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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

Higher Loss Absorbency (HLA)

IAIS Stakeholder meeting, 5 October 2015

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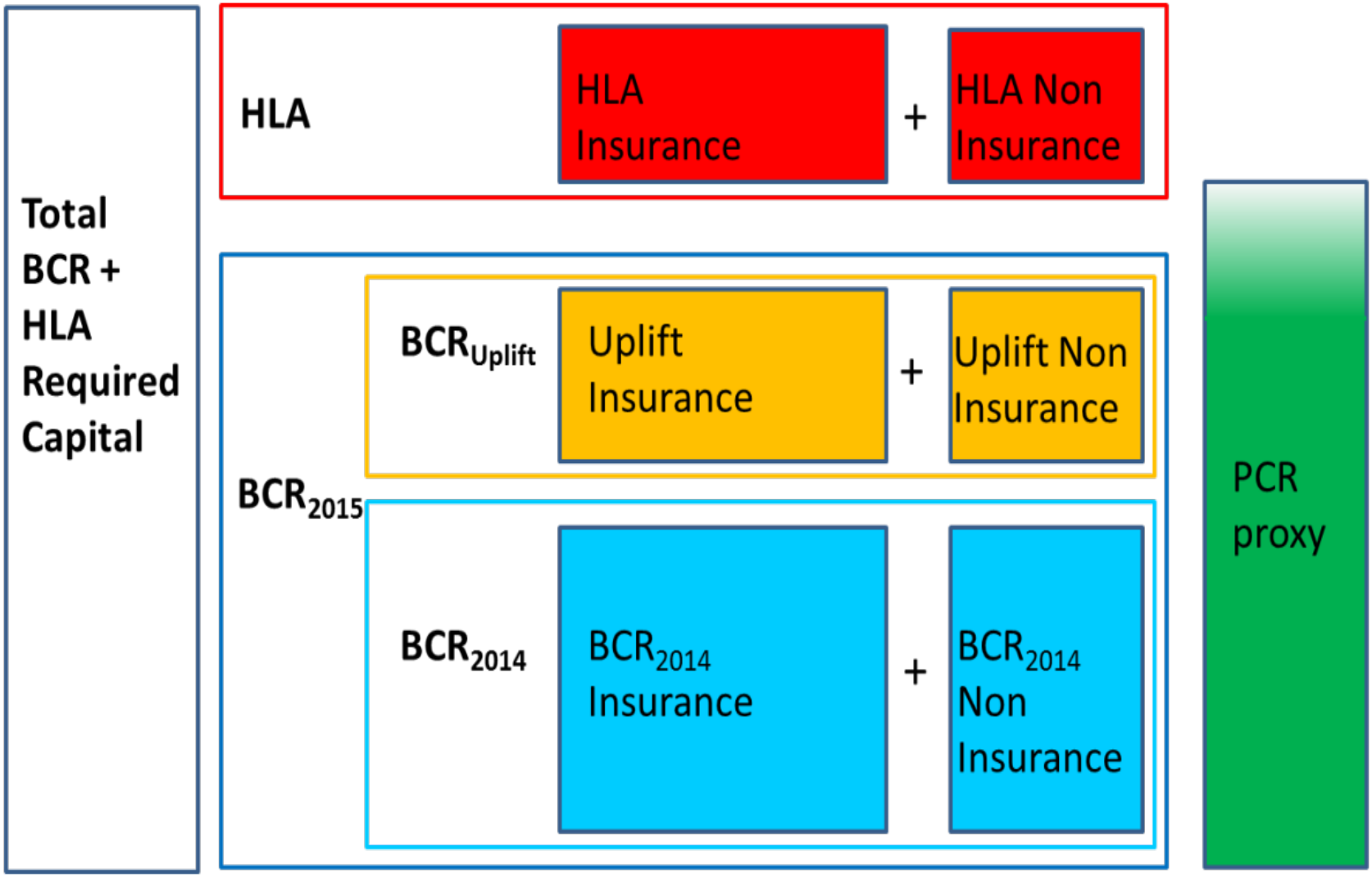
Agenda

- Higher Loss Absorbency (HLA)
- IAIS Global capital standards
- Basic Capital Requirements (BCR)

Higher Loss Absorbency (HLA)

1. **Architecture**
2. **Key design considerations**
3. **BCR uplift**
4. **Required capital formula factors**
5. **Overall HLA calibration & hypothetical outcomes**
6. **Advantages of HLA design**
7. **BCR+HLA Ratio**
8. **Average impacts for current G-SIIs**
9. **Review process**
10. **More detail on the HLA**

1. Architecture



2. Key design considerations

- Balance three key policy objectives, risk sensitivity, robustness and simplicity
- Disincentives built into the HLA formulas to encourage G-SIIs to reduce potential systemic activities
- Separate Insurance and NI business aspects so that existing global regulatory requirements in non-insurance sectors may be reflected
- The HLA is initially built on the foundation of the BCR. When the ICS is developed, the HLA will then be reviewed as the ICS will replace the BCR as the foundation for HLA.

3. BCR Uplift

- Based on 2014 and 2015 field testing data, the average BCR_{2014} required capital, expressed as a percentage of PCR, in aggregate for all G-SIIs, was 75%.
  - To scale the value of the aggregate BCR_{2015} required capital up to 100% a 33% uplift of the BCR_{2014} is needed.

- The Uplift is achieved by;
  - Increasing the BCR_{2014} scalar α (alpha) from 1.00 to 1.33
  - Applying a 33% uplift to all NI components of BCR_{2014} except Regulated banking (based on BCR_{2015} - greater of 3% leverage ratio and 8% of risk weighted assets)

4. Required capital formula factors

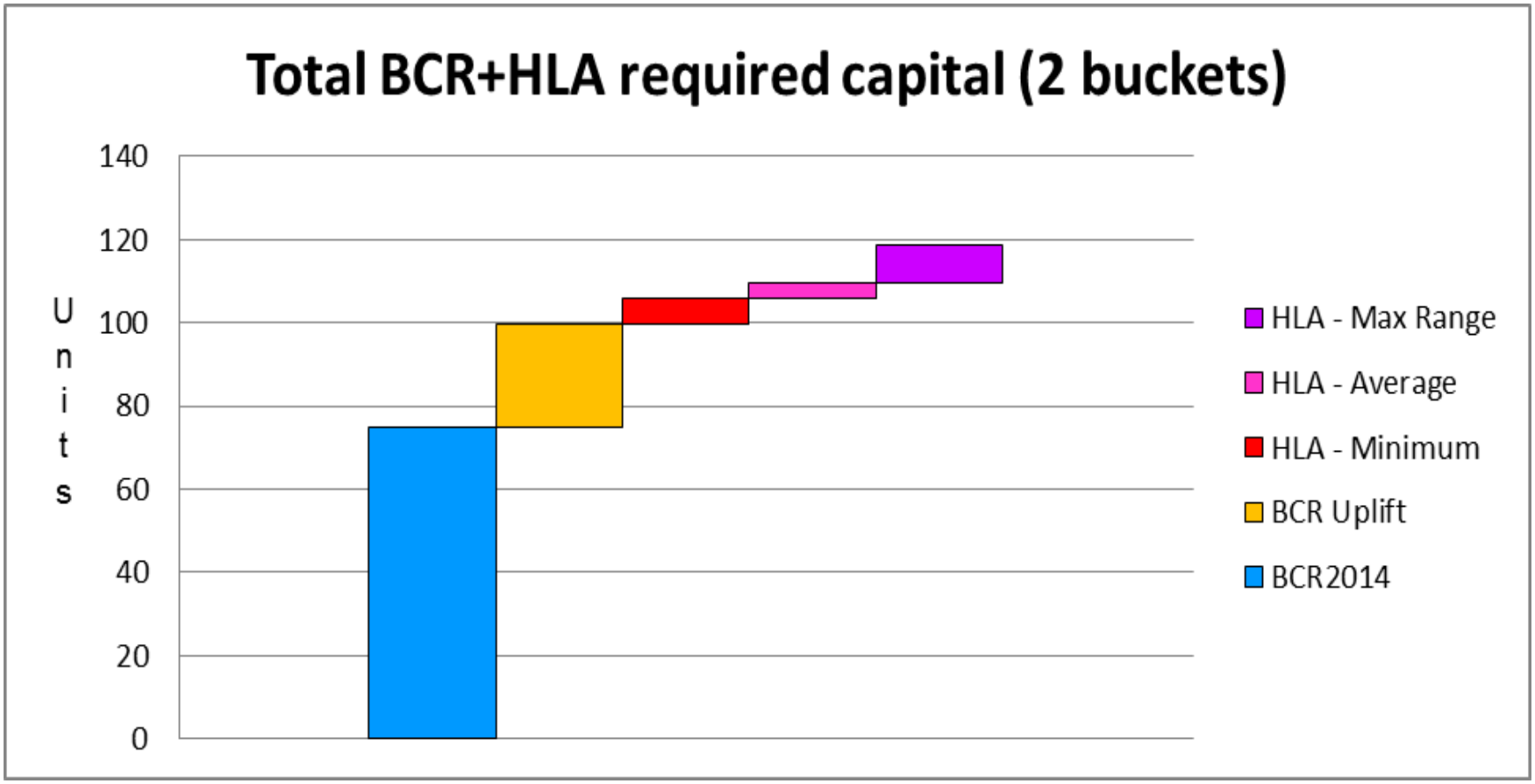
BCR required capital exposure	HLA Factors		
	Low Bucket	Mid Bucket	High Bucket
Traditional Life insurance	6%	9%	13.5%
Traditional Non-Life insurance			
Assets			
Non-Traditional insurance	12%	18%	27%
Non-Insurance – Assets Under Management			
Non-Insurance – Other			
Non-Insurance – Regulated Banking	8.5%	12.5%	18.75%
Non-Insurance – Unregulated Banking	12.5%	18.75%	25%

5. Overall calibration outcomes

- On average, over the set of G-SIIs designated in the past years, the HLA required capital amount with the two populated buckets and HLA factors generated an average of approximately 10% of the BCR_{2015} amount

- In combination, the BCR_{2015} + HLA increase the overall required capital compared to the BCR_{2014} is 45% on average.

Range of hypothetical outcomes



- HLA results reflect the full range of possible values based on the HLA Factors. They do not report results for any actual G-SII

Calibration considerations

- The overall calibration level and HLA design strike an appropriate balance between competing elements:
  - **Minimum level** -The need to ensure an appropriate minimum level of HLA for G-SIIs
  - **Relativity (1)** - The need for an appropriate relativity between traditional insurance business, non-traditional insurance business and non-insurance business
  - **Relativity (2)** - The need for an appropriate relativity between traditional insurance business and regulated banking business
  - **Ordering between G-SIIs** - Not producing an outcome that is significantly different with respect to what has been produced by the G-SIIs designation methodology
  - **Maximum level** - Not producing a calibration level for individual G-SIIs that is significantly higher than a G-SIB allocated to the lowest bucket (12.5%)

6. Advantages of HLA design

- Advantages of 4 factors per bucket
  - Further incentive to reduce NT and NI activities (as measured by BCR required capital exposures)
  - Need to reflect existing or future cross-sectoral requirements:
    - Direct linkage with HLA charges for G-SIBs for regulated banking activities
    - Higher charges for unregulated banking activities
    - Anticipated linkages with other cross-sectoral requirements
  - Robust design if G-SIIs change their business mix over time

Advantages of using buckets

- Advantages of 3 buckets
  - Incorporates focus on systemic footprint (85% based on NTNI and Interconnectedness)
  - Clear incentives to reduce systemic footprint (as measured by G-SII assessment methodology)
  - Recognises two populated buckets for G-SIIs
  - Clear incentives not to increase systemic footprint (due to third higher unpopulated bucket)

7. BCR+HLA Ratio

- BCR+HLA status given by

  $$\text{BCR+HLA Ratio} = \frac{\text{Qualifying Capital Resources (for BCR+HLA)}}{\text{Required Capital (for BCR+HLA)}}$$

- Required capital - Factor-based
  - Exposures based on BCR required capital amounts
  - HLA factors reflect the assessed systemic risk of each G-SII
  - Buckets reflect assessment of systemic risk from G-SII designation process
- Qualifying capital resources
  - HLA: Of the highest quality (BCR Core capital)
  - BCR+HLA = Core Capital +min(50% BCR, Additional Capital)

8. Average impacts on current G-SIIs

	G-SII	All Volunteer
BCR_{2014} / BCR_{2015}	75%	n/a
HLA / BCR_{2015}(*)	10%	n/a
BCR_{2015} / PCR (**)	100%	90%
(BCR_{2015}+HLA) / PCR (**)	110%	100%
BCR+HLA Ratio (**)	260%	305%

Notes

- Results averaged over 2014 and 2015 field testing
- Results rounded to 1% (*) or 5% (**)
- Non-G-SII Volunteers assumed in lowest HLA bucket only for illustrative purposes

9. Review process

- Annual review of BCR and HLA, including considering impact of possible changes in
  - Definitions of NT and NI activities
  - G-SII designation methodology
- Review of role of BCR and the design and calibration of HLA once ICS developed
- Supported by
  - Annual field testing and confidential reporting through to (at least) 2019
  - Interaction with field testing Volunteers and key stakeholders

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Initial questions

Higher Loss Absorbency (HLA)

10. More details on HLA

- Policy objectives
- Flexibility, transparency & independence
- Cumulative BCR + HLA exposures
- Principles guiding HLA development
- Additional design considerations
- Construction
- BCR, BCR Uplift and HLA
- Buckets
- Banking factors

Policy objectives

- Higher loss absorbency (HLA) capacity reflects greater risks G-SIFIs pose to global financial system
  - G-SII more resilient to low probability but high impact events
  - Supervisors intervene earlier than for non G-SIIs (time to address emerging risks)
  - Internalise some of the costs to the financial system and overall economy … that occur as a result of G-SII distress or failure by making G-SIIs more resilient to low probability, high impact events
  - Any implicit or explicit funding subsidy linked to G-SII status is offset

Flexibility, transparency & independence

- **Flexibility.** Capacity to change a factor without necessarily being required to change others
- **Transparency.** The direct linkage to the BCR components and their associated BCR required capital exposures is more intuitive and increases transparency
- **Independence.** A G-SII can see the impact of changes in its business mix, from the perspective of HLA required capital. These changes are independent of the behaviour of other G-SIIs (for a particular set of factors/bucket)

Cumulative BCR + HLA exposures

BCR segment	BCR proxy measure for risk exposure	BCR_{2014} Factor value ($\alpha_{BCR\ 2014}$ = 1.00)	BCR Factor value (α_{BCR} = 1.33)	Cumulative BCR and HLA Factor (Mid Bucket)
Traditional Life (TL)				
Participating products	Net Current Estimate	0.60%	0.80%	0.87%
Traditional Non-life (TNL)				
Property	Premium Measure	6.3%	8.4%	9.15%
Non-Traditional (NT)				
Variable annuities	Notional Value	1.2%	1.6%	1.89%
Assets (A)				
Credit - investment grade	Fair Value	0.70%	0.93%	1.015%
Non-Insurance (NI)				
Assets Under Management (AUM)	3 year average of gross income	12%	16%	19%

- For AUM, gross income typically under 1% assets, so HLA charge is 2-3 basis points

Principles guiding HLA development

Principle	Summary
Comparability	Across jurisdictions
G-SII risks	Reflect drivers of assessment of G-SII status
Internalise costs	Some costs of failure or distress of a G-SII may generate
Resilient	HLA remains valid in a variety of economic conditions
Going concern	Assume G-SIIs are going concerns
Quality of capital	HLA met by highest quality capital
Pragmatic	Design balances granularity and simplicity
Consistent	Applicable to range of insurance and non-insurance entities needed to be covered
Transparent	Optimise regarding final results and use of public data
Refinement	Reflect experience and additional data

HLA: Additional design considerations

- The HLA will be a globally comparable group capital requirement that applies to all G-SIIs
- The HLA will apply to all group activities, including non-insurance subsidiaries, taking a going concern approach
- G-SIIs should be required by their group-wide supervisors to hold higher levels of regulatory capital than would be the case if they were not designated as G-SIIs
  - This regulatory capital amount should not be less than the sum of the BCR required capital and the HLA required capital

HLA: Construction

- Builds on foundation of BCR
- Two stage process
  - Uplift BCR (of 2014)
  - HLA
  - Total required capital is sum from BCR and HLA
  - Reflects current NI global sectoral capital requirements
- Reflects G-SII designation process by using buckets
  - 3 buckets, 2 currently populated
- Factor based formula
  - Exposures are BCR required capital amounts
  - For each bucket, specified factors

BCR, BCR Uplift and HLA

- Minimum required regulatory capital for a G-SII (from 2019) is the sum of BCR and HLA requirements

- The framework is to uplift the existing BCR and add an HLA requirement
  - $BCR_{2015} = BCR_{2014} + BCR_{Uplift}$
  - Total requirement = BCR_{2015} + HLA
  - BCR_{2014} is as specified in the October 2014 document

- Separate Insurance and Non-Insurance
  - Accommodate the need to reflect other sectoral global capital requirements (regulated banking in particular)

HLA: Buckets

- **Bucket 1 – Low bucket:** G-SIIs with a full score below 0.04 in the G-SII Assessment Methodology (where there are 50 participating insurers, so the average score is 0.02 = 1/50)
- **Bucket 2 - Mid bucket:** G-SIIs with a full score between 0.04 and below 0.06 in the G-SII Assessment Methodology
- **Bucket 3 – High bucket:** G-SIIs with a full score of 0.06 or above in the G-SII Assessment Methodology

HLA: Banking

- Regulated banking
  - Mid bucket has 12.5% uplift following banking HLA uplift in lowest banking bucket of 1% (on 8% RWA)
  - Upper bucket has 18.75% uplift following banking second bucket which has 1.5% uplift (on 8% RWA)
  - Low bucket uses the mid bucket factor scaled by the Traditional relativity, that is 2/3, and then rounds to give 8.5%
- Unregulated banking
  - Uses factors from regulated banking but from the banking bucket one higher then for the regulated banking

Global capital standards

IAIS global capital standards

- Basic Capital Requirement (BCR)
  - Foundation for higher loss absorbency for G-SIIs
- Higher Loss Absorbency (HLA)
  - Develop additional capacity requirements for G-SIIs
- Insurance Capital Standard (ICS)
  - Risk-based global insurance capital standard
  - Apply to IAIGs (including all G-SIIs)
  - Included in ComFrame

Work program

	Adopt	Confid Report Annual Review	Apply	Apply to
BCR	2014	2015 ->	2019 ->	G-SII
HLA	2015	2016 ->	2019 ->	G-SII
ICS 1.0	2017	2017 ->	n/a	IAIG (G-SII)
ComFrame incl ICS 2.0	2019	n/a	2020 ->	IAIG (G-SII)

- BCR: FSB/G-20 endorsement October/November 2014
- HLA: FSB endorsed. IAIS formal adoption at GM Nov 2015
  G-20 endorsement anticipated November 2015
- Development and refinement informed by Field Testing

Summary timeline

Expected timing	Key milestone
November 2015	IAIS General Meeting scheduled to formally adopt HLA G20 Leaders expected to endorse HLA
Mid-2016	Publication of 2nd ICS Consultation Document and ComFrame Consultation
Mid-2017	Approval of ICS Version 1.0 for confidential reporting
Mid-2018	Publication of ICS Version 2.0 and ComFrame Consultation
IAIS 2019 General Meeting	Adoption of ComFrame, including ICS Version 2.0

Basic Capital Requirement (BCR)

BCR formulas

- BCR status given by

$$\text{BCR Ratio} = \frac{\text{Qualifying Capital Resources (for BCR)}}{\text{Required Capital (for BCR)}}$$

- $\text{BCR Required Capital} = \alpha\left[\sum_{i=1}^{4} a_i\, TL_i + \sum_{i=1}^{4} b_i\, TNL_i + \sum_{i=1}^{4} c_i\, NT_i + \sum_{i=1}^{3} d_i\, A_i\right] + \sum_{i=1}^{n} NI_i$

  - α (alpha) is the scalar to adjust the overall BCR level
  - a_i, b_i c_i and d_i are factors applied to the exposures
  - TL_i, TNL_i, NT_i, and A_i represent the exposures
  - NI reflects charges provided by sectoral rules for non-insurance activities – for example, Basel Accord requirements.

- 2014: α (alpha) = 1.00

BCR factors

BCR segment	Proxy measure for risk exposure	Factor	Factor value
Traditional Life (TL)			
Protection life	Net Amount At Risk	a_1	0.056%
Participating products	Current Estimate	a_2	0.6%
Annuities	Current Estimate	a_3	1.2%
Other life	Current Estimate	a_4	0.6%
Traditional Non-life (TNL)			
Property	Premium	b_1	6.25%
Motor	Current Estimate	b_2	6.25%
Casualty	Current Estimate	b_3	11.25%
Other non-life	Current Estimate	b_4	7.5%
Non-Traditional (NT)			
Variable annuities	Notional Value	c_1	1.2%
Mortgage insurance	Face Amount	c_2	1.11%
GICS & Synthetic GICS	Notional Value	c_3	1.11%
Other non-traditional	Current Estimate	c_4	1.29%
Assets (A)			
Credit - investment grade	Fair Value	d_1	0.69%
Credit - non investment grade	Fair Value	d_2	1.8%
Equity	Fair Value	d_3	8.4%

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Thank you …

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