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Position Paper

Insurance Europe's comments on the second BCR consultation on basic capital requirements for global systemically important insurers

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Q1 General comments on Executive Summary

Insurance Europe welcomes the opportunity to contribute to the second International Association of Insurance Supervisors (IAIS) basic capital requirements (BCR) consultation.

Solvency II is a modern risk-based system which was finalised after the financial crisis. Its measures have been subject to a long period of development and have been tested through several rounds of quantitative studies over the course of many years. As a result of this, the IAIS has the opportunity to draw on this work and experience. The IAIS should in particular avoid developing fractionally different versions of concepts already developed and tested for Solvency II because, in addition to the effort and work that this would generate for the IAIS, European G-SII would face unnecessary additional costs for doing such calculations. The IAIS should therefore take care to avoid reinventing the wheel where there is an adequate existing basis that they could use.

Despite the additional details provided, a thorough assessment of the BCR calibration is not possible until other aspects such as the alpha scalar and the design and calibration of the higher loss absorbency (HLA) become more clear.

Discussions on the BCR and the international capital standards (ICS) should be separated. It is too early to state that the ICS will replace the BCR and inappropriate to state that the BCR development will inform the ICS given that:

i. there is not sufficient information available on the design of the ICS – for example, it's not yet clear whether the ICS is a measure or a set of standards/principles, and
ii. the BCR and the ICS are being developed with distinctly different aims

We note the clarification that the BCR currently under development would not apply beyond G-SIIs and agree that the scope of the BCR should be limited to the development of the HLA.

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Insurance Europe welcomes a fair value approach for assets and a best estimate approach for liabilities. However, while the discounting approach for liabilities avoids complexity, as acknowledged in the consultation document, it will not correctly reflect the long-term nature of the insurer's business. Moreover, the economic benefits of asset liability matching, diversification, profit sharing and non-proportional reinsurance are unfortunately not explicitly taken into account or have been completely ignored. It is not yet clear if the above simplifications are fatal flaws. Fatal flaws would be, for example, a BCR+HLA measure that bites too often or forces pro-cyclical behaviour. This will be influenced by the final calibration of the BCR and the design and calibration of the HLA.

Insurance Europe strongly opposes current or potentially envisaged proposals aimed at:

- introducing margin over current estimate (MOCE) as part of technical provisions – this would in effect be an additional provisions for the same risks that the capital requirements are intended to cover
- applying the ComFrame approach to capital tiering in the BCR, which we find unnecessarily restrictive

Looking ahead, Insurance Europe believes that it is very important that:

- a consistent implementation of the new requirements is envisaged and ensured across jurisdictions
- the IAIS seeks to understand how the proposed measures would work if applied at different points in time, including periods of market stress
- the HLA development focuses on the systemically risky non-traditional and non-insurance (NTNI) activities, in line with the financial stability board (FSB) mandate

§2
While we understand that the ICS development may be "informed" by work on the BCR, it should be recognised that the BCR is a very crude capital measure. Given its different purpose, the design of the ICS would require considerably more work than has been allowed in the case of the BCR.

§3
Insurance Europe disagrees with the principle put forward in the paper that "G-SIIs should hold higher levels of capital" than would otherwise be the case. This statement does not take into account the interaction between the BCR/HLA measures and local capital regimes. It also does not recognise that capital charges imposed via national legislation might be above the HLA uplift and therefore there would be no actual capital increase.

Higher capital for G-SIIs is therefore not a valid objective in its own right. The key point should be that capital add-ons, if applied to G-SIIs, do not create unintended consequences.

§5
Insurance Europe welcomes the acknowledgement that there are implementation and other issues that may affect the timeframes for ICS application.

Q2 Comments on background and mandate

§13
While Insurance Europe understands that the BCR is meant to be a simple measure, it's too early to state that the ICS will replace the BCR given that:

i) there is not much information available about the design of the ICS, the strategy and the goals pursued by the IAIS, and
ii) the BCR and the ICS are being developed with distinctly different aims

Insurance Europe therefore believes that discussions on the BCR and the ICS should be kept separate at this stage. The IAIS' focus should be on the BCR and not on the ICS.

If the BCR is removed as basis for the HLA it is not clear why the BCR should remain. We doubt the BCR could be changed to serve a different objective.

Q3 Comments on BCR design

§17
Insurance Europe supports the use of a consolidated group-wide basis for the BCR required capital, as well as the use of sectorial rules for non-insurance activities.

§21
Insurance Europe welcomes the use of the Market Adjusted Valuation Approach and particularly the use of a current best estimate liability valuation.

Insurance Europe also believes that it should be made absolutely clear that the valuation approach will be applied consistently across G-SIIs (ie consistent approach for calculating best estimate liabilities and fair value of assets).

§23
Insurance Europe believes that if capital remains classified as core and additional, then the BCR required capital should be covered by both core and additional capital.

It's not clear at this stage what is meant by "the IAIS is still assessing whether one or both categories of Qualifying Capital Resources will be assessed against the BCR Required Capital".

We believe that an approach that only allows core capital for backing the BCR would create an unnecessary constraint given that additional capital is just as valid as core capital as source of support.

§24
As previously indicated, Insurance Europe believes that diversification is key to the insurance industry, and the lack of explicit diversification recognition is a major weakness of the BCR.

§25
Insurance Europe would like to reiterate that asset-liability matching and profit sharing are fundamentally distinctive features of the insurance industry and also crucial to appropriately assess exposure to market risk. Insurance Europe understands that given the challenging calendar of the BCR design, such features could not be explicitly reflected in the BCR formula.

Nevertheless, transparency and details on how the implicit recognition of asset-liability matching was approached in the BCR calibration as well as information on how the IAIS plans to approach profit sharing would be welcomed.

There is a risk that undesirable incentives could be created if the BCR i) is calibrated above the local capital measures – aimed at encouraging good risk management behaviour – and ii) does not explicitly take into account and/or ignores important issues, such as diversification, asset-liability matching, profit sharing and non-proportional reinsurance.

Q5 General Comments on Proposed BCR Approach

§28
While we understand that all on- and off-balance-sheet exposures are due to be taken into account, Insurance Europe would like to seek more clarity on how derivatives, securities lending and repurchase agreements will be factored in.

Insurance Europe would like to see appropriate recognition of rights of set-off in the case of pledged assets.

Q6 Comments on Application of BCR

§31
We note that the previous uncertainty whether the current BCR would apply beyond G-SIIs has now been clarified.

§32
Insurance Europe welcomes confidentiality in the BCR reporting.

§33
Insurance Europe believes that it's too early to decide whether the ICS will be a basis for calculation of HLA for G-SIIs.

Q7 Comments on BCR ratio

§34
Insurance Europe believes that more clarity should be given regarding the target level of the BCR ratio, in order to enable companies to assess interaction between the BCR level and existing local capital measures.

Q9 Comments on Insurance

§36
Insurance Europe believes that in the assessment of the "investment grade" status for credit-like assets, both external and internal ratings should be allowed. G-SIIs generally rely on a mix of external and internal ratings and have significant expertise and sophisticated techniques for assessing the credit quality of exposures such as mortgage loans and infrastructure debt. Internal ratings of assets should therefore be recognised.

Regarding the calibration of the factors, Insurance Europe believes that it should be recognised that these calibrations were based on a specific group of companies, at a single point in time, which, as recognised in the BCR principles, may be not enough to test the resilience of the measures.

Q10 Comments on Non-insurance

§ 40
Insurance Europe would welcome more guidance on how the Basel III leverage ratio will be used to determine capital requirements. Insurance Europe is also concerned by the proposal to apply the higher of the Basel III leverage ratio and Basel III risk-weighted assets (RWA) in the case of non-insurance (NI), as this could result in a disproportionately high measure for NI activity.

§41
Insurance Europe would welcome information on when the IAIS expects to clarify the treatment of non-regulated banking activities. In addition, Insurance Europe believes that materiality and proportionality principles should be taken into account when considering such activities. For example, for groups where the non-regulated banking entities represent non-material exposures, a simplified approach to capital calculations should be considered.

§42
Insurance Europe believes that no charge should be imposed on the asset management activity, as this would create an un-level playing field with other asset managers.

§43
Insurance Europe believes that risks emerging from non-financial activities are marginal and should not be included in the BCR. Insurance Europe agrees that such risks "are difficult to capture in a capital requirement" and also notes that, given the simplicity of the BCR, it would be challenging to include qualitative risk-assessments to address such risks. Before investing too much time and effort into this issue, the IAIS should identify exactly what the risks and worries are and should get a more clear view on why such risks can't be ignored.

Q11 Comments on Indicative capital allocation

§44
Insurance Europe would welcome more information on how the NTNI assessment was made, in particular on how the category addresses systemic activities and risks.

Q12 Comments on BCR principles

§45
We welcome recognition that the current BCR design and calibration have been developed by using a single data point and therefore resilience has not been tested in a wide range of macroeconomic conditions. We look forward to seeing further investigation on resilience to stress and how that can affect the BCR design and calibration.

Q14 Comments on Tiering of Capital Resources

§48
As highlighted in the response[1] to the ComFrame consultation in December 2013, Insurance Europe has strong concerns about using ComFrame's approach to qualifying capital resources for the BCR, which we consider unnecessarily restrictive. For example, a much wider range of financial instruments than is envisaged by ComFrame can be viewed as loss-absorbing capital in protecting policyholders. While we expect ComFrame–Module 2 to be subject of major revisions as a result of the field testing exercise, we are concerned that, given the ambitious BCR timetable, finalisation is unlikely to happen before adoption and implementation of the BCR measure.

Insurance Europe believes that the Solvency II approach to capital resources should be considered by the IAIS for the BCR purpose.

Q15 Comments on BCR Ratio and HLA requirement

§49
It is unclear what the purpose and value of the additional BCR ratios would be. We believe that a total capital approach is the only one needed.

§50
Insurance Europe believes that, in line with the FSB mandate and the IAIS policy measures of July 2013, the focus of the HLA development should be on an insurer's NTNI activities that are considered systemic.

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[1] http://www.insuranceeurope.eu/uploads/Modules/Publications/response-to-comframe-consultation.pdf

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

§52

Insurance Europe strongly opposes the proposal to consider introduction of MOCE as part of technical provisions and supports that MOCE (understood as the additional margin over best estimate liabilities (BEL)) recognised under certain regulatory regimes, including Solvency II and generally accepted accounting principles (GAAP) accounts should be part of core capital (as referred to in paragraph 6 of Annex D). Re-consideration of the MOCE purpose would in effect translate into an additional provision for the same risks that the capital requirements are intended to cover.

We also note that where MOCE exists, it's arrived at in very different ways and it's not comparable.

In addition, we believe that the potential extension of non-qualifying reinsurance to agreements that do not include "a sufficient transfer of risk" should not exclude reinsurance agreements where the transfer of risk is legally effective and enforceable. The term "sufficient" is ambiguous and should be replaced with "legally effective and enforceable".

Q17 Comments on G-SII capital resources

§ 53

The 75% observed rate of GAAP capital resources is derived based on calculations at a single data point and we believe it's important to also note that the core capital ratio can exhibit significant volatility, as a result of, for example, changes in the external environment.

Q18 General Comments on Market Adjusted Valuation Approach

§55

Insurance Europe welcomes recognition that both available and required capital need to be comparable.

Insurance Europe agrees that comparable valuation is vital for achieving comparability of BCR outcomes.

Q19 Comments on Valuation principles

§57

Insurance Europe agrees upon the use of fair values for investment assets.

§60

Insurance Europe believes that, from a solvency standpoint, the sensitivity and volatility of the balance sheet is at least as important (or even more important) than the difference between the GAAP/market adjusted approach to valuing liabilities. We think that the IAIS should focus on any balance sheet volatility concerns.

Q21 Comments on Calibration Level and Capital Resources

§62

Insurance Europe notes that the conclusions put forward by the IAIS regarding, for example, the ratio between BCR and prescribed capital requirement (PCR) are based on a (fixed) 100% alpha scalar. However, we understand that alpha is subject to change and will be further assessed, including during the development of the HLA. The lack of clarity on the precise role, methodology and variability of the alpha scalar makes assessment of results difficult.

Insurance Europe would welcome more details on how the PCR and the minimum capital requirement (MCR) were mapped to the various measures in the local regimes.

Q22 Comments on Reporting and Applicability

§66
Insurance Europe welcomes confidential reporting of results for individual companies in the transitional period.

Insurance Europe would also appreciate more clarity regarding the purpose of such reporting (given that the BCR without the HLA does not provide meaningful information) and also more clarity on which aspects on the BCR are expected to be revised over time.

We believe that the IAIS should recognise that there may be other aspects, apart from the BCR factors, that may need to be changed over time.

We reiterate the need to understand how the proposed measures work under stress conditions and we believe that it cannot be assumed that the next few years will provide a fully appropriate basis for testing.

Q23 Comments on Implementation of the BCR

§67
The paper notes that implementation of the BCR is the responsibility of each jurisdiction. Insurance Europe would welcome clarification as to whether the IAIS will play a role in ensuring the BCR is implemented and applied consistently across jurisdictions.

Insurance Europe believes it's very important that any new regulation covering G-SIIs is implemented consistently across the globe. Only a consistent application of requirements can ensure an appropriate implementation of the FSB proposed measures for addressing systemic risks.

At the same time Insurance Europe realises that implementation of BCR/HLA could require changes in national laws, which would trigger political scrutiny. It would therefore be important to know whether the IAIS has sought political agreement on the implementation of the proposals and whether it has agreed a coordinated implementation timetable with the G-SIIs' jurisdictions.

Q24 General Comments on Communication plans and next steps

§68
Insurance Europe believes that the following points are worth noting in order to improve data quality in future field testing exercises:

- i) specifications should be provided much earlier than was the case for the BCR field testing
- ii) reporting should be only on an annual basis, and
- iii) there should be a commitment for increased consistency between data calls for G-SIIs designation and ICS /BCR field testing

Q27 Comments on Annex C – Insurance Liabilities and Reinsurance Recoverables

§4
This section seems to indicate that both "real world" and "risk neutral" cash flows can be used as part of the current estimate. However, it should be recognised that there is an important difference between the two approaches which can potentially create material differences in the current estimate for certain products. The IAIS should therefore ensure the application of a consistent approach in this respect.

The IAIS should be aware of and appropriately assess any such differences emerging between participants in the field testing exercise and create a clear basis for comparability in future field testing and/or implementation of the BCR.

§43

While Insurance Europe understands that, for simplicity and timing reasons, the BCR uses standard yield curves to achieve comparability, future developments in this area should consider refinements to better reflect the long-term nature of insurance liabilities.

In addition, Insurance Europe believes that, instead of using pre-specified yield curves, it is more important for the yield curves to reflect the nature of the assets and liabilities and therefore it may be more appropriate for liabilities across insurers to be valued at different yield curves. In order to achieve consistency, the IAIS should lay down principles (eg the discounting curves should be based on observable yield curves at the valuation date).

Insurance Europe would also note that, in addition to yield curve adjustments, a number of ways aimed at mitigating pro-cyclicality could be considered, based on flexibility of supervisory intervention, eg commitment that in event of whole industry ratio <100% then a longer timeline for recovery should be allowed, high-level adjustments to overall calibration of target capital and/or shifting thresholds for any ladder of intervention.

§44

The proposed valuation approach for liabilities avoids complexity but, as acknowledged in the consultation document, will not correctly reflect the long-term nature of the insurer's business and makes the link between the valuation of assets and the valuation of liabilities very poor. While assets are measured at fair value, the valuation of liabilities risks creating significant balance sheet volatility for (at least) the following reasons:

i) the spread adjustments do not reflect the actual portfolios of companies, but rather average allocation weights of G-SIIs, and
ii) the adjustment for corporate bonds is fixed at the 10-year maturity and applied to all the points of the discount rate curve

This approach for measuring liabilities can potentially lead to a significant exaggeration of the volatility of the balance sheet, and therefore own funds, especially during periods of financial stress. Whether or not this will cause problems by resulting in BCR/HLA measures that bite too often or force pro-cyclical behaviour will depend on the level of calibration of the BCR and design/calibration of the HLA.

§49

Insurance Europe believes that an adjustment of only 40% of the actual corporate bond spread insufficiently reflects the illiquidity of many products and also creates significant balance sheet volatility, which can potentially lead to pro-cyclical actions during periods of financial markets stress.

In addition, an approach based on 10-year spreads creates basis risk between assets and liabilities, as the value of assets reflects changes in spreads at different points on the curve, while the value of liabilities would not. The focus on the 10-year spread unfortunately reflects no link between an insurer's liabilities and the actual spread the insurer earns on the actual bond portfolio.

§55

While Insurance Europe understands the objective of simplicity, the use of the proposed replication approach would, in principle, be inconsistent with the "current estimate" approach to liability valuation: the former would include the impact of a risk margin, while the latter would not, unless interpreting the risk margin as zero in such cases.

Q28 Comments on Annex D – Qualifying Capital Resources – ComFrame

As highlighted in Insurance Europe's response to the ComFrame consultation (December 2013), ComFrame should not contain specific definitions as to which capital resources qualify in the context of the capital adequacy assessment. Rather, principles should be articulated that permit the flexibility needed for the various accounting regimes. Each accounting regime contains rules that help to determine whether specific capital can be considered for capital adequacy purposes. Insurance Europe believes that the Solvency II approach to capital resources should be considered by the IAIS for the BCR purpose.

Insurance Europe would also welcome more clarity on a number of points missing or vague in Annex D, paragraphs 6 and 7, namely:

i) the treatment of minority interests is not clear
ii) the items referred to under point h) of paragraph 7and the third bullet point of paragraph 8 are not appropriate adjustments to group capital resources if the starting point is a consolidated balance sheet

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

§2
This paragraph makes a reference to IFRS/GAAP approaches for valuing property assets. The IFRS approach to property is not market value based. Given that European insurers will have to use a market value approach in the Solvency II context, Insurance Europe would welcome confirmation that market values are allowed for property assets (even if not part of the IFRS/GAAP approach).

Q30 Comments on Annex F – BCR Formula and Derivation

§26
Insurance Europe welcomes the recognition of reinsurance as a risk mitigating tool through the use of current estimate net of reinsurance recoverables. However, the BCR fails to correctly reflect the economic benefits of risk-mitigating tools more generally including non-proportional reinsurance and profit/risk sharing. Further work should be done to see how risk-mitigation techniques can be included to better reflect the actual market risk exposure of insurers.

§35
Given the comment that "Current estimate liabilities were considered, but were not chosen as the exposure base because they may be negative" we understand that current estimate liabilities in respect of variable annuities would not include the value of the separate account. We would welcome clarification on whether it is the intention of the IAIS that when considering the BCR capital requirement the current estimate liabilities for unit-linked business should in the same way exclude the value of the unit fund.

§41
Insurance Europe welcomes the recognition of no asset risk attached to unit-linked business. In addition, Insurance Europe believes that the exposure measure for assets needs to appropriately recognise any policyholder participation in movements in asset values.

§43
Insurance Europe would welcome more information on how implicit diversification was taken into account in the BCR calibration. Insurance Europe would like to note that an industry-based approach for diversification fails to account for differences between highly-diversified and poorly-diversified insurers. This is another example why the simplicity of the BCR may cause problems in practice.

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

In any rare cases where due to the relative immateriality of guarantees relative to separate account values, the capital requirement for a group's variable annuity (with living benefits) business calculated as the factor for “variable annuities” applied to the notional value of guarantees is lower than the capital requirement that would apply if the business was treated as traditional unit-linked business (ie calculated by multiplying the factor for "Other Life" applied to the total current estimate liabilities (including separate account), we believe that the variable annuity business should be apportioned to "Other life". We would request that the IAIS confirm more explicitly if this is the intention.