

IAIS Consultations

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Q-Nr.	Reference Question
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2. Executive summary

Q-1	2.	General Comments on Executive Summary <p>The factor based approach is a practical way to create an approximate measure of required capital levels and is an approach used both in the US and in Solvency II. The document shows good self-awareness of the limitations of such an approach, the trial nature of its use that will be undergone over the next few years, and what has already been learned through the field testing process so far. Our major observations (which will be detailed below) address the following topics which are of particular interest to the IAA: 1. How to address on an ongoing basis the risk sensitivity shortcomings of whatever becomes the recommended BCR factor approach? 2. Recommended improvements for the BCR itself. 3. Recommended focus on items that need to be addressed from first principles if carried over into the ICS requirements (BCR methods & approaches which may work for a small set of GSII's, may not translate easily to an International Capital Standard or may need further development as work continues on an HLA charge). 4. Some questions and suggestions to manage the issue of Current Estimates through actuarial standards. We think it would be helpful to focus on the outcome that is desired by the IAIS i.e. estimates without any conservatism/margin in them and then have the actuarial profession address the methods and principles to use to achieve that purpose. The IAA Council has already added a proposed IAA global actuarial standard on BCR current estimates to its official proposed International Standard of Actuarial Practice list and a Statement of Intent for this standard is currently under consultation.</p>
Q-2	2.1	Comments on Background & Mandate <p>We appreciate that asset charges and valuation methods for banks are different than those being proposed for insurers. Despite attempts to deal with NT and NI business separately within the BCR this difference is not overcome easily, This should be clearly recognised in any comparison with capital requirements for the banking sector. We recognize that even getting comparisons across insurers is a challenge due to the varying time horizons and risk management practices needed to manage insurance. We do think it helpful to understand that historically banks have capital for their assets, but not their liabilities. The asset charges are there because that is the risk they are underwriting – the risk of loaning out money they already have. Insurers traditionally have had capital charges for their liabilities and then added charges for assets that create liquidity risks because they are not matched to liabilities or because their book yield may not be realized due to liquid liabilities. Also, what consequences are intended to flow from the calculated numbers? Is it just to be used as a basis for a HLA or will there also be an implied or actual regulatory intervention of some sort? If it is just for the HLA, then we suspect the real critique of the BCR needs to be on what BCR charges are related to systemic/contagion type risks vs. diversifiable risks and fewer nuances may be needed for</p>

the relative risk weights assigned to the insurance risks.

Q-3	2.2	Comments on BCR Design	<p>What to do about ALM and Diversification? The proposed solution will not be consistent with a level playing field to achieve comparability across GSIs. A formula meant to adjust the average charge across all G-SIs for the impact of diversification (ALM risk) will penalize the highly diversified (best matched) companies and wrongly benefit the least diversified (and least matched) companies. Even a simple option like using a square root formula to capture diversification for uncorrelated risks could be a practical alternative here. How the BCR will “implicitly account” for both diversification effects and ALM (P 9 of BCR consultation document) needs to be described as fully as possible (e.g. by reference to field testing results) to avoid the “black box” accusations that would otherwise inevitably follow. The BCR formula does not address the quality of reinsurance, which can be a significant element that results in calls on capital. The IAIS report (page 18) indicates that more work is planned on this element, which we would highlight as being quite important. Lastly, fungibility is not addressed, which can be a significant legal impediment to accessing what should be adequate capital on a consolidated basis. There is a lot of effort to split out core vs. non-core capital to reflect if consolidated capital could really be used, if needed. Yet, fungibility may be an even greater limitation on what might be seen as available capital</p>
Q-4	2.3	Comments on Next steps	<p>We appreciate the tone used throughout as to the evolutionary nature of the BCR requirements. To this end, we think it would accelerate the needed evolution of the BCR if there were a requirement for a company self-assessment of how well the BCR measure risk charges actually reflect the internally calculated risk profile of the company. Averages and approximations used at one point in time for BCR will be less and less relevant over time unless they can be assessed against the dynamic updating that occurs within a firm’s own ERM process due to its changing mix of business and risk profile. The report requirements could be worked out through a blend of regulatory requirements and/or actuarial standards.</p>

3. Proposed BCR Approach

Q-5	3.	General Comments on Proposed BCR Approach	
Q-6	3.1	Comments on Application of BCR	
Q-7	3.2	Comments on BCR ratio	
Q-8	3.3	Comments on Required Capital	
Q-9	3.4	Comments on Insurance	<p>We have some concerns with the factors due to the uncertainty about what their ultimate impact and usage will be. Will users/viewers of the end results appreciate the approximate nature of the charges and the simplicity of the risk buckets? In some cases, the BCR as currently drafted, will not distinguish well between the levels/diversity of risks within, for example, annuities and non-life insurance and direct vs. reinsured business.</p>
Q-10	3.5	Comments on Non-insurance	
Q-11	3.6	Comments on Indicative capital allocation	
Q-12	3.7	Comments on BCR principles	

4. Qualifying Capital Resources

Q-13 4. General Comments on Qualifying Capital Resources

Q-14 4.1 **Comments on Tiering of Capital Resources**

Q-15 4.2 **Comments on BCR Ratio and HLA requirement**

Q-16 4.3 **Comments on Further work potentially affecting the current definition of Core Capital**

Q-17 4.4 **Comments on G-SII capital resources**

5. Market Adjusted Valuation Approach

Q-18 5. General Comments on Market Adjusted Valuation Approach

Q-19 5.1 **Comments on Valuation principles**

6. Impact on G-SIIs and potential G-SIIs

Q-20 6. General Comments on Impact on G-SIIs and potential G-SIIs

Q-21 6.1 **Comments on Calibration Level and Capital Resources**

Q-22 6.2 **Comments on Reporting and Applicability**

Q-23 6.3 **Comments on Implementation of the BCR**

7. Communication plans and next steps

Q-24 7. General Comments on Communication plans and next steps

Q-25 **Annex A** BCR Principles

Principle 5 states a desire for internal consistency over time. If the Current Estimate is meant to have no margins, then looking forward to the ICS, the major challenge will be how to reflect changes in the volatility of the risks over time and across jurisdictions through the capital charge. A factor only based approach will be hard pressed to capture these.

Q-26 **Annex B** Glossary

We see some needed refinement to get a Current Estimate that meets the purposes of the BCR with a consistent set of principles. We see a focus on specific granularity that leads to the following kinds of compromises from the goal of having an unbiased Current Estimate so that the desired risk margin can be captured in the capital charge. These include:

1. Contract boundaries limited to premiums that can only be forced to be paid. This introduces a conservatism/margin most of the time and also ignores a systemic risk of companies getting substantial levels of voluntary premiums when guarantees are too high. The contract boundary definition mirrors that of the IASB, but that boundary was purely driven by accounting considerations as to the accounting definition of an asset. For capital requirement purposes on a “going concern” basis it would be more consistent if all expected premiums can be considered from existing agreements with the policyholders.
2. Using a 40% corporate bond spread for discounting for assets that are marked at market values ends up introducing a margin into the balance sheet when those same assets are generating higher liability cash flows based on a higher earned rate. We appreciate the need to haircut the full asset earnings rate and to assess the exposure to a stress of earning less than the corporate rate. But this is not the same thing as producing a current estimate of the likely outcomes. For example, different sections imply that both real world and risk-neutral cash flows are the “right” cash flows to discount when current estimates should not include a risk adjustment. For example, from P24 Annex C paragraph 4, it is not clear whether the probabilities (and/or term structures) are meant to be risk-neutral or historical. The example cited on page 30 says that “For non-discretionary amounts such as bonuses or crediting rates, the Current Estimate should recognize the amounts expected to be paid consistent with the expected future experience and economic scenarios for which the liability valuation is based. For example, if a reference group of assets is expected to earn a greater amount than the contractual crediting rate and discretionary additional credit rates can be declared, the expected discretionary crediting rate should be taken into account. This projection should be consistent with the yield curve that is used to discount the cash flows for the contract” Let’s assume the current asset yield is 5%, there are expected defaults of 25 basis points, a credited rate of 2% guaranteed, an excess credited rate of 150 basis points and a risk free rate of 2.5%. Which cash flows should form the basis for the “current estimate”?
 - a. Asset yield is 4.75% and liability cashflows grow at 3.5% (the expected set of cashflows seen in the real world).
 - b. Asset yield is 3.5% and credited rate is 2% (40% corporate bond factor impact so “projection is consistent with the yield curve used to discount the cash flows”).
 Part of the challenge here is distinguishing between products where the policyholder shares some of the asset risk as well as whether the method is meant to portray estimates under “reasonable expectations” or is also meant to capture a value for the cost of any guarantees which may come into play under less “reasonable” (but certainly possible) futures. While this may well be a manageable issue for a BCR structure, it (along with handling currency related complexities) will be key issue to work out for HLA and ICS purposes.
3. Since there is only one discount curve, the current estimate produced via this method for long duration products will most certainly not be the average present value of the cash flows. The “IAIS specified discount curves” needs further development, as implied on P31 of the consultation document. (Note that the recently produced IAA discount rates monograph may be of assistance).
4. The use of the phrase “probability weighted set of cash flows (p. 24 C4-8) misunderstands the intent (as we have understood it) of a current estimate. Such a reference applied by the IASB turned out to be misleading since many believed that the calculated expected value had to be estimated that way. The phrase implies that there is a known distribution when all we really have is an estimated distribution and the number reported is an estimate of the expected value which can only be estimated. This estimated distribution has its own level of uncertainty about whether that estimate is correct so there is fuzziness even around what the actual distribution might be. This topic is being actively discussed within the actuarial profession and is why we would want to have the important principles and definitions in a standard.
5. If participating products include future policyholder dividends as “equity” then they are not using a central estimate approach for the future expected cashflows to be paid by the company and the equity is being used, not for a going concern purpose but to settle liabilities other than those incurred for the participating business (or, similarly, for non-guaranteed elements of stock company business as well). For this reason, it will be important to understand whether current estimates are to be done based on a going concern vs. wind up basis. For example, the Protection business measure recommends using a net amount at risk measure because technical reserves in early years will be negative. There may be other reasons to use NAAR, but the stated reason (Section F, par 26) introduces conservatism by not using the actual expected cashflows (due to concerns about what may be relevant to wind up an insolvent company). Thus, it makes sense to not allow negative technical reserves if the guiding principle is a wind up basis. But on a going concern basis (as referenced in 4.2 paragraphs 50 & 51), the actual cashflows as they unfold would be more appropriate. A similar issue would hold for the inclusion/exclusion of overhead expenses, the impact of new business and the impact of deferred tax assets. In conclusion, we would hope that

many of these issues could be reconciled through the use of an actuarial standard to provide some guiding principles on the objectives of a current estimate as defined by the IAIS.

Q-28 **Annex D** Qualifying Capital Resources - ComFrame

Q-29 **Annex E** Guidance for specific balance sheets items

Q-30 **Annex F** BCR Formula and Derivation

Q-31 **Annex G** Mapping table: BCR category to field testing data collection

Q-32 **Annex H** Sensitivity Analysis
