approach for insurance business. -The long-term commitment character of insurance, esp. life insurance, can only be properly reflected using a cost of capital approach that enables either solvent run-off or transfer to a solvent insurer. The currently proposed technical provisions with the ill-defined MOCE are insufficient to protect policy holders. -The MOCE definition might even incentivise to set up insurers as Ponzi schemes, as the definition my make insurers unable to go out of business without causing material harm to their policyholders.

Section 6 - Capital Resources

7. Do you have comments on the changes regarding eligibility criteria for Tier 1 Limited and Tier 2 financial instruments? Please explain your response based on actual terms and conditions of instruments commonly issued by insurers.
The extensive and detailed ICS requirements in the area of capital resources can potentially lead to diverging impacts per jurisdiction – immediately after implementation as well as over time - keeping in mind that local rules around such instruments can differ significantly. For the established solvency standards in Europe, i.e. Solvency II, Solvency UK and SST specifically, the local valuation and eligibility rules for determination of available capital resources should apply and be used as an implementation of the ICS to preserve the coherence of these existing frameworks. The Actuarial Association of Europe has the following specific remarks regarding capital resources: -In comparison to ICS 2.0, the Candidate ICS criteria for Tier 1 Limited instruments relaxed the general prohibition of all event calls other than tax and regulatory calls during the first five years (articles L2-112.e and L2-114.e). We welcome this relaxation. -However, the Candidate ICS only allows such other event calls subject to prior “economic” (lower cost) replacement. In case of event calls, the requirement for the cost of replacement instruments to be lower than those of the instrument to be called is not prudentially justifiable because the occurrence of an event that gives rise to an event call means that the instrument has become inefficient for rating, accounting, or other purposes. Replacing the now inefficient instrument with a new, efficient instrument may make perfect economic sense even if the replacement instrument is more costly than the now inefficient instrument. -The terms and conditions of the new (but efficient) instrument will likely have to differ from those of the old (but inefficient) instrument, and to the extent that efficiency requires terms that increase the economic risks borne by investors, the replacement instrument will be more costly than the old (but inefficient) instrument, all else equal. Nonetheless, an issuer may want to make use of its call right to pay a higher spread (accept higher costs) in return for increasing the efficiency of the instrument. Yet the new Tier 1 Limited criteria (Candidate ICS) would prohibit the replacement. -The concept of “economic replacement” is prudentially more meaningful in the context of ordinary calls, where the instrument to be called is typically fully efficient and thus better comparable with the potential replacement instrument. In case of event calls, the Candidate ICS do not require tax and regulatory calls to be “economic” (lower cost replacement). All other customary event calls including accounting, rating and clean up calls should also be exempt from the requirement of economic replacement. -We also point to the logical and prudential inconsistency of limiting event calls on the one hand but allowing repurchases at any time (L2-112) on the other hand. Event calls have the benefit of a contractually defined call (redemption) price (typically at par). Event calls define a maximum redemption price. Limiting an issuer’s ability to make use of event calls “forces” issuers to make a (more costly) repurchase instead. -The recognition of Tier 2 non-paid-up capital resources should not depend on an IAIGs legal form or ownership as various insurers have access to non-paid-up capital that is external to the group, such as letters of credit. Tier 2 non-paid-up capital resources should form part of the tier 2 capital resources and should be subject to the normal capital composition limits. -The current 10% limit for Tier 2 non-paid-up capital resources is overly restrictive and can clash with jurisdictional solvency frameworks, i.e., could create an unlevel playing field locally if IAIGs are subject to more restrictive limits than non-IAIGs and solo entities. -The restriction in tier 2 financial resources for residual maturities less than 5 years is very restrictive and could lead to uncertainty, so it should be removed. Specifically, regarding capital composition limits the following is noted: -There should be no distinction in capital composition limits for mutuals and non-mutuals, in order to avoid an unlevel-playing field. -Tier 1 limited capital composition limit of 10% of the ICS capital requirement is too onerous and clashes with jurisdictional solvency frameworks, i.e., it creates an unlevel playing field locally if IAIGs are subject to more restrictive limits than non-IAIGs and solo entities. -We request to delete the exclusion of encumbered assets from T1 capital resources (L-1-60 lit b)). The distinguishing feature of T1 and T2 capital resources is its loss absorbency in a going-concern (T1) and the additional absorbency in liquidation or resolution (T2). Encumbered assets are clearly loss absorbing in going concern. There may be a timing issue when they will become available. However, this is a liquidity restriction and not a capital restriction. It must be addressed in liquidity regulation – not in capital regulation. The current draft might not be implementable in many countries as is lacks inner logic and appropriateness.

8. Do you have comments on the introduction of a limit on non-controlling interests, such as the one specified in section 6.4.4?

9. Do you have other comments regarding capital resources?
Articles L2-116 and L2-117 allow holding companies to issue senior debt instruments to third parties and enables structural subordination by down streaming the proceeds to insurance subsidiaries. These structurally subordinated instruments may qualify as eligible Tier 2 own funds for purposes of the ICS capital requirement. -While the practice of down-streaming of senior bond proceeds in the form of equity contributes to the subsidiary's solo own funds), it does not benefit the entire group, as the group internal equity contribution cancels out on a group basis, and since the externally raised funding (senior bond) is unable to absorb losses for purposes of the group. -Considering senior debt as group own funds conflicts with the scope and perimeter of the ICS as a group capital standard. The concept of structural subordination of intragroup transactions relies on very stringent solo regulation (solo regulation that does not consider interest of the wider group). Therefore, the down-streamed capital cannot be considered available to the group, and thus it cannot be justified for an insurer to simultaneously benefit from the group consolidation and diversification benefit, while senior debt is considered to be eligible capital.

Section 7.1 - ICS Risks and Calculation Methods

10. Do you have comments regarding the ICS risks and calculation methods?
Internal Models (full and partial) must be an integral part of the ISC Standard. -We welcome the proposal to allow firms to use internal models to identify their capital requirement subject to suitable controls. -Internal models are indispensable to realistically reflect the risk profile of many IAIGs. Generally, insurance undertakings or groups applying for an internal model must prove that their risk profile cannot be realistically covered using the standard method, at least partly. In allowing and providing approval for using internal models, supervisory authorities implicitly confirm the inadequacy of the standard method for the undertaking/group. Therefore, the option to use internal models must be an integral part of ICS as it is indispensable to realistically reflect the IAIG's risk profile. -To the extent they are used to determine the capital requirement, internal models must be eligible for valuation purposes, too. It is important to maintain consistency between valuation and risk measurement. -Moreover, group wide supervisors should not "benchmark" internal model results against standard method results. Such comparisons are misleading, as the standard method does not realistically reflect the risk profile of the IAIG. Especially, corresponding capital floors must not apply as the standard method does not realistically reflect the risk profile of the IAIG. -Finally, IAIGs that use an internal model should not report standard method results. Such a reporting would be misleading for report users, because the standard method does not realistically reflect the IAIG's risk profile. IAIGs should be allowed to use their own risk reporting granularity and structure as these are best suited to foster a meaningful dialogue about their risk situation. Transparency on calibration and expert judgement in calibration -We encourage the IAIS to provide greater transparency on the calibration of the ICS and to seek comment on key aspects of the calibration prior to finalizing the ICS. There has been insufficient detail provided on the calibration of several risk factors, most notably the interest rate risk charge. The ICS was calibrated in a 'low for long' interest rate environment that has radically changed in nearly all of the markets in which insurers conduct their activities. -Generally, we believe that there has been insufficient consultation, discussion, and transparency into the ICS calibration process. We urge the IAIS to offer opportunities for stakeholder discussion and feedback on the IAIS's calibration methods.

Section 7.2.1 - Grouping of policies for life insurance risks

11. Do you have comments regarding the grouping of policies for life insurance risks?

Section 7.2.2 - Calculation of Life risk charges

12. Do you have comments regarding the calculation of the Life risk charges?
The Actuarial Association of Europe considers applying flat mortality shocks to all geographies and age groups simultaneously as an unrealistic approach to estimate the target confidence level. More appropriate would be an approach which allows for diversification across geographies and across age groups. -In addition, offsetting effects should be considered because it would be more appropriate if the shocks were also applied to policies where an increase in mortality rates would lead to an increase in the net asset value. -Furthermore, capital charges for mortality and longevity should not be cumulative as it is highly unlikely that both shocks would materialise together. Therefore, the Actuarial Association of Europe suggests adopting the maximum of mortality and longevity capital charges. Regarding morbidity/disability risk - the additional granularity within the ICS approach can result into complexity. Regarding lapse risk - The Actuarial Association of Europe believes that the current mass lapse stress factors are unnecessarily high. High surrenders at a certain moment or over a short period are very unlikely, particularly for life insurers, because policyholders usually buy life insurance products not only for investment purposes but also for protection against old-age poverty or of family members in case of their own death. Reviewability Clauses - We insist that reviewability clauses in life insurance contracts are a contractual right of the insurer and therefor increase the value of the contract on the insurers balance sheet (in case the net position is a liability: decrease the liability amount). Moreover, the risk reducing quality of this contractual right must be fully recognizable when determining the required capital.

Section 7.2.3 - Calculation of Non-Life risk charges

13. Do you have comments regarding the calculation of the Non-life risk charges?

Section 7.2.4 - Calculation of Catastrophe risk charges

14. Do you have comments regarding the calculation of the Catastrophe risk charges?

Section 7.3.1 - Calculation of the Market risk charge

15. Do you have comments regarding the list of market risks considered in the ICS, the general principles to calculate them and the way to aggregate them?

Section 7.3.2 - Interest Rate risk

16. Do you have comments regarding the Interest Rate risk?

Section 7.3.3 - Non-Default Spread risk

17. Do you have comments regarding the Non-Default Spread risk?

Section 7.3.4 - Equity risk

18. Do you have comments on the differentiated treatment for investments in infrastructure equity?
Care should be taken when including measures such as the differentiated treatment for investments as some designs create, rather than mitigate, additional solvency volatility for insurers by their impact on terms and conditions of available investments.

19. Do you have comments on the inclusion of the Equity risk counter-cyclical measure (NAD)?
Care should be taken when including measures such as the counter-cyclical measure that basis risk inherent in some designs does not create, rather than mitigate, additional solvency volatility for insurers.

20. Do you have comments on the proposed design of the Equity risk counter-cyclical measure?

21. Do you have comments on whether the Equity risk counter-cyclical measure should allow for more granular calibrations to reflect geographical market specificities?

22. Do you have other comments regarding Equity risk?

Section 7.3.5 - Real Estate risk

23. Do you have comments regarding Real Estate risk?

Section 7.3.6 - Currency risk

24. Do you have comments regarding Currency risk?
IAIGs' Currency Risk must be measured against the basket of currencies in which the extreme loss is expected to occur. Only this definition incentivizes the IAIG to invest its capital resources in those currencies that are going to be needed to cover extreme losses, i.e., the use they are held for. The current method (measuring against the IAIG's reportion currency) incentivizes IAIGs to hold all capital resources in reporting currency. This jeopardizes policyholder protection systematically.

Section 7.3.7 - Asset Concentration risk

25. Do you have comments regarding Asset Concentration risk?
The Actuarial Association of Europe highlights that the approach to asset concentration risk considers the contribution of individual counterparties to credit and equity risk charges, which is in contrast to the calculation of credit and equity risk modules, that operate on a more aggregated level. Thus, a certain level of assumptions and loops within the process are required.

Section 7.4 - Credit risk

26. Do you have comments on the differentiated treatment for investments in infrastructure debt?

27. Do you have other comments regarding Credit risk?
The Actuarial Association of Europe suggests the IAIS to reconsider its decision to treat internal ratings as non-rated, according to point (b) of L2-330, providing the internal rating process is well governed. This will serve to reduce reliance on external rating agencies, support the development of robust internal risk management processes, and promote investment in emerging economies and other where ECAI ratings are not available. The treatment of internal ratings in combination with the very conservative stresses for non-rated credit exposures does not reflect the economic reality and leads to an unjustified high credit risk charge. According to L1-131, there is no recognition of potential policyholder participation in the calibration of the credit risk charge which can exaggerate the capital requirement for credit risk. Article L2-304 prescribes that collateral does not offset the reinsurance exposure but rather only allows the redistribution of the exposure to the credit rating of the collateral rather than the reinsurer. It would be more economically accurate to allow the collateral to reduce the reinsurance exposure and hence the credit risk charge, which is also how it is treated under Solvency II. This would be more reflective of the reinsurance credit risk than the redistribution approach, which seems excessively penal.

Section 7.5 - Operational risk

28. Do you have comments regarding Operational risk?
The Actuarial Association of Europe notes that the IAIS has decided to reflect Operational risk in ICS by imposing factor-based capital charges. As recognized in IAIS ICP 17.7.4, however, operational risk is less readily quantifiable than other risks and is subject to data and valuation challenges. In view of this ICP 17.7.4 provides for supervisory tools other than imposing capital charges to control operational risk. The policy choices currently granted by ICP 17.7.4 should be reflected in the ICS in order to enable national competent authorities to ensure consistency between IAIGs and non-IAIG insurance undertakings. While always arbitrary to some extent, the Actuarial Association of Europe believes that compared to other frameworks and under the premise that this is the way a jurisdiction chooses to supervise operational risk, the overall approach for the calculation of operational risk is reasonable. However, The Actuarial Association of Europe would advise IAIS the following: -To consider the Gross Earned Premiums as a premium and growth exposure instead of Gross Written Premiums. Generally, gross earned premiums are a better proxy indicator for operational risk exposure as earned premium patterns are linked to the insurer's core business activities as well as the underlying overall risk of product. -Liability is not a good representation of operational risk for products where the policyholder bears the investment risk. The Actuarial Association of Europe would suggest using the expenses of these products as a proxy.

Section 7.6 - Aggregation / diversification of ICS risk charges

29. Do you have comments regarding the aggregation / diversification of ICS risk charges?
The Actuarial Association of Europe encourages the IAIS to provide greater transparency on the calibration of diversification in the candidate ICS and to seek comments on key aspects of the calibration prior to finalizing the ICS. There has been insufficient detail provided on the calibration of several risk factors, most notably the interest rate risk charge. The ICS was calibrated in a 'low for long' interest rate environment that has now radically changed in nearly all of the markets in which insurers conduct their activities. Generally, we believe that there has been insufficient consultation, discussion, and transparency into the ICS calibration process. We urge the IAIS to offer opportunities for stakeholder discussion and feedback on the IAIS's calibration methods. -The Actuarial Association of Europe refers to the results of the International Association of Actuaries "Working Party on Risk Aggregation with Correlation Matrices". They show clearly that dependent on marginal distributions and copulas involved, the linear correlations to be put into the standard methods' correlation matrix may differ by a factor 2. -More specifically, 25% correlation for normal margins and copula produces the same effect as 12% correlation for more extreme (skewed) margins and copulas (more tail dependence). This indicates that applying a one size fits all correlation approach is materially inappropriate in the context of insurers risk absorbing the tail risks on this planet. -The Actuarial Association of Europe urges the IAIS to fully consider the result of the International Association of Actuaries "Working Party on Risk Aggregation with Correlation Matrices".

Section 7.7 - Non-insurance risk charges

30. Do you have comments regarding the optionality given to group-wide supervisors to require a calculation based on the Basel III approach for calculating risk charges for non-insurance non-banks financial entities?

31. Do you have comments regarding the optionality given to group-wide supervisors to require an additional risk charge for non-insurance, non-bank financial entities without a sectoral capital requirement where an operational risk charge would not capture all material risks?

32. Do you have other comments regarding non-insurance risk charges?

Section 8 - Tax

33. Do you have comments regarding the use of a simplified utilisation approach for tax?

34. Do you have comments regarding the option given to the supervisor to require a more complex approach for tax?

35. Do you have other comments regarding tax?
According to L1-149, the calculation of Deferred Tax Assets is based on the GAAP balance sheet. While L2-348 implies that the MOCE results in a DTA, it is unclear whether the DTA resulting from the corresponding item on the GAAP balance sheet (e. g., in IFRS) is removed. If not, this would exaggerate the DTA value. It should be made clear that the Deferred Tax Assets and Liabilities are based on valuation and income differences between the ICS and the underlying tax balance sheets. We suggest clarifying that article L1-149 refers to the tax balance sheet as the starting point of the DTA calculation. Moreover, when the definition of the MOCE is reverted to a reasonable production/transfer concept, the tax treatment must be changed accordingly.

Section 9.1 - General principles

36. Do you have comments regarding Other Methods for the calculation of the ICS capital requirement?
Internal Models (full and partial) must be an integral part of the ISC Standard •We welcome the proposal to allow firms to use internal models to identify their capital requirement subject to suitable controls. •Internal models are indispensable to realistically reflect the risk profile of many IAIGs. Generally, insurance undertakings or groups applying for an internal model must prove that their risk profile cannot be realistically covered using the standard method, at least partly. In allowing and providing approval for using internal models, supervisory authorities implicitly confirm the inadequacy of the standard method for the undertaking/group. Therefore, the option to use internal models must be an integral part of ICS as it is indispensable to realistically reflect the IAIG's risk profile. •To the extent, internal models are used to determine the capital requirement, they must be eligible for valuation purposes, too. It is important to maintain consistency between valuation and risk measurement. •Moreover, group wide supervisors should not "benchmark" internal model results against standard method results. Such comparisons are misleading, as the standard method does not realistically reflect the risk profile of the IAIG. Especially, corresponding capital floors must not apply. •Finally, IAIGs that use an internal model should not report standard method results. Such a reporting would be misleading for report users, because the standard method does not realistically reflect the IAIG's risk profile. IAIGs should be allowed to use their own risk reporting granularity and structure as these are best suited to foster a meaningful dialogue about their risk situation.

Section 9.3 - Supervisory Owned and Controlled Credit Assessments (SOCCA)

37. Do you have comments regarding SOCCA processes?

Section 9.4 - Internal models

38. Do you have comments on the overall requirements (section 9.4.1)?
The Actuarial Association of Europe welcomes the recognition of IM in the ICS, although further improvements should be made to the candidate ICS to properly capture the benefits of IM (see questions below for more detail). It is key to make optimal use of supervisory approved internal models consistently for the capital requirement, as well as for the capital resources. ICS must not preclude the application of GWS approved IM to be used to determine capital resources. Calculating capital requirements and capital resource on different bases could lead to misrepresentation of risk and misguided incentives. As an example, we refer to the MOCE part of all kinds of technical provisions. In view of this, L1-154 should be amended in a way that i) group-wide supervisors can authorise the use of internal models for the determination of the balance sheet and more generally the capital resources and ii) GWSs should ensure consistency between the approaches used for the determination of capital requirements and the balance sheet (and more generally the capital resources) rather than comparing the balance sheet as per the internal model with the one according to the ICS standard method.

39. Do you have comments on the general provisions on the use of an internal model to determine regulatory capital requirements (section 9.4.2)?
Internal Models (full and partial) must be an integral part of the ISC Standard -We welcome the proposal to allow firms to use internal models to identify their capital requirement subject to suitable controls. -Internal models are indispensable to realistically reflect the risk profile of many IAIGs. Generally, insurance undertakings or groups applying for an internal model must prove that their risk profile cannot be realistically covered using the standard method, at least partly. In allowing and providing approval for using internal models, supervisory authorities implicitly confirm the inadequacy of the standard method for the undertaking/group. Therefore, the option to use internal models must be an integral part of ICS as it is indispensable to realistically reflect the IAIG's risk profile. -To the extent they are used to determine the capital requirement, internal models must be eligible for valuation purposes, too. It is important to maintain consistency between valuation and risk measurement. -Moreover, group wide supervisors should not "benchmark" internal model results against standard method results. Such comparisons are misleading, as the standard method does not realistically reflect the risk profile of the IAIG. Especially, corresponding capital floors must not apply as the standard method does not realistically reflect the risk profile of the IAIG. -Finally, IAIGs that use an internal model should not report standard method results. Such a reporting would be misleading for report users, because the standard method does not realistically reflect the IAIG's risk profile. IAIGs should be allowed to use their own risk reporting granularity and structure as these are best suited to foster a meaningful dialogue about their risk situation.

40. Do you have comments on the criteria for internal model approval (section 9.4.3)?
L2-408: An annual revision of model parameters would necessarily lead to a re-parametrisation of all model components for comparison. Such a re-parametrisation of all model components is a highly resource-intensive task with potentially disproportionally little value. We suggest a lower minimal frequency if the IAIG is compliant with all validation criteria and without any known model malfunction. L1-163: IAIGs that use a different confidence level, risk measure or time horizon are required to ensure that policyholders and beneficiaries are provided with an equivalent or higher level of protection in comparison to the standard approach. It should be made clear that this is meant with respect to the confidence level by adding “[…] equivalent or higher level of protection than VaR 99.5 % over the one-year time horizon.” at the end of the paragraph. This is the confidence level applicable in Solvency II and Solvency UK while the TVaR 99% confidence level applicable in SST is deemed equivalent or more conservative in some situations. L2-426: A full Back-Testing is highly dependent of appropriate data on realisations. There may not be this kind of appropriate data for each model component. Therefore, we think an addendum of “[…] where appropriate data is reasonably available.” should be included. It may also not be feasible to maintain benchmark or alternative models on each component parallel to the model-in-use. Benchmark-Testing should be desirable but not a necessary step in model validation.

41. Do you have comments on the additional considerations (section 9.4.4)?

42. Do you have comments on the general provisions on the use of partial internal models (PIM) (section 9.4.5)?

43. Do you have other comments regarding the use of internal models?

Section 10 - General feedback

44. Do you have additional comments on the ICS?
See the comments to Question 1

Section 11.1 - Impact on product availability

45. Do you anticipate any impacts from the implementation of the ICS on the new business strategy of IAIGs? If so, please explain the potential impacts.

46. Do you anticipate any impacts from the implementation of the ICS on the pricing of products of IAIGs and/or across the insurance industry? If so, please explain the potential impacts.

47. Do you anticipate any impacts from the implementation of the ICS on the range of product features available in the market (for example investment guarantees? If so, please explain the potential impacts.

48. Do you anticipate any impacts from the implementation of the ICS on the duration of products written (eg offering products with shorter-term guarantees)? If so, please describe the products that might be affected and the potential impacts.

49. Do you anticipate the implementation of the ICS resulting in an IAIG's withdrawal from writing specific types of products? If so, please describe the products that might be affected and the potential impacts.

50. Do you anticipate the implementation of the ICS requiring changes to risk appetite of IAIGs? If so, please explain the potential impacts.

51. Do you anticipate any circumstances in which the implementation of the ICS might create or help resolve protection gaps (eg due to changes in product availability)? If so, please explain the potential impacts.

52. Do you anticipate that any reduction in product availability from IAIGs could be filled by other market participants? If so, please explain the potential impacts.

An economically sound and actuarially rigid approach to the MOCE must be (re-) established. Else in jurisdiction without an economically sound and actuarially rigid cost of capital approach, weak and under-reserved products may be incentivised. These products may replace or hinder the development of sound value for money products.

53. Do you anticipate any opportunities for an increase in the range of products available in the insurance market as a result of the implementation of the ICS? If so, please explain the potential opportunities.

Section 11.2 - Impact on IAIGs' business models and capital position

54. Do you anticipate any impacts from the implementation of the ICS on the long-term strategy of IAIGs? If so, please explain the potential impacts.

See question 52.

55. Do you anticipate that the implementation of the ICS could lead to a change in the risk sensitivity of the solvency position of IAIGs? If so, please explain the potential impacts.

The Actuarial Association of Europe warns to introduce an ICS Standard without internal models. Else the reported risk sensitivity of the solvency position of IAIGs might be impacted materially.

56. Do you anticipate that the implementation of the ICS could lead to a change in the profitability of an IAIG's business units or insurance entities focusing on a specific product type or market segment? If so, please describe the products or market segments potentially affected.

57. Do you anticipate any circumstances in which IAIGs will need to raise additional capital (beyond those currently anticipated) as a result of the implementation of the ICS? If so, please explain the potential impacts.

58. Do you have any concerns over the ability of IAIGs to raise capital or issue debt in the future as a result of the implementation of the ICS? If so, please explain the potential impacts.

59. Do you anticipate any circumstances in which IAIGs might change their risk management strategy as a result of the implementation of the ICS? If so, please explain the potential impacts.

60. Do you anticipate any circumstances in which IAIGs might change their approach to risk mitigation as a result of the implementation of the ICS? If so, please explain the potential impacts.

61. Do you anticipate circumstances in which IAIGs would re-structure their business as a direct result of the implementation of the ICS? If so, please explain the potential impacts.

62. Do you anticipate any other changes to the operating model of IAIGs as a result of the implementation of the ICS? If so, please explain the potential impacts.

63. Do you anticipate any changes to risk management practices across the insurance industry as a result of the implementation of the ICS? If so, please explain the potential impacts.

64. Do you anticipate any benefits to the business model of IAIGs as a result of the implementation of the ICS? If so, please explain the potential benefits.
The Actuarial Association of Europe believes that a globally accepted standard, if implemented in all jurisdictions to the same high degree and thus enabling consistent comparisons across IAIGs from various jurisdictions, would be beneficial to policyholders, IAIGs, supervisors, report users, and the wider economy.

65. Do you anticipate any impacts to the competitiveness of IAIGs relative to non-IAIGs with the implementation of the ICS?

Section 11.3 - Impact on financial markets

66. Do you anticipate any changes to the investment strategy of IAIGs which could lead to greater pro-cyclical behaviour, as a result of the implementation of the ICS? If so, please explain the potential impacts.

67. Do you anticipate any changes to the investment strategy by other market participants which could lead to greater pro-cyclical behaviour, as a result of the implementation of the ICS? If so, please explain the potential impacts.

68. Do you anticipate any impacts from the implementation of the ICS on asset concentration risk, either within IAIGs or across insurance markets? If so, please explain the potential impacts.

69. Do you anticipate the implementation of the ICS altering the investment strategy or investment decisions of IAIGs in response to stressed market conditions? If so, please explain the potential impacts.

70. Do you anticipate the implementation of the ICS resulting in a change in the market demand for specific asset classes (eg AAA / BBB rated corporate or government bonds, equities) driven by IAIGs? If so, please explain the potential impacts.

71. Are there any other areas of the financial markets (eg derivatives or stock lending) that might be impacted – directly or indirectly – by the implementation of the ICS? If so, please explain the potential impacts.

72. Do you have any concerns over the availability of longer-term assets in the market to meet any increase in demand from IAIGs as a result of the implementation of the ICS? If so, please explain the potential impacts.

73. Do you anticipate any increased risk to the broader financial markets (eg from re-allocations into or out of specific asset classes in response to shocks in financial markets) as a result of the implementation of the ICS? If so, please explain the potential impacts.

74. Do you anticipate any specific benefits to the insurance market or broader financial markets as a result of the implementation of the ICS? If so, please explain the potential benefits.
See answer 64.

Section 11.4 - Implementing the ICS

75. To the extent that it can be predicted, do you anticipate the insurance industry having to devote resources, including training, to implement the requirements of the ICS? If so, please explain the potential impacts.

76. To the extent that it can be predicted, do you anticipate impediments to implementing the requirements of the ICS? If so, please explain the potential impacts.

77. Could any costs of implementing the ICS be absorbed by or shared with other implementation projects running concurrently (eg IFRS 17)? If so, please explain how this might be achieved.

78. Do you anticipate any other impacts from the implementation of the ICS, not covered above? If so, please explain the potential impacts.