Position Paper

Insurance Europe response to the IAIS BCR consultation

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Note: The structure and sections of our response are meant to replicate the IAIS response template.

Chapter 2: Executive Summary

General comments on Executive Summary

- Insurance Europe welcomes the opportunity to take part in this public consultation on the Basic Capital Requirement (BCR) and contribute constructively to its design.
- In our analysis of the current proposal **we assume that the BCR is a temporary measure, until the ICS is developed**. According to the policy measures put forward by the IAIS and the FSB in July 2013, "G-SIIs will be subject to an increased loss absorption capacity requirement based on the NTNI activities that those G-SIIs undertake." We therefore understand that, in the absence of a global capital standard, the BCR is meant to represent a measure based on which capital add-ons would apply to G-SIIs.
- We expect the BCR to be calibrated as a "minimum" level, for example, significantly below the level set by the SCR under Solvency II, because otherwise the simpler BCR would create conflicting requirements relative to the sophisticated Solvency II requirements.
- The **timetable** that has been set for finalising the development of the BCR is very ambitious. This must not compromise achieving a system that works well enough in practice to achieve its aims. In addition, it is vital that the measurement system developed for the BCR is not overly volatile and does not create pro-cyclical behaviour, which insurance companies are naturally able to avoid.
- Given both the aim to keep the measurement system as simple as possible and the ambitious timetable, we support the idea of a factor based approach. While we are aware of the challenges of appropriately addressing the balance between risk sensitivity and complexity, we believe that **the measure must be risk sensitive enough to work as intended and this includes recognition of key risk mitigation techniques** such as re-insurance, hedging and participating products.
- Care should be taken regarding the implementation and the use of the BCR measure. As a general comment, we believe that principles of proportionality and materiality should be embedded in the framework.
- In the current BCR consultation we agree with the following aspects of the proposal:
  - Single, consolidated group level approach.

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- Best estimate for liabilities so that all prudence and buffers against risk are put into the BCR.
  - The use of market values for valuation of invested assets – but only if the liability measurement is able to recognise the long-term nature of the business and therefore can, where it is an appropriate reflection of product design, ALM or other risk management activities, reduce or eliminate the own funds' exposure to market value movements.
  - The exclusion of non-material items.
- However, although not explicitly addressed in the consultation, **challenges remain on a range of valuation and capital related issues**, such as: the definition of discount rates for measuring liabilities best estimates, contract boundaries and qualifying capital resources – on which we have already expressed significant concerns in the context of the ComFrame–Module 2 consultation. As qualifying capital resources and the definition of discount rates represent important elements in the BCR calculation, concerns should be addressed in time before the BCR implementation becomes effective.
- Achieving both simplicity and enough accuracy to avoid unintended consequences is a significant challenge.
- The BCR and associated valuation basis should leverage the extensive set of methodologies and work developed for Solvency II such as data granularity, calculations and reporting requirement that European companies will be required to produce under Solvency II. We believe this can help speed up the development of a workable and suitable BCR and also the ICS measures that may follow.

Comments on Overview (para 8-12)

- We particularly welcome the recognition of the fact that the BCR has a different role and characteristics compared to the Basel III leverage ratio, as appropriately explained in **paragraphs 9 and 10**.

Comments on Approach (para 13-20)

- Given both the aim to keep the measurement system as simple as possible and the ambitious timetable**, we support the idea of a simple factor based approach** to be adopted for the development of the BCR, as indicated in **paragraph 13**.
- We agree that the consolidated group balance sheet is the right starting point for the BCR and we support the idea that, for simplification reasons, immaterial activities should be excluded. However, we believe that **paragraph 19** should make clear that this is an optional simplification and not compulsory.
- We understand that the IAIS, as stated in **paragraph 15**, is strongly in favor of a simple approach and a limited number of risk measures and factors in order to meet the ambitious deadline set by the FSB. However, even a simplified method must be sufficiently granular (in terms of eg liabilities segmentation) to capture the essential characteristics of the risk profile and ensure reasonable comparability.

Comments on Generic Example (para 21-23)

- Without a concrete system to evaluate, it's not possible to assess if the generic example given is the most suitable way to design a factor based approach able to capture, to a sufficient degree, risk sensitivity, diversification and risk mitigation. We therefore believe that further clarity on how such a generic example could be designed and calibrated is needed.
- Other potential approaches should also be considered. For example, where risk factors are applied solely to major liability homogenous risk segments, the number of segments that will be needed should appropriately capture the specificities of the risk drivers. In such an approach the factors could be designed to (implicitly or explicitly) take liability, asset risk and ALM into account (as with any approach). Key diversification and risk mitigation effects should also be included.
  - One criteria for determining liability segments could be based on the extent to which financial market risk embedded in the assets is borne by the insurer (eg life products with guarantees), by the policyholder (eg unit-linked products) or shared (participating products).
- Regarding NTNI activities we believe that:
  - NI activities should be addressed under relevant sectorial rules and reflected as a net adjustment to available capital (own funds), and not as part of required capital.
  - How to deal with NT risks requires further thought but should be addressed, so that the HLA can be explicitly targeted.
- Whichever approach is put forward by the IAIS, care must be taken to ensure the approach is risk-sensitive enough to work as intended taking into account key risk drivers (liability, asset, ALM), key risk

mitigation (including reinsurance, participating products, hedging, risk absorbing liabilities, etc) and key diversification effects. However, some thought is needed on the potential design options as this will determine the data and level of granularity required to be gathered in the field testing.

- In addition to that, adjustments of qualifying capital resources as foreseen in **paragraph 23** need prior reflection on whether the underlying issue is already addressed by the required capital in order to prevent double counting of risks.
- We believe that the loss absorbing capacity of liabilities should also be reflected – either explicitly or implicitly in the model.
- In addition to that, adjustments of qualifying capital resources as foreseen in **paragraph 23** need prior reflection on whether the underlying issue is already addressed by the required capital in order to prevent double counting of risks.

Comments on key Risks Addressed (para 24-28)

- We agree with the key risks indicated in **paragraph 24.**
- We understand that the HLA requirement is targeting the NTNI exposures of companies. We thus believe that the NTNI part of the BCR should be explicitly identified for HLA purposes.
- Regarding NTNI risks we believe that consideration should be given to ensure that the reflection of such risks in the BCR takes into account the three principles set out in the IAIS's G-SII's policy measures put forward in July 2013.
  - NT activities which are materially systemically risky need to be separately identified to facilitate the targeting of the HLA. One way to capture this would be to address them in the segmentation of liabilities.
  - NI activities should be addressed using sectorial rules. For example, for a non-insurance subsidiary concentrating on banking activities, Basel III rules should be used.
- While we understand the importance of striking the right balance between simplicity, comparability and risk sensitivity, we believe that appropriate recognition should be given to the very different risks embedded in insurance liabilities. Granularity (as defined under **paragraphs 25 and 100**) should thus go beyond a simple life vs. non-life insurance split.
- In addition, we believe that non-proportional reinsurance, as a key risk mitigation technique, deserves careful consideration, given its specific risk characteristics.

Comments on Other considerations (para 29-34)

- We welcome the recognition in **paragraph 29** of the fact that the Basel III leverage ratio is not appropriate for G-SIIs.
- Although we support the efforts for a simple and straightforward approach, as indicated in our responses in earlier sections, we support an approach that may have more than 10 liability segments and therefore more than 10 risk factors. Consequently, we believe that it might not be helpful to limit from the beginning the number of risk measures and factors (as mentioned in **paragraph 30**). The field testing exercise will reveal which level of granularity is needed to ensure a comprehensive assessment of the risk profile.
- We doubt that Solvency I or Basel III would provide a useful basis for setting factors as suggested in **paragraph 31**. The purpose of a potential approach aiming to split the total business into liability segments is to allow a simple, but risk based approach. Solvency I and Basel III are based on entirely different approaches. While the Solvency II MCR calibrations could be examined as a useful reference, recognition needs to be given to the fact that the Solvency II MCR has a very limited reflection of diversification.
- We would like to the importance of diversification to be considered. In the specific case of the BCR, diversification could be taken into account either explicitly (through a correlation matrix) or implicitly (through calibration of the factors). As already indicated, any of these approaches would need appropriate investigation to make sure that the BCR is enough risk sensitive and appropriately captures the risks that the insurance company is exposed to on a consolidated basis.

Comments on Conclusion and next steps (para 35-38)

- According to **paragraph 38**, a decision regarding whether the BCR would apply to IAIGs is set to be taken during 2014. The development of the BCR was triggered by the need to have a basis for defining the HLA

to be applied to G-SIIs. We also understand it to be a temporary measure until ICS will be developed. We therefore believe that, at this stage, the scope of the BCR should be limited to the development of the HLA.

Chapter 3: Context

General comments on Context

Comments on background (para 39-43)

None

Comments on The BCR mandate (para 44-47)

None

Comments on Scope of application (para 48-49)

- Off-balance sheet exposures, as indicated in **paragraph 48**, should be considered only if material. With the consolidated balance sheet as a starting point, it is expected that there will be only a limited number of off-balance sheet exposures subject for consideration. The principle of economic valuation requires that both off-balance sheet assets and liabilities deserve equivalent consideration.
- The definition and purpose of the NT component of the NTNI activities, including the statement made in **paragraph 49** on the BCR/HLA role vis-à-vis the NTNI risks remain very unclear.

Comments on Principles (para 50-53)

- In various parts of the consultation the focus is placed on investigating trade-offs between simplicity, risk sensitivity and comparability. We are therefore surprised to notice that risk sensitivity is not mentioned in the principles stated in **paragraph 50** (as it is the case for simplicity and comparability). It is paramount that risk sensitivity receives the same emphasis.

Comments on Role of a "basic" BCR (para 54-61)

- **Paragraph 58** implicitly indicates that internal models increase complexity inappropriately and make supervision more difficult. We would argue that appropriately designed and supervised internal models are proper tools for measurement of insurers' risk exposures. Equally, **paragraph 58** emphasises the difficulties posed by the pursuit of increased risk sensitivity. We believe that this perspective should be balanced with the recognition of the dangers of crude, non-risk-sensitive measures, which may impose inappropriate capital requirements.

Comments on Qualifying capital resources (para 62-64)

- As indicated in **paragraphs 62 and 63**, further guidance on capital resources to serve the BCR purpose is given under ComFrame - Module 2. However, as highlighted in our response to the ComFrame consultation in December 2013[1], we have strong concerns about ComFrame's approach to qualifying capital resources. For example, we consider that it should not contain specific definitions of which capital resources qualify, but that it should set out principles that permit the flexibility needed by various regimes. Furthermore, the definitions of core capital and additional capital are far too strict. One of the main aims of a regulatory capital standard should be the protection of policyholders. From this perspective, 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.

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

Comments on Non-insurance activities (para 65)
None

Chapter 4: Comparability of valuations

General comments on Comparability of valuations (para 66-71)

- We believe that valuation cannot be seen as an isolated issue, but should be considered in conjunction with the eligibility of own funds (qualifying capital resources) and the manner in which these are derived.
- We support the use of market values for valuation of assets as indicated in **paragraph 69** – but only if the liability measurement is able to recognise the long-term nature of the business and therefore can, where it is an appropriate reflection of product design, ALM or other risk management activities, reduce or eliminate the own funds' exposure to market value movements.

Comments on Valuation of liabilities – current estimates (para 72-76)

- Although discounting is not explicitly addressed in the BCR proposal, it is crucial that the discount rate used to determine the (present) value of technical provisions reflects the illiquidity (and often long-term) characteristics of insurance liabilities, as well as the consequent reduced risk of losses from forced sales of corresponding assets – and therefore reduced exposure to market value movements.
- Equally, both top-down, as well as bottom-up approaches for deriving best estimates should be possible, in order to ensure that the valuation methodology correctly reflects the overall balance sheet and does not create artificial volatility or pro-cyclical behaviour. A principles-based approach (such as the IFRS 4-Phase 2 framework) should be adopted for deriving yield curves to be used in the calculation of BEL. Yield curves that comply with the pre-defined principles should qualify as eligible for BCR purposes.
- As indicated under **paragraph 75**, risk margins, when calculated, should be treated as a component of capital resources for BCR purposes. Given that the MOCE appears to have no explicit role in deriving the BCR, it would maybe be useful, for simplicity reasons, to explicitly indicate that there is no need to calculate the MOCE.
- Regarding the definition of current estimate quoted in **paragraph 73** from ICP standard 14.8, we agree that it is important to include all the future cash flows, without arbitrary exclusions. For the purpose of the upcoming BCR field testing exercise (and only for that purpose), firms should be able to use existing approaches and should be requested to explain how insurance contract boundaries have been treated.

Comments on Valuation of assets (para 77-81)

- Where an economic balance sheet is taken as basis for deriving the BCR, there should be no exclusion of assets (as suggested in **paragraph 81**) nor adjustments to best estimates (as suggested in **paragraph 105**).

Chapter 5: Factor-based approach

General Comments on Factor-based approach
Please refer to our comments on Approach (paragraphs 13-20).

Comments on Context (para 82-95)

- We agree that it is important that the BCR be risk sensitive as stated in **Paragraph 89,** however we do not agree that the aim should be that it is "not overly so". While achieving simplicity in the BCR measure may result in less risk sensitivity – this is not an aim *per se*. If it can be both simple and risk sensitive this is obviously ideal – even if very difficult to achieve in practice.
- **Paragraph 90** highlights the importance of aligning "incentives to G-SIIs consistent with their risk management activities and decisions." However, risk management activities and decisions are strongly influenced by internal governance and existing regulatory valuation and capital requirements. Accordingly, the creation of a simplified measure of the type envisaged for the BCR, even if risk sensitive, must not be considered as the measure that drives risk management behaviour.
- As indicated in **paragraph 91**, consideration could be given to implicit allowances for detailed diversification benefits through the calibration of factors. However, we would like to highlight that

diversification is important, at the very least for composite insurers, between the life and non-life businesses.

- As already indicated, we strongly welcome recognition in **paragraph 94** of the irrelevance of the Basel III leverage ratio in an insurance context. We believe that it's of paramount importance to understand that, given the significantly different balance sheets and business models that insurers and banks have, imposing banking-inspired risk measures is not appropriate to the insurance business model.

Comments on Major risks (para 96-103)

Please refer to our comments on Approach and Key risks addressed (paragraphs 13-28)

Comments on Factor-based approach calculation (para 104-107)

- Where an economic balance sheet is taken as basis for deriving the BCR, there should be no exclusion of assets (as suggested in **paragraph 81**), nor adjustments to best estimates (as suggested in **paragraph 105**).

Comments on level of granularity (para 108-111)

None

Comments on Generic example (para 112-115)

Please refer to our comments on Generic example and Key risks addressed (paragraphs 21-28).

We believe that the statement under paragraph 113 regarding the fact that risk sensitivity will always increase by including additional factors needs a caveat saying that risk sensitivity will increase if and only if the factors themselves are predictive of risk.

Comments on Field testing process (para 116-123)

- As already mentioned, we believe that the field test design needs to be sufficiently flexible with regard to the granularity of segmentation.
- Given the limited timeframe to complete the BCR, we recommend that the IAIS focus only on this during the initial field testing and on the valuation basis to be used for it.
- Field testing should be organised such that those participating will be able to assess the structure and quantitative impact of the BCR, allowing also time for further refinement and testing in order to deliver an appropriate and workable measure.

Comments on Next steps (para 124-126)

None

General additional questions raised by the IAIS in their response template:

A second consultation in mid-2014 will specifically invite comments on a range of questions regarding the BCR and its relationship with other existing and proposed regulatory measures affecting G-SIIs and Internationally Active Insurance Groups (IAGs). You may comment below if you wish to provide input on any of these general questions in advance of the second consultation:

Please note that these comments are for information only as we consider that it is premature, at this stage, to be more specific in the absence of more detailed information on the BCR.

1. Is the purpose of the BCR clear enough?

As already noted, we are confused by the indication that the scope of the BCR might be extended beyond G-SIIs. Our understanding, emerging from the policy measures put forward by the IAIS and the FSB in July 2013, is that 1) the role of the BCR is to provide a basis for the computation of the HLA for G-SIIs and 2) is a temporary measure. We have taken this as a hypothesis in our input and we strongly believe that this is the most appropriate way to regard the BCR, especially given the significant time constraints and simplicity objectives.

We however agree that work in the BCR debate will provide useful insights and conclusions to inform the developments of the ICS – and the relevant MCR/PCR measures already defined via ICPs.

2. At what level should the BCR be calibrated compared to existing national benchmarks?

Given the tradeoff between simplicity and risk sensitivity, the benchmark for the BCR should be calibrated as a minimum capital requirement. In this respect, the Solvency II MCR would provide a useful reference point for calibration of the BCR, given that it is a simple factor-based approach based on a similar valuation framework, which has been tested.

3. Is the BCR expected to be a temporary measure, until the risk-based group-wide global insurance capital standards (ICS) is in place, or will it continue to apply?

As already indicated, we believe that the BCR should be a temporary measure. Moreover, we expect the BCR to be calibrated as a “basic” level, for example, significantly below the level set by the SCR under Solvency II, because otherwise the simpler BCR would create conflicting requirements relative to the sophisticated Solvency II requirements.

4. Should a backstop capital measure be introduced to complement the proposed ICS, in addition to or instead of the BCR? If so what should the purpose of such a backstop capital measure be, compared to the BCR?

Please refer to our responses to questions 1, 2 and 3.

However, we believe it would be helpful to clarify if, as we have assumed, the backstop capital measure referred to in the consultation is the same as the Minimum Capital Requirement (MCR) defined in ICP 17. If not, their different purpose should be defined.

5. Will the proposed approach to valuation of assets and liabilities provide sufficient global comparability?

We believe that a more clear idea on comparability will be achieved once field-testing is concluded.

6. Can a reasonable balance of risk sensitivity and simplicity be achieved using a factor based approach?

We believe that an appropriate balance is achievable for the BCR purpose, but is extremely challenging given the time-table. Striking the right balance between simplicity and appropriate risk-sensitivity should be an outcome of the field testing exercise and requires collecting more data than will potentially be used for the scope of the BCR framework.

7. How should the BCR be integrated into national or regional frameworks which are in the process of being implemented or modified?

The implementation and integration of the BCR can represent a significant challenge for the currently set timing targets. All efforts should be made to avoid the emergence of global capital rules that conflict with local/regional ones. We therefore believe that interaction between global and local/regional rules should be carefully assessed.

8. How should supervisors enforce the BCR in a consistent manner across jurisdictions?

Required legal powers will need to be in place so that supervisors can set appropriate capital requirements to reflect HLA from 2019. We believe it’s important that a level playing field is ensured across G-SIIs.