Insurance Capital Standards cause stakeholders concern at IAIS meeting

It may have been California dreamin' to expect the emergence of consensus at the International Association of Insurance Supervisors (IAIS) Capital-related Stakeholder Meeting held in a large, crowded, windowless conference room in a luxury hotel in Newport Beach. But as the daylong session on insurance capital standards (ICS) wore on, it became ever more evident that the gap between the international supervisors and most US stakeholders was much like that between early East Coast and West Coast rappers — a little difficult to understand from the outside, but of obvious importance to both and apparently close to unbridgeable.

The meeting could be described as a frank and open exchange of views. At least one European panelist seemed frustrated by the US industry response, repeatedly encouraging attendees to provide constructive comments on the technical issues under discussion instead of simply rejecting the IAIS's vision. Such comments could influence the direction of the ICS, and not commenting would be a missed opportunity, he said.

Some US stakeholders seemed to have renewed energy in their opposition to the IAIS move to impose ICS that they think may be unnecessary and rushed. Some stakeholders reminded the IAIS panel that while that organization could propose such standards, only US legislators and regulators could impose them in the US.

Insurers may well have been looking at Basel III, the closest banking equivalent to the current IAIS planned standards. The banking standards were adopted by the international community in 2010, yet a December 2014 report from the Basel Committee on Banking Supervision of the Bank for International Settlements still found the US only "largely compliant," a step below fully compliant.[1] The European Union "was evaluated to be materially non-compliant with the minimum standards prescribed under the Basel framework."[2]

This may illustrate the political difficulty of local implementation of agreed upon international standards.

Stakeholders attending the meeting included US and international trade associations, international insurance groups, US domestic-only groups, state insurance regulators, federal insurance regulators and other federal insurance officials, international insurance supervisors, and other interested parties. Many testified, with shared concerns including the increased cost of the proposed requirements not being accompanied by a clear justification for their existence.

The IAIS told attendees that this meeting was the first step in a lengthy process, and offered reassurances that ICS was a group-wide, consolidated insurance capital standard applicable to IAIGs (including G-SIIs), and not intended as a legal entity requirement.

Hugh Savill, chair of the Global Federation of Insurance Associations, opened by expressing an oft-repeated concern about a potential one-size-fits-all ICS, saying, "We do not believe that a global intervention level will fit appropriately."

Savill was also the first to say he thought ICS would not happen by the 2019 deadline, and should be done incrementally.

Who's doing what with capital standards?

Organization	Focus
NAIC	US Group Insurance Capital Standards
Federal Reserve Board and Banks	SIFIs, BHCs, SLHCs
IAIS (incl. state insurance commissioners, NAIC, Fed, FIO)	G-SIIs, IAIGs

Note: There may be overlap and US bodies have reported cooperating on their approach.

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Andrés Portilla, Managing Director for Regulatory Affairs at the Institute of International Finance was one of many echoing that view and evoking concerns about the politics of the process, saying, "No major global standard has been developed…without a clear understanding of the political process…This view has not been articulated in this process…giving uncertainty." He called for ICS to be evolutionary, not a "big bang shock to the system."

The need for a principle-based framework that still recognized and was compatible with local regulatory regimes was a central theme of many stakeholders.

In many ways, US and IAIS representatives seemed to be talking past each other. One stakeholder ascribed the communication difficulties hindering the process to a fundamental difference in perception, saying the IAIS seemed to be asking the US how it preferred to be executed, while the US was still proclaiming its innocence and planning to appeal its conviction.

Common ground seemed hard to find, and may prove elusive at least until the June 19 general stakeholder hearing in Macau. There, industry and other stakeholders will get the chance to discuss high-level concepts with the IAIS Executive Committee as opposed to technical details.

The presence in Newport Beach of numerous US industry representatives not directly affected by the proposed ICS may indicate that US stakeholders now realize the importance of the game afoot. The representative of one US-only group specifically testified about fears that ICS would eventually be imposed on non-IAIGs.

While the final effect of communications by stakeholders on the IAIS and ICS remains to be seen, recent reports have indicated that the IAIS has moved toward flexibility in timing for ICS, and is moving toward flexibility in the structure.[3]

2015 IAIS Capital-related Stakeholder meetings

Friday, March 20	Rome
Wednesday, May 6	New York
Tuesday, May 12	Tokyo
Friday, June 19	Macau (General Stakeholder hearing)
Tuesday, August 4	Basel
Monday, October 5	Basel

Background and comments

This stakeholder meeting was hosted by the IAIS Capital Development Working Group and the Field Testing Working Group. This meeting was one in a series of steps toward development of ICS, begun in July 2013, when the IAIS announced that it would develop global ICS by 2019. During the third quarter of 2014, the IAIS published and held a hearing on draft ICS Principles. On December 17, 2014, the IAIS released a draft of the ICS for consultation to members and stakeholders, which included 169 questions to be addressed at these consultations.

Comments noted at the stakeholder meeting varied based on the nature, scale, and complexity of the group represented, as well as by Supervisor. They included:

General comments

- Several stakeholders requested more clarification on comparability, the purpose of the ICS, and capital neutrality in the initial implementation phase. Much of this was part of a back and forth with Paolo Cadoni, Technical Head of Department in the Prudential Policy Division of the Prudential Regulatory Authority (UK), Chair of the Field Testing Working Group, on the fundamental need for and purpose of the ICS.
- The American Academy of Actuaries (AAA) recommended a "total asset requirement" rather than the current focus on capital.
- Members of the IAIS Secretariat stated that regulatory arbitrage was a major concern for the IAIS, and specifically cited reinsurance (in general) as an area of capital arbitrage. This may echo views expressed by some from the EU at the last open meeting of the IAIS in Amsterdam, where US regulatory oversight of reinsurers was blasted as insufficient and risky.

Comments on valuation

- Tom Finnell, Deputy Director, Regulatory Policy of the US Federal Insurance Office (FIO) discussed the GAAP+ approach, including related concerns. During its October 2014 annual meeting in Amsterdam, the IAIS decided that the market-adjusted valuation approach would be used as the initial basis to develop an example of the standard method in the ICS. However, the GAAP valuation approach data will be collected. Reconciliation between the market-adjusted valuation approach and GAAP valuation approach will be requested of the participating IAIGs. This information will be used to explore and, if possible, develop a GAAP with adjustments approach.

- Cadoni said that in designing the valuation method, the goal was comparability and responsiveness to stress.
- Peter Windsor of the IAIS Secretariat stated that different products have different complexity, and if, based on professional judgment, a deterministic approach provides proportionality, then it can be used in the valuation of non-life reserves. Ian Marshall, head of the Solvency Assessment and Management Unit at the Financial Services Board of South Africa confirmed that if liabilities are symmetric, then effectively it is a probability weighted average.
- Most US stakeholders did not support using the margin over current estimate (MOCE) in the technical provisions for various reasons. Among the most important was that it provided little benefit in light of the complexity it added, and the significant effort required to determine the value.
- Cadoni, chair of the Field Testing Working Group, said that group would consider testing the three-bucket approach for construction of the discount curve, as presented by one large insurance group. That company's representative argued that the choice of discount rate is among the most important decisions affecting the level and behavior of the insurance capital metric. Beyond deep and liquid markets, observable rates are not reliable or do not exist at all, and the resulting volatility of reserves would result in volatile and misleading capital ratios. She proposed the "3-bucket approach" for the construction of the discount curve based on principles to be consistently applied across jurisdictions:
  - **Bucket #1:** Use market rates in "Deep and Liquid" markets
  - **Bucket #2:** Grade
  - **Bucket #3:** Determine stable long-term rate

Comments on capital resources

- There was strong opposition from stakeholders regarding the exclusion of debt (e.g., surplus notes, senior holding company debt, and hybrid debt) as capital resources. Discussions included whether debt was structurally, not contractually subordinated to senior issues.
- The IAIS members on multiple occasions reminded the stakeholders that the ICS is a group capital requirement that includes the consideration of financial stability. Some stakeholders wondered if this meant that the ICS would possibly protect debt holders or counterparties to a certain confidence level. However, the IAIS representatives, especially Cadoni, said that the IAIS was not designing a zero failure system, but rather wanted to ensure an orderly resolution.

Comments on capital requirements

- Many stakeholders supported a minimum capital requirement (MCR) or slightly above MCR for calibration as opposed to a prescribed capital requirement (PCR). MCR would be informative, allowing regulators to discuss the capital status of an insurer holistically, as opposed to PCR, which could require regulatory action that may not be warranted in a given situation. Regarding triggers for intervention, several stakeholders suggested that a breach of the ICS requirement should result in a discussion between the supervisory college and the IAIG, rather than mandating specific remedial actions.
- For risk measures, the pros and cons of Value at Risk (VaR) and Tail Value at Risk (TVaR) were widely discussed, with most stakeholders supporting the use of VaR.
- The majority of stakeholders supported a one-year time horizon, with the notable exception of the AAA, which called that inadequate.

What should stakeholders, including industry, do?

1. **Participate** This may be the sole point of clear agreement among US state and federal officials and the international regulatory community. IAIS panelists and the NAIC's International Insurance Relations Committee Chair, Florida Insurance Commissioner Kevin McCarty, urged attendees to get involved in shaping the debate.
2. **Review** Current products and processes may be affected by the various proposals, and added costs may be incurred. As the discussion continues, an ongoing evaluation of the effect of new standards will aid in planning.
3. **Plan** There is as yet no firm and final proposal, but medium- to long-term product and capital planning should take into account the effects of possible changes, and preparing contingency plans could lead to a faster, more appropriate response to the outcome.

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Endnotes

1 "Basel Committee on Banking Supervision Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – United States of America," Basel Committee on Banking Supervision, Bank for International Settlements, December 2014.

2 "Basel Committee on Banking Supervision Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – European Union," Basel Committee on Banking Supervision, Bank for International Settlements, December 2014.

3 Barry Leigh Weissman, "International Capital Standards Delayed," (blog), Lexology, March 2, 2015 http://www.lexology.com/library/detail.aspx?g=d9e3177b-05e1-4c19-a0c0-8b1e5e0dfc42.

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