North American CRO Council

January 11, 2018

Dr. Victoria Saporta
Executive Committee Chair
International Association of Insurance Supervisors (IAIS)
c/o Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel, Switzerland
Via e-mail to: Romain Paserot

Re: Risk-based Global Insurance Capital Standard Version 1.0 for Extended Field Testing ("ICS Version 1.0")

Dear Dr. Saporta,

The North American CRO Council ("CRO Council") is a professional association of Chief Risk Officers ("CROs") from leading insurers based in the United States, Canada, and Bermuda. Member CROs currently represent 31 of the largest Life and Property and Casualty ("P&C") insurers in North America. The CRO Council seeks to develop and promote leading practices in risk management throughout the insurance industry, and provide thought leadership and direction on the advancement of risk-based solvency and liquidity assessments.

The CRO Council sent a letter to the IAIS, dated July 31, 2017, emphasizing the importance of alignment between the valuation of assets and liabilities in a market adjusted valuation ("MAV") approach within the Insurance Capital Standard ("ICS"). In that letter, we provided an example of the additional credit charges and non-economic regulatory capital volatility that will arise from misaligned valuations where discount curves reflect haircuts on the expected portfolio spread earned to support insurance liabilities. The letter also identified the potential unintended consequences that would result from such a volatile and pro-cyclical framework. We are writing this second letter to highlight additional areas of concern to the CRO Council, which we believe need to be further developed or vetted before the adoption of ICS Version 2.0. The CRO Council believes it is critically important for the IAIS to continue to evaluate these issues and explore multiple approaches to them in the 2018 Field Test as such analysis is essential for ensuring the design of ICS Version 2.0 is appropriate.

The CRO Council agrees with many of the themes included in the IAIS' ICS Principles that are guiding development of the standard, particularly the theme of promoting strong risk management behavior in a way that is transparent, balances simplicity with complexity of risk sensitivity measures and is applicable broadly across jurisdictions. The CRO Council acknowledges that ICS Version 1.0 is a developmental step in the broader ICS project and reflected progress on areas of concern. With that said, we believe there are several areas that require considerable further thought and refinement. The CRO Council's concerns fall into three categories: General Design of a Globally Consistent Group Capital Standard; Stress Design and Calibration; and Approach to Capital Resources. Should the IAIS fail to address the areas of concern noted in this letter, the ICS could lead to volatile and pro-cyclical outcomes, drive poor risk management practices, and incentivize non-economic behavior to the extent capital resources and requirements are based on overly conservative or distortive methodologies.

(1) General Design of a Globally Consistent Group Capital Standard

- **MAV Approach:** The MAV approach must take into account the long-term nature of the life insurance business model and avoid injection of artificial, non-economic volatility. To achieve this there must be symmetry between the valuation of assets and insurance liabilities. Please refer to the letter we sent, dated July 31, 2017, for additional details on our concerns with the MAV approaches included in the 2017 Field Test and ICS Version 1.0. Further, when a MAV capital calculation is applied to insurers whose inforce contains meaningful amounts of long term products that extend beyond the investable horizon, results may be inappropriately sensitive to near-term interest rate changes. For that reason, we encourage the IAIS to continue to consider alternatives, such as GAAP with adjustments and the aggregation based approach the U.S. is developing.
- **Margins Over Current Estimate ("MOCE"):** In ICS Version 1.0, the IAIS acknowledged many of the concerns stakeholders have raised regarding the use and design of a MOCE. The CRO Council believes that the ICS should not include a MOCE. The MOCE appears, at a high level, to be a solution in search of a problem. The prudence MOCE is a quantitative measure of unexpected losses and therefore is duplicative of required capital. The cost of capital MOCE represents a transfer concept, which does not have relevance as a deduction from "going concern" capital, particularly given a rigorous process underlying the determination of best estimate liabilities. Rather than include a MOCE, the IAIS should ensure supervisory concerns regarding the uncertainty of liability cash flows are adequately captured solely through the ICS capital requirements. Clearly segregating current estimate liabilities, available capital resources, and required capital is both transparent and simple and thus, will help ensure that risks are not double-counted. Alternatively, the cost of capital MOCE could be used to determine minimum capital requirements (MCR) under ICS i.e. to determine the minimum capital resources over current estimates to enable the insurance obligations to be transferred to another insurer. Using the MOCE as an MCR would not affect ICS capital resources but would provide a relevant indicator for supervisor intervention under ComFrame.
- **Treatment of Taxes:** It is important that the ICS apply a coherent approach to the treatment of taxes. Areas that require further attention include the treatment of deferred tax assets ("DTAs") for capital resource purposes, tax rates to be applied, and – should it continue to be part of the ICS – tax treatment of the MOCE. It is important that the IAIS not reflexively import Basel tax treatments. For example, the potential realization of DTAs under conditions of economic stress could differ for an insurance group with diversified financial and non-financial risks, relative to a banking organization concentrated in financial risk whose earnings are likely to be more volatile under stress. Further, suitable approaches to these items will need to appropriately reflect key differences in tax policy and treatment across jurisdictions. We commend the IAIS for scheduling the round-table in January 2018 that will focus on how to achieve a holistic view of taxes for the ICS.

(2) Stress Design and Calibration

- **Stress Calibration Setting:** There is concern among CRO Council members that the current stress calibrations exceed the intended 99.5% stress level (i.e., 1 in 200-year event) in many cases. For example, it is unrealistic to apply a 30% mass lapse assumption to life products generally.
- **Equity Risk Stress Design**: Equity risk factors do not sufficiently differentiate between the different types of equity classes e.g., private/unlisted equity, hedge funds, limited partnerships, commodities, infrastructure and other alternative investments, many of which can be shown to have exhibited lower market volatility than listed equity. In addition, the calibration of equity

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volatility risk is not reflective of observed historical volatility in stressed markets, and is specified using multiplicative factors that will increase the pro-cyclicality of ICS capital requirements for this risk.

- **Interest Rate Risk Stress Design:** For life insurers, interest rate risk beyond the investable horizon (e.g., 30 years in the U.S.), where liability cash flows cannot be hedged, should be treated differently than hedgeable exposures. Stresses to long-dated "tail" liability exposures should be reduced as near-term rate stresses are of little relevance in providing information about where rates will be at the time these exposures become hedgeable (i.e.., as they enter the investable universe, often 10, 20 or 30 years from now).
- **Mortality / Longevity Risk Stress Design:** While the CRO Council understands there are diverging views among global stakeholders on how to best measure mortality and longevity risk, we stress the need for the ICS to include an approach that is conceptually sound and provides a reliable measure of risks, while balancing the need for simplicity. The approach included in ICS Version 1.0 – a combined base stress covering both mortality and longevity – does not appropriately capture the way these risks manifest themselves for insurers with significant and credible claims experience. The CRO Council recommends the IAIS adjust the calibration of the base stress to a more appropriate level and add an appropriately calibrated stress on the trend component of these risks to the ICS.
- **Use of NAIC Ratings Designations:** The CRO Council believes consumers and financial markets will be best served by an ICS that accommodates the diversity of global insurance markets and recognizes existing risk sensitive regulatory tools and frameworks. Further, the IAIS must consider potential unintended consequences of not allowing the use of NAIC ratings such as potential reductions in the flow of capital to investments which rely on such ratings (e.g., private placement investments, loans, etc.) and potential disincentives for jurisdictions around the world to develop risk sensitive frameworks like that of the NAIC. Additionally, for certain securitization exposures, the use of rating agency credit ratings could significantly overstate the economic capital applicable to these positions. Rating agency ratings that solely address default risk (or the probability of default) would not capture the potentially significant expected recovery on thicker tranches. Additionally, if an insurer were to purchase a distressed securitization position at a significant discount to its fundamental value, this discounted price represents a form of buffer against future realized deterioration in the credit performance of the asset.
- **Mortgage Risk Charges:** The CRO Council recommends the IAIS incorporate the NAIC's formula for mortgage risk charges. While the 2017 Field Test and ICS Version 1.0 retain the NAIC-based quality scale structure it incorporates BCBS proposed increased risk charges where the loan repayment is dependent on property income – a rule that should not apply to residential mortgages. Further, buy to rent property should be classified as commercial property and residential property is unlikely to produce income.
- **Financial Risk Mitigation:** While the 2017 Field Test and ICS Version 1.0 include improvement in the recognition of risk mitigation practices (i.e., the ICS now permits inclusion, subject to specific criteria, of the value of rolling hedge programs on the balance sheet in required capital calculations), work remains to be done on the treatment of dynamic hedge programs. The CRO Council supports the recognition of well governed hedging programs in the ICS, which would incentivize good risk management practices as these programs are appropriate and effective risk management techniques that are used under clearly defined and documented guidelines.
- **Diversification of ICS Risk Factors:** The correlation assumptions used in ICS Version 1.0 insufficiently recognize benefits of geographical and risk diversification within and across risks.

The ICS should use a more granular aggregation approach that accounts for a realistic level of intra-risk geographical diversification as well as diversification across different risk types.

(3) Capital Resources

- **Capital Fungibility:** Currently, the ICS assumes capital fungibility across the group. The CRO Council believes it is important for the IAIS to recognize that the ICS should serve as a complement to existing legal entity specific and group statutory capital calculations and/or requirements.
- **Structural Subordination:** As a practical matter, senior debt issued by insurance holding companies, whose proceeds are then down-streamed to operating insurance subsidiaries, is subordinate to policyholder claims in the event of an insolvency. Subsequent payments from the operating subsidiary to the parent require supervisory notice or approval, which effectively restricts actions that would adversely affect policyholders. For this reason, it is appropriate to treat structurally subordinated debt equal to contractual subordinated debt (i.e., as a Tier 2 capital resource).
- **Contract Boundaries:** If designed appropriately, the ICS MAV approach is an economic approach based on realistic, best estimate assumptions and observable data. The GAAP with Adjustments ("GAAP Plus") approach similarly leads to a valuation of liabilities on a best estimates basis when designed appropriately. Requiring a strict legal interpretation of a contract boundary is inconsistent with this approach and results in implausible assumptions that all short term, renewable business lapses at the next policy anniversary/renewal date. Effective available alternatives to a strict legal interpretation of a contract boundary – such as an economic approach, enhanced reporting, or stress testing – should be considered.
- **Encumbered Assets Capital Deduction:** We suggest that the ICS permit insurers to exempt assets from the encumbered assets capital deduction where a counterparty does not have rights to the excess collateral in the event of default and foreclosure. Certain counterparties require overcollateralization of a secured liability to protect against potential decline in the market value of an invested asset. The ICS requires credit risk and other capital charges on the invested assets in addition to an encumbered assets charge. We propose that where the counterparty does not have rights to the excess pledged assets, the ICS credit risk and other capital charges on the invested assets are a sufficient capital charge for these assets and that the encumbered assets charge is unnecessary.

The CRO Council commends the IAIS on the progress it has made in developing ICS Version 1.0. We recognize the value of well-designed regulation and stand ready to support the development tools, where needed, which help protect insurance consumers and financial markets. Poorly designed regulatory capital frameworks can amplify risk, promote pro-cyclicality and volatility, and undermine the role insurers play in providing protection to consumers and as a stable provider of long term funding in the markets. To avoid such outcomes, the CRO Council believes that further development of the ICS should be afforded an appropriate amount of time to ensure the final standard is fit for purpose. To this end, we strongly encourage the IAIS to continue to refine the ICS: before adoption of ICS Version 2.0 in 2019, during the five-year monitoring phase (i.e., 2020-2025) that was announced at the IAIS Annual Conference in Kuala Lumpur, and after implementation as a prescribed capital requirement ("PCR") in 2026.

We look forward to engaging with the IAIS, and expanding on the concerns we have raised, at a technical level over the years ahead and request that the IAIS consider these points during their continued efforts to develop the ICS.

Sincerely,

Rahim Hirji, Chair
North American CRO Council

cc:

Mr. Jonathan Dixon, IAIS Secretary General
Ms. Catherine Lezon, IAIS Deputy Secretary General
Mr. Romain Paserot, IAIS Deputy Secretary General & Head of Capital and Solvency
Ms. Julie McPeak, IAIS Executive Committee – Vice Chair
Mr. Hiroshi Ota, IAIS Executive Committee – Vice Chair
Mr. Bernard Dupont, IAIS Executive Committee – Member
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