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International Association of Insurance Supervisors (IAIS)
Public Consultation: Risk-based Global Insurance Capital Standard Version 2.0

Please note that the CIA did not respond to all questions in the consultation on the risk-based global insurance capital standard version 2.0. The CIA's comments to questions to which it responded appear below.

Q21 Are there any further comments regarding the base yield curve methodology that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Yes.

Aggregation of real rate of return across all developed countries is too broad, and results in real rate of return assumptions that are too low for North America. We recommend that these assumptions are recalibrated using geography-specific assumptions.

Q22 Are any practical difficulties foreseen in the implementation of the proposed multi-bucket approach (eg issues with products that are close to the boundaries of the buckets)? If "yes", please explain.

This approach requires bucketing of asset and liability cash flows into granular term buckets to assess degree of matching for top/middle bucket. This may not be practical to implement in many jurisdictions and would likely pose challenges regarding auditability. Of note, this approach will not be practical under IFRS 17, which by design does not require asset cash flow information.

Q23 Are the eligibility criteria defined for the Top Bucket appropriate for ICS Version 2.0? If "no", please explain.

No.

Cash flow matching as defined in the top bucket (and middle bucket) criteria is not consistent with ALM methodologies used in practice and is not consistent with the prudent ALM practices as described in ICP 15.

Q24 Are the eligibility criteria defined for the Middle Bucket appropriate for ICS Version 2.0? If "no", please explain.

No. See Q23.

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Q28 Is the application ratio considered for the Middle Bucket appropriate for ICS Version 2.0? If "no", please explain.

No.

The rationale for inclusion of an application ratio in ICS is not clear. Specifically, an application ratio is intended to address the risk of selling assets in a stressed market environment where expected returns on those assets may not be realized. This is a liquidity risk which is outside the scope for ICS and should be addressed elsewhere in ComFrame.

In addition, the use of an application ratio causes the asset and side of the balance sheet to be treated inconsistently when measuring risk in the stressed market environments, and as a result leads to a lack of comparability of results across companies, including increasing the risk of false positives or false negatives.

Q29 Is the list of eligible Assets specified for the Middle Bucket (which also applies to the Top and General Buckets) appropriate for ICS Version 2.0, taking into consideration the objective of the MAV spread adjustment? If "no", please provide sufficient detail and rationale.

No.

Eligibility criteria do not include equity (and other similar) assets that are widely used in actual practice to back long-term business. As a result, market-adjusted valuation (MAV), and consequently ICS, produces a misleading and distorted view of risks associated with long-term business. This could potentially result in the IAIGs being unable to support the sale of long-term insurance products once ICS is in effect. However, non-IAIGs would not be restricted. Clearly there would be broad social and macroeconomic implications if this were to be the case. The ability to fund long-term insurance and pension products is a concern for the Financial Stability Board (FSB). We strongly recommend that the IAIS consider conducting an impact study to assess the impact of ICS on the ability of insurers to continue to offer long-term insurance products to support retirement needs and to support investment in long-term assets such as infrastructure.

Q33 Is the application ratio considered for the General Bucket appropriate for ICS Version 2.0? If "no", please explain.

No. See question 28.

Q34 Are there any further comments regarding the General Bucket methodology? Please explain with sufficient detail and rationale.

Yes.

It is premised on a one-size-fits-all determination of spreads (average asset mix, average spread assumption). Clearly the industry does not invest based on the 'average', and as a result, using the general bucket approach to determine CEL will misrepresent the risk for the entity. Ultimately, it does not conform to ICS Principle 4 (reflects all material risks), ICS Principle 5 (comparability of outcomes), or ICS Principle 6 (promotes sound risk management).

Q35 Should the ICS include an adjustment above the base yield curve at the LTFR maturity? If "yes", how should it be calibrated? Please provide sufficient detail and rationale.

Yes.

As for the LTFR, the calibration of the adjustment should be based on historical data. The data would be the same as those used at the valuation date for the adjustment of the yield curve below the last observed term (LOT).

Q36 What is the most appropriate technical approach to address the issue identified? Please provide sufficient detail and rationale.

Paragraph 134 in the consultation document seems to confuse higher yielding with lower credit quality. The general bucket design could incent investment in higher yielding, high credit quality, short-term assets that are not appropriate to long-term liabilities. It is the duration mismatch that is the issue, not the credit quality, and as such it does not make sense to address asset liability duration mismatch within the credit spread risk calculation. ALM duration mismatch should be addressed as part of the ALM governance process as described in ICP15, and through calculating a liability discount rate that is dependent on the term of the actual assets held by the entity (not an assumed representative asset mix as is the case with the general bucket).

Q38 Are there any further comments on MAV that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Yes.

It is fundamental to a sound required capital design that assets and liabilities are valued consistently when measuring risk. To do this, it is necessary that the rate used to discount liabilities is aligned with the actual ALM practice of the company. In its current form, MAV has an emphasis on cash flow matching that is not consistent with actual ALM practice in the industry, and defaults to a general bucket approach that has no direct link to the actual assets held by the company.

Q40 Are there any modifications or simplifications to the methodology for the C-MOCE that would make it more appropriate for the intended purpose? If "yes", please explain with sufficient detail and rationale.

Yes.

The value of a C-MOCE is that it sets aside sufficient funds (current estimate liabilities plus C-MOCE) that the company can be taken over by another company that can supply the required capital and still earn a market return on capital. This is an admirable aim if the regulator in a jurisdiction wishes the problem company to continue to operate as a going concern.

However, this is not the role of a required minimum capital calculation, which is to give an indication of a company's ability to withstand severe adversities so as to protect policyholder guarantees. Ensuring continuation of a going concern is not a function of the ICS as it is currently envisaged. If a supervisor wishes to ensure the continuation of its companies as going

concerns, then that supervisor, in its jurisdiction, should require an explicit additional separate amount of required capital for that purpose.

An exit value is the combination of the current estimate liabilities plus a C-MOCE. A fulfilment value is the combination of the current estimate liabilities plus a P-MOCE. While the risks covered by a P-MOCE are already included in the ICS required capital, the excess of C-MOCE over P-MOCE is not included in the ICS required capital. It represents additional funds that a purchaser of a company would require to set up the required capital needed for a going concern business plus a sufficient return on capital to the shareholders of the purchaser.

A flaw with the use of a C-MOCE is that it could be taken to be a capital amount that would ensure that an entire IAIG company continues to operate as a going concern. However, in practice, given that an IAIG operates in numerous jurisdictions, it is not probable that a single company would take over the entire IAIG. This has been shown to be the case in actual past scenarios of IAIGs requiring financial assistance. Such rescues have taken place via purchases of individual subsidiaries in individual jurisdictions. This appears to be contrary to ICS Principle 1, which states that the ICS is a measure for a consolidated group as a whole, not as a collection of parts.

In summary, we do not see the value of calculating a C-MOCE as a part of the ICS.

Q42 Are there any modifications or simplifications to the methodology for the P-MOCE that would make it more appropriate for the intended purpose? If "yes", please explain with sufficient detail and rationale.

Yes.

The identification of the margins which make up the P-MOCE is consistent with the ICP 14 requirements for a margin within the valuation of liabilities and is consistent with requirements for a margin in valuations needed for IFRS 17. While the P-MOCE risks are already within the required capital defined by ICS 2.0, the advantage of showing a separate P-MOCE is that it gives an explicit measure of the margins that are required for ICP 14 liabilities and IFRS 17 liabilities.

Q43 Is the treatment of the P-MOCE, as defined in the Technical Specifications with full deduction from the capital requirement, appropriate? If "no", please explain with sufficient detail and rationale.

Yes.

A full deduction of the P-MOCE amount from the ICS capital requirement is appropriate since the level of risk covered by the P-MOCE is already included in the required capital of the ICS. A deduction thus avoids inappropriate double counting of the same risk margin.

Q44 Is the treatment of the C-MOCE, as defined in the Technical Specifications with no deduction from the capital requirement, appropriate? If "no", please explain with sufficient detail and rationale.

No.

We do not see the value of calculating a C-MOCE as a part of the ICS.

Q67 Should any changes be made to the criteria for recognition? Please explain. If "yes", please also provide:

- **Suggestions for how the criteria could be amended; and**
- **Specific examples of risk mitigation arrangements that would qualify if these changes were made.**

Yes.

The 20 percent haircut to renewal of hedge positions is arbitrary and does not reflect the underlying liquidity risk of these hedges in developed markets. For example, it can be shown that S&P 500 equity futures are highly liquid even in stressed financial markets, including the 2008 financial crisis. The current approach of applying a 20 percent haircut, therefore, fails to distinguish between renewal/liquidity risks for different types of risk mitigation strategies, and ultimately disincentivizes sound risk mitigation strategies such as dynamic hedging.

Q71 Should dynamic hedging arrangements be included in the scope of recognised market risk mitigation techniques for ICS Version 2.0? If "yes", please also comment on:

- **The approaches currently used in local jurisdictions or internally within insurance groups to assess the risk mitigation properties of dynamic hedging programs for the purposes of regulatory or economic capital.**
- **How these could be incorporated into the ICS as another method for calculating the ICS capital requirement; and**
- **The criteria required to be met to allow the use of these other methods.**

Yes.

While detailed modelling of dynamic hedging would likely be outside the scope of a standard formula approach, practical alternatives for reflecting a prudent recognition of dynamic hedging should be considered. This could include, for example, applying a hedge effectiveness factor as approved by the local regulator, where the factor is based on an analysis of a company's historical hedge performance effectiveness.

Q74 Are there examples of other instances for which an extension of management actions to allow for the recognition of premium adjustments may be appropriate? Please explain.

Yes.

Other examples of possible management actions are

- Changes in credited interest rates on certain universal life insurance contracts; and
- Experience rating refunds on group insurance contracts.

Q75 How should the cap on management actions be applied across risks?

The impact of any management action should reflect the following lags in the time it takes for management actions to take effect:

- Analysis of past experience and lags in resulting decisions for management to take action; and
- Time to implement any action.

Note that the ICS 2.0 is based on a target criterion of 99.5 percent over a one-year time horizon, and management actions may take longer than the one year to take effect.

Q77 The design for Longevity risk in 2017 Field testing balances the need for a risk-sensitive approach and a practical design of the risk charge. Are there any changes to the current design and calibration of the Longevity stress that would significantly improve the reflection of the underlying risk in the ICS? If "yes", please explain and provide examples and/or rationale to support the proposal.

Yes.

While the single stress for longevity combining both level and trend simplifies the calculation, it makes the calibration of this risk difficult to assess and ultimately reduces comparability of outcomes when comparing this risk across entities.

We recommend that the specification of this risk revert back to the level and trend specification used in the 2016 field test.

Q84 Are there any comments on Lapse risk that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Yes.

Mass lapse assumes flooring based on homogeneous risk groups—this implicitly assumes perfect policyholder behaviour selecting against the insurer based on moneyness, level of reserves, etc., which in practice is overly conservative.

Q110 Is the definition of Non-Default Spread risk appropriate for ICS Version 2.0? If "no", please provide rationale and details.

No.

The impact of changes in spreads that are not as a result of default materializes only in the event that the entity is required to sell assets in the stressed spread environment. Since changes in non-default spreads are temporary in nature, the NDRS is in fact a liquidity risk that should be assessed elsewhere in ComFrame and not in ICS.

Q124 Is the treatment of long-term equity investments (such as strategic and infrastructure investments) appropriate? Please explain. If "no", how should they be treated differently, and what criteria should be used to define long-term equity investments? Please highlight key design features and provide supporting evidence (including data).

No.

There is a significant amount of quantitative analysis, including a report from the World Bank Group in 2018, that supports a lower risk charge for infrastructure assets. In contrast, ICS applies a higher risk charge to infrastructure assets which potentially disincentivizes investment in this asset class.

Q125 Is the current method of adding the shock to the current volatility appropriate? If "no", please provide an alternative suggestion with rationale.

No.

There is significant empirical evidence, including the 2008 financial crisis, to demonstrate that spikes in implied volatility are temporary in nature. Given their temporary nature, it is unclear how a spike in implied volatility meaningfully impacts the ability of an insurer to fulfil its long-term liabilities. The ICS specification of this risk assumes that a volatility shock is permanent in nature, and as a result, the volatility risk specified in ICS as a component of equity risk is fundamentally miscalibrated.

Q135 Is the current design of Credit risk appropriate for ICS Version 2.0? If "no", please explain with sufficient detail and rationale.

No.

The exclusion of internal ratings in ICS is fundamentally misaligned with sound ALM practices, many of which allow the use of internal ratings subject to appropriate governance. We recommend that internal ratings be allowed within ICS, where these ratings are subject to oversight by the local regulator.

Q151 Are there any further comments on Aggregation and Diversification that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Yes.

The IAIS should consider explicitly reflecting geographical diversification. The proposed correlation factors are significantly higher than those used in practice in the Canadian market. We recommend that the correlation matrices be reviewed.

Q152 Should all IAIGs apply the same utilisation criteria for starting GAAP DTAs (eg greater than 50% probability) regardless of whether their GAAP applies a more stringent utilisation assessment approach? If "yes" please explain how IAIGs, that apply a more stringent assessment, could re-perform a utilisation analysis using a common approach given the complexity of the assessment.

No.

Tax regimes are country-specific, as are the standards to calculate DTAs and DTLs. It would be incorrect to harmonize the utilization criteria. DTAs and DTLs should be calculated at the legal-entity level.

The use of a group-effective tax rate for these values is an unnecessary interim step which may mask the analysis at a legal-entity level.

The majority of the IAIG participants in the field testing will have their legal-entity financial statements subject to external audit. Each IAIG should be required to report the validation process used. The monitoring process proposed by the IAIS will capture this information, allowing modifications to these reporting requirements to be made during the testing period.

Q154 The utilisation assessment of the DTA resulting from the ICS adjustment and the ICS tax effect on the capital requirement is based on a top-down approach. Is this a reasonable way for determining the ICS tax treatment? If "no", please provide, in sufficient detail, any alternate approach that would consider data limitations, prudence, practicality, and comparability between insurance groups.

No.

DTA should be reported at a legal-entity level without a cap on utilization.

Q157 Is the 2018 Field Testing group effective tax rate calculation based on the jurisdictional audited GAAP consolidated financial statements a reasonable approach for ICS Version 2.0? If "no", please provide any other proposed method for calculating a group effective tax rate with a rationale for the methodology.

No.

Q159 How should issues like newly announced statutory tax rates, negative tax rates and volatile tax rates be addressed in the group effective tax rate calculation? Please provide the following information:

- **Details on the proposed methodology**
- **Rationale for the methodology**

This issue is resolved by reporting the group effective tax rate as a metric but excluding it from the calculation of DTAs/DTLs.

Q176 Should the IAIS develop additional guidelines and criteria for elements where there is significant judgment and potential for abuse in the calculation of a discount rate derived from a blend of book yield and a reinvestment assumption or dividend fund crediting rate? If 'no', please describe the mitigating controls that would serve to limit abuse or aggressive actions and ensure that valuation results are comparable across IAIGs. If 'yes', please describe the elements where there may be a need for additional guidelines or criteria. Include in the response whether there may be opportunity to align this criteria with the MAV approach or whether criteria should be specific to U.S. GAAP Plus and why.

No.

As long as financial statements are audited, the assumptions will be sufficiently documented and independently reviewed as part of the audit process.

Q178 Are there any other suggested refinements to the U.S. GAAP Plus approach or elements of the specifications that remain unclear that would need to be incorporated prior to the release of ICS Version 2.0?

No.

Q179 If a wide range of practice is observed, in particular for discounting, should the IAIS seek to narrow that range? Why or why not?

No.

We understand that with a wide range in practice, it will be difficult to compare capital positions among companies. However, we hope that disclosure required by accounting standards should reduce that range. If disclosure does not materialize as an effective deterrent to a wide range of practice, then reducing the range would make sense.