Client Update
IAIS Issues Consultation on Global Insurance Capital Standard

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OVERVIEW

On December 17, 2014, the International Association of Insurance Supervisors (the "IAIS") published its long-awaited public consultation document on a group-wide, consolidated risk-based insurance capital standard ("ICS") for global systemically important insurers ("G-SIIs") and internationally active insurance groups ("IAIGs").[1]

The ICS consultation is a significant step in the multi-year IAIS process to develop global regulatory capital standards for the largest insurance groups: G-SIIs and IAIGs.[2] The document addresses three primary issues: (i) the approach to valuation of assets and liabilities to be used in the new standard; (ii) the factors to be followed for determining qualifying capital resources, including classification within tiers; and (iii) the nature and composition of the ICS capital requirement, including calculation methodology. It invites stakeholders to provide feedback on over 160 specific questions or to raise additional issues. The ICS consultation focuses on insurance activities with the expectation that non-insurance financial activities will be addressed by other relevant global capital standards.

Prior to the release of the ICS consultation, the valuation approach was a key discussion point. The ICS consultation adopts a market-adjusted valuation approach to the calculation of the ICS, an approach that many expected after the

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1 IAIS, *Risk-based Global Insurance Capital Standard: Public Consultation Document* (Dec. 17, 2014) [hereinafter IAIS ICS Consultation].

2 Under the IAIS Common Framework for the Supervision of IAIGs ("ComFrame"), an insurance group is an IAIG if it meets certain criteria related to international activity and size. The IAIS expects approximately fifty IAIGs to be identified by supervisors, including the nine current G-SIIs. IAIS ICS Consultation para. 29.

release of the Basic Capital Requirements ("BCR").[3] This issue remains open, though, as the IAIS plans to collect data on a GAAP valuation approach in order to explore, and possibly develop, a "GAAP with adjustments" valuation approach.

Comments on the ICS consultation are due by February 16, 2015. A second round of quantitative field testing will occur through June 2015, and the ICS consultation on the IAIS ComFrame, including the ICS, will be revised by December 2015. The IAIS expects to finalize the ICS by December 2016. IAIS members are expected to adopt ComFrame, including the ICS, by the fourth quarter of 2018. The ICS is intended to apply from January 2019. As with other IAIS standards, the ICS must be implemented by individual jurisdictions to have legal effect.

We provide a summary of key aspects of the ICS consultation below.

VALUATION

Valuation continues to be one of the most controversial aspects of a global regulatory capital standard for insurers. The IAIS has stressed the need for a single approach that ensures comparability across jurisdictions, which would, in its view, argue against an approach following strictly local accounting rules.

The IAIS states in the ICS consultation that it field tested three different approaches to valuation for the BCR and ICS:

- **Accounting Valuation.** Assets and liabilities are valued according to existing accounting rules applicable to the insurance group (*e.g.*, International Financial Reporting Standards, in the case of many European and Asian insurers, or U.S. GAAP for U.S. public insurance groups and U.S. statutory accounting principles for U.S. mutual insurers[4]) on an unadjusted basis. The IAIS refers to this approach as the "GAAP Valuation Approach."
- **Market-Adjusted Valuation.** Assets and liabilities are valued according to jurisdictional accounting standards and then subject to IAIS-prescribed adjustments, *e.g.*, using current estimates for insurance liabilities based on an IAIS-prescribed discount curve.

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3 *See* IAIS, *Basic Capital Requirements for Global Systemically Important Insurers* (Oct. 23, 2014). For a detailed discussion of the final BCR, please see our October 31, 2014 Client Update.

4 The ICS consultation notes that U.S. mutual insurers that are not required to report on the basis of U.S. GAAP would report using U.S. statutory accounting principles. Although the ICS consultation only specifically identifies U.S. mutual insurers, it notes that "similar situations may also exist for insurers in other jurisdictions." IAIS ICS Consultation para. 63.

- **Economic Valuation.** Assets and liabilities are valued using internal economic models developed by the insurance group.

Similar to the BCR, the ICS consultation opts to apply, as an initial preferred option, a market-adjusted valuation approach to the calculation of the ICS in order to provide for comparability of outcomes across jurisdictions. U.S. insurance groups, in particular, have raised concerns about applying a market-adjusted valuation approach, arguing that such an approach would unduly raise costs and burdens for U.S. groups. U.S. insurers currently calculate risk-based capital on the basis of statutory accounting principles. U.S. insurers are also concerned that applying a market-adjusted valuation standard would lead to significant pro-cyclical incentives (*e.g.*, fire sales of assets).

The ICS consultation does state that the IAIS plans to collect data on a GAAP valuation approach, which data will be used to explore, and possibly develop, a "GAAP with adjustments" valuation approach — one that uses local jurisdictional GAAP as a starting point, with incremental and quantifiable adjustments.[5] In addition, the IAIS will consider further refinements to existing components of the market-adjusted valuation approach, including to the definition of "contract boundaries" (a concept that determines the scope of liabilities in an insurance contract, such as future premiums, that need to be reflected in the ICS), which for now uses the existing IAIS/BCR terminology, and to the IAIS yield curve used to calculate the current estimate of liabilities. Complicating matters, the process for determining the valuation approach is being undertaken in a period of evolving accounting standards for insurance; for instance, the consultation notes, the International Accounting Standards Board, responsible for developing International Financial Reporting Standards, is expected to revise insurance contract standards in late 2015, for implementation by the end of 2018 — the same time the ICS is due to be adopted.

The ICS consultation includes details about the valuation approaches used in the 2014 field testing, including insurance liability segments.[6] The release of these field testing parameters provide the public with more detailed information about the IAIS' proposals as to segmentation of products along business lines and the scope of non-traditional non-insurance ("NTNI") activities. NTNI activities conducted within insurance business lines include separate accounts with minimum guaranteed benefits (including, but not limited to variable annuities), mortgage insurance, financial guarantees and guaranteed investment contracts.

5 IAIS ICS Consultation paras. 42 and 66.
6 *See* IAIS ICS Consultation at Annex 1 and Annex 5.

The scope of NTNI activities is an important concept throughout ComFrame, which subjects the activities to enhanced supervision and regulation.

QUALIFYING CAPITAL RESOURCES

The ICS consultation's classification of qualifying capital resources is substantially similar to the BCR's classification. Under the ICS consultation, qualifying capital resources are divided into higher quality Tier 1 capital, which is analogous to the BCR's core capital, and lower quality Tier 2 capital, which is analogous to the BCR's additional capital.

Qualifying capital is categorized into a higher or lower tier based on the capital element's (1) subordination, (2) availability (the extent to which it is paid up and available to absorb losses), (3) loss-absorbing capacity, (4) permanence and (5) absence of encumbrances or mandatory servicing costs.

Tier 1 Capital

Tier 1 capital is composed of financial instruments and capital elements that absorb losses throughout the lifecycle of an insurance group, from going-concern through stress to winding up. In delineating Tier 1 capital, the ICS consultation largely adopts the core capital criteria outlined in the BCR, but it also adds additional requirements, such as excluding instruments purchased by the IAIG or a party it controls. In addition, the ICS consultation contemplates requiring a principal loss absorbency mechanism that would "provide a means for [Tier 1] instruments to absorb losses on a going-concern basis through reductions in the principal amount in addition to cancellation of distributions."[7] The ICS consultation contemplates limiting the proportion of Tier 1 capital that may be comprised of certain types of Tier 1 capital instruments.

Tier 2 Capital

Tier 2 capital is composed of non-Tier 1 financial instruments and capital elements that are available to meet liabilities to policyholders and non-subordinated creditors in the event of winding up. Limits on Tier 2 capital are expected to be determined following consultation and field testing.

Qualifying capital is determined on a consolidated basis across an insurance group. The evolving definitions of qualifying capital resources under the ICS, which almost certainly will be different from analogous definitions under Solvency II and similar U.S. standards, means that capital instruments will need to satisfy varying requirements for qualification in the relevant tier once the new

7 IAIS ICS Consultation para. 92.

rules come into effect in 2019 — in effect adopting the most restrictive of the rules that may apply to the insurer.

ICS CAPITAL REQUIREMENT

The bulk of the ICS consultation and its questions focuses on the nature and composition of the capital requirement component of the ICS, particularly the risks covered, ways to measure risk and the extent to which risk mitigation techniques, such as credit for risk diversification, should be included in the ICS Capital requirement.

The ICS consultation groups risks into four categories: insurance, market, credit and operational, as shown in the following table. The ICS consultation notes that group and liquidity risk are not quantified in the ICS capital requirement and will, instead, be addressed in ComFrame's qualitative requirements.

Risk category	**Key risk**	**Scope/definition: Risk of adverse change in the value of qualifying capital resources due**
Insurance risk	Mortality risk	Unexpected changes[8] in the level, trend or volatility of mortality rates
	Longevity risk	Unexpected changes[8] in the level, trend or volatility of mortality rates
	Morbidity/ disability risk	Unexpected changes[8] in the level, trend or volatility of disability, sickness and morbidity rates
	Expense risk	Unexpected changes[8] in liability cash flows due to the incidence of expenses incurred
	Lapse risk	Unexpected changes[8] in the level or volatility of rates of policy lapses, terminations, renewals and surrenders
	Premium risk (non-life)	Unexpected changes[8] in the timing, frequency and severity of future insured events (to the extent not already captured in morbidity or disability risk)
	Claim reserve/ revision risk (non-life)	Unexpected changes[8] in the expected future payments for claims (to the extent not already captured in morbidity or disability risk)
	Catastrophe risk	Unexpected changes[8] in the occurrence of low frequency and high severity events

[8] Expected impacts are assumed to be incorporated in valuation methodologies.

Risk category	Key risk	Scope/definition: Risk of adverse change in the value of qualifying capital resources due
Market risk	Interest rate risk	Unexpected changes[8] in the level or volatility of interest rates
	Equity risk	Unexpected changes[8] in the level or volatility of market prices of equities
	Real estate risk	Unexpected changes[8] in the level or volatility of market prices of real estate or from the amount and timing of cash-flows from investments in real estate
	Spread risk[9]	Unexpected changes[8] in the level or volatility of credit spreads over the risk-free interest rate term structure
	Currency risk	Unexpected changes[8] in the level or volatility of currency exchange rates
	Asset concentration risk	The lack of diversification in the asset portfolio
Credit risk		Unexpected counterparty default, including their inability or unwillingness to meet contractual obligations in a timely manner
Operational risk		Operational events including inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk, but excludes strategic and reputational risk

Many of the remaining questions are focused on specific risks, although the ICS consultation flags two broad outstanding issues. The first issue is the type of approach or approaches that will be used to determine capital requirements for one or more risks. The ICS consultation presents a factor-based approach, like the BCR; a stress approach; a stochastic modeling approach; and a structural modeling approach. Many of the risk sections in the ICS consultation seek comment on the proposed risk measurement methodology. The second issue is whether value-at-risk or tail value-at-risk will be used to measure the risks borne

9 The definition of credit risk used for the ICS may be broadened to include spread risk, and may also subsume risks besides default risk that can adversely affect the value of credit-sensitive assets, such as migration risk and obligor-specific risk. If spread risk is included within the ICS credit risk category, then it will not be included as a component of the ICS market risk category. Additionally, the ICS definition of credit risk may be expanded to cover risks arising from all credit-sensitive obligations due to an insurer, which would include obligations due from counterparties as a subcategory.

by insurance groups.[10] The IAIS expects to make a determination based on field testing results.

Among the other issues left open in the ICS consultation is the possibility of a further "backstop" capital requirement, which could be a simplified capital measure to serve as an early warning measure, or alternatively, a capital floor to the ICS.

NEXT STEPS

The IAIS has opened the ICS consultation to public comment until February 16, 2015, and intends to engage in field testing and further analysis of the ICS in 2015, particularly with respect to further consideration of the approaches to valuation, the definition of qualifying capital resources and the risk measures.

A second round of field testing will take place through June 2015, and the ICS consultation on ComFrame, including the ICS, is to be revised by December 2015. A third round of field testing will take place in 2016 with the ICS expected to be finalized in December 2016. The ICS consultation contemplates that ICS confidential reporting to supervisors will begin in 2017, followed by further refinement of the ICS consultation. ComFrame, including the ICS, is expected to become effective beginning in 2019 following adoption by individual jurisdictions.

The IAIS has planned several open meetings with stakeholders in 2015 focusing on the ICS and the development of global capital standards for insurance groups. Further stakeholder engagement initiatives in connection with the development of ICS and ComFrame are expected to be announced.

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Please do not hesitate to contact us with any questions.

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[10] Value-at-risk "is the loss at a predefined confidence level (*e.g.*, 99.5%), i.e., the loss that is not exceeded with probability equal to the confidence level. [Tail value-at-risk] is the expected value of the loss given that the loss exceeds the predefined confidence level." IAIS ICS Consultation paras. 122-123.