INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

Public

ICS Consultation Document - Responses to Comments: ICS Valuation Methods (Section 5)

20 November 2015

About this slide deck

1. This is the next tranche of resolutions of ICS Consultation Document (ICS CD) responses and comments received from IAIS Members and Stakeholders.
2. Member comments are grouped, noting that:
   i. Members who provided confidential responses are not explicitly identified, but the total number of responses received is reported; and
   ii. it is the policy of some Members to not comment on public consultations.
3. Stakeholder comments are presented on a thematic basis.

MAV - Margin Over Current Estimate (MOCE)

Question 4. Should the IAIS attempt to develop a consistent and comparable MOCE? Why or why not?

BMA (Bermuda), CIRC (China), EIOPA, BaFin (Germany), Central Bank of the Russian Federation, MAS (Singapore) and five other Members responded yes, without highlighting any conditions, that the IAIS should develop a consistent and comparable MOCE.

The following Members also responded yes, but highlighted some conditions:

- Not if it only serves to increase total minimum resources (one Member);
- As ultimate goal, as it may not be achieved by 2019 (OSFI Canada);
- If capital required is an addition to liability and MOCE not in cap resources (AMF-Quebec);
- For life insurance (prudence), non-life MOCE implicit (undiscounted) (NAIC).

Many responded MOCE is consistent with ICP 14 requirements.

MAV - Margin Over Current Estimate (MOCE)

Question 4. Should the IAIS attempt to develop a consistent and comparable MOCE? Why or why not?

The majority of stakeholders responded no, with many associating a need for MOCE with the MAV approach. While the no response was received from stakeholders across all regions, it was most prevalent amongst North American stakeholders. Other comments included:

- Difficult to answer question without a clear statement on the purpose of the MOCE;
- MOCE is a potential driver of further complexity and implementation challenges;
- Develop a MOCE approach that is consistent with direction of IFRS 4 Phase 2.

IAIS Response: The IAIS consideration of MOCE is not only with respect to the market-adjusted valuation (MAV) approach. ICP 14.7 standard requires that the valuation of insurance liabilities include a margin over the current estimate (MOCE). It is the IAIS's intention to develop a consistent and comparable MOCE for ICS, in line with member comments.

For 2015 field testing purposes, the IAIS developed two options for recognising a consistent and comparable MOCE: a 'prudence' approach and a 'transfer' approach. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results for these alternative approaches.

MAV - Margin Over Current Estimate (MOCE)

Question 5. If the IAIS were to develop a consistent and comparable MOCE should it fulfil one of the possible purposes listed (a Margin for prudence or a margin to recognize transfer value)? If yes, please explain. If no, what should be the purpose of the MOCE? Please explain.

BMA (Bermuda), AMF-Quebec, EIOPA, BaFin (Germany) and five other Members support a MOCE based on the purpose of transfer.

CIRC (China), Central Bank of the Russian Federation and the NAIC support a MOCE based on the purpose of prudence.

OSFI (Canada) supports a combination of prudence and deferral of recognition of future profit.

MAS (Singapore) indicated it depends on the market: it supports transfer purpose if markets are deep and liquid.

MAV - Margin Over Current Estimate (MOCE)

Question 5. If the IAIS were to develop a consistent and comparable MOCE should it fulfil one of the possible purposes listed (a Margin for prudence or a margin to recognize transfer value)? If yes, please explain. If no, what should be the purpose of the MOCE? Please explain.

The majority of stakeholders supported a transfer purpose for the MOCE, if the IAIS were to develop a consistent and comparable MOCE, with few supporting a prudence approach. However, a large portion of North American stakeholders did not support any purpose, highlighting their objections to the IAIS developing an ICS MOCE. Comments included:

- Transfer value would be in-line with a market consistent valuation;
- Uncertainty should be reflected in required capital, not in the insurance liability;
- Should be a margin for prudence at an agreed percentile, transfer value is unnecessarily complex.

IAIS Response: For 2015 field testing purposes, the IAIS developed two options for recognising a consistent and comparable MOCE: a 'prudence' approach and a 'transfer' approach. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results for these alternative approaches.

MAV - Margin Over Current Estimate (MOCE)

Question 6. If the IAIS were to develop a consistent and comparable MOCE, what principles should underlie its development?

Member responses varied based on their definition of the word ‘principles.’ EIOPA and four other Members highlighted the ICS principles (with focus on 1, 2, 5, 6, 7, and 8).

The BMA (Bermuda) indicated principles underlying the cost-of-capital approach.

OSFI Canada noted that the MOCE should reflect the uncertainty about the amount and timing of future cash flows.

The CIRC (China) noted the MOCE should fulfil the prudence purpose.

BaFin (Germany) highlighted MOCE should support a transfer purpose.

The Central Bank of the Russian Federation suggested the MOCE should reflect a common methodology with a prudence purpose.

MAV - Margin Over Current Estimate (MOCE)

Question 6. If the IAIS were to develop a consistent and comparable MOCE, what principles should underlie its development?

MAS (Singapore) highlighted a 2009 IAA paper indicating the characteristics that risk margins should exhibit.

One Member indicated support for a transfer approach to capture risks within insurance liabilities that cannot be hedged.

The NAIC suggested the principles should be aligned with ICP 14, be adaptable for both the MAV and the GAAP with adjustments approach, be based on a comparable measure of risk associated with the uncertainty of the estimates for a particular product line, not duplicate existing margins in reserves (i.e. reserves with overlapping purposes should not be additive, and any existing reserves over current estimate held by firms will be counted to satisfy a consistent MOCE requirement), and for assets that support reserves over and above defined comparable MOCE (to be retained in reserves) be considered as loss absorbing capital resources in the appropriate capital tier.

MAV - Margin Over Current Estimate (MOCE)

Question 6. If the IAIS were to develop a consistent and comparable MOCE, what principles should underlie its development?

Stakeholders provided a range of responses, with many indicating that the MOCE should be simple, objective and ensure consistency and comparability. Other stakeholder responses included: the ICS principles, transfer purpose, cost of capital, and economic principles.

IAIS Response: The IAIS will develop a consistent and comparable MOCE based upon ICS principles.

For 2015 field testing purposes, the IAIS developed two options for recognising a consistent and comparable MOCE: a ‘prudence’ approach and a ‘transfer’ approach. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results for these alternative approaches.

MAV - Margin Over Current Estimate (MOCE)

Question 7. Depending on your answers to the above three questions, what calculation methodology should be applied for the MOCE?

BMA (Bermuda), OSFI Canada, AMF-Quebec, EIOPA, BaFin (Germany) and five other Members responded that a cost of capital calculation should be applied for MOCE. The following Members provided alternative responses:

- MAS (Singapore) indicated that any calculation methodology that largely satisfies the desired characteristics stated in the question should be allowed as an acceptable methodology for the MOCE. In this respect, it indicated that both the quantile approach and cost of capital be considered as acceptable methodologies;
- The NAIC referenced its response to question #4.

Stakeholder responses most often mentioned the cost of capital approach. Other stakeholder responses included: percentile, VaR, and tail-VaR approaches. However, a large portion of North American stakeholders did not support any approach, highlighting their objections to the IAIS developing an ICS MOCE.

IAIS Response: For 2015 field testing purposes, the IAIS developed two options for recognising a consistent and comparable MOCE: a ‘prudence’ approach and a ‘transfer’ (using cost-of-capital) approach. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results for these alternative approaches.

MAV - Other refinements

Question 8. Should the IAIS develop an alternative definition of contract boundaries? If so, please provide such a definition with rationale for that alternative definition.

EIOPA and four other Members indicated that the IAIS should not develop an alternative definition to contract boundaries, but they were open to discussing refinements.

The AMF-Quebec responded no.

One Member noted that they accept the proposed definition but, in an ideal world, the definition would be aligned to definition proposed in the international accounting standards.

BaFin (Germany) indicated concern with the criterion that the IAIG needs not only to be able but also willing to compel the policyholder to pay the premiums, and noted this may lead to incomparable insurance liabilities across insurers as their willingness to compel can be different according to their capital resources. BaFin suggested deleting the requirement with respect to "willingness".

MAV - Other refinements

Question 8. Should the IAIS develop an alternative definition of contract boundaries? If so, please provide such a definition with rationale for that alternative definition.

One Member suggested more clarity for unbundling contracts to determine boundaries.

MAS (Singapore) proposed including future premiums when it seems evident the insurance contract is likely to extend and such renewals lead to a higher best estimate.

The NAIC responded that decisions as to whether to reflect contract renewal assumptions in a capital standard should be consistent with other design aspects of the capital formula, including valuation, and noted that such renewals are not reflected in US GAAP (nor US SAP, nor IFRS.)

MAV - Other refinements

Question 8. Should the IAIS develop an alternative definition of contract boundaries? If so, please provide such a definition with rationale for that alternative definition.

Most stakeholders responded yes, supporting a pure economic contract boundaries definition, with many others suggested that the definition be aligned with IFRS/GAAP. Only some suggested that no change to the definition was necessary.

Some stakeholder respondents also commented on issues relating to the recognition, and de-recognition, of insurance liabilities under the MAV approach.

IAIS Response: For 2015 field testing purposes, the IAIS developed several questions to further explore issues around the contract boundaries definition used by the IAIS. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing questionnaire results.

MAV - Other refinements

Question 9. If such alternative definition is adopted what would be the impact on the definitions of ICS capital requirement and qualifying capital resources?

No themes emerged from Member responses. As the majority of Members indicated in their responses to question #8 that the IAIS should not develop an alternative definition to contract boundaries (with many open to discussing refinements, and some suggesting refinements), most Members did not highlight potential impacts of alternative definitions. Of the Members that did discuss impacts in their responses, the discussions were very general (such as that it would have knock-on impacts to capital requirements and capital resources, which could have large magnitudes).

No themes emerged from stakeholder responses. Most stakeholder responses were general in nature, highlighting that alternative definitions would have knock-on impacts to capital requirements and capital resources, without discussing magnitudes. Some stakeholders noted that impacts would likely be immaterial.

IAIS Response: For 2015 field testing purposes, the IAIS developed several questions to further explore issues around the contract boundaries definition used by the IAIS. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing questionnaire results.

MAV - Other refinements

Question 10. Are there any other aspects of the market-adjusted approach that would benefit from further enhancement or greater specificity or other changes in any way?

The AMF-Quebec replied no.

EIOPA and five other Members highlighted that particular emphasis should be put on the method for determining the IAIS yield curve.

The CIRC (China) suggested specific considerations for developing the IAIS yield curve.

One Member noted the specification of the MAV will need to be clear to ensure consistency of interpretations across jurisdictions, but that it would need to be balanced with the level of detail/ complexity.

The NAIC referred to their comments regarding discount rates and effect on long term business in answers to Questions 11, 12 and 13.

MAV - Other refinements

Question 10. Are there any other aspects of the market-adjusted approach that would benefit from further enhancement or greater specificity or other changes in any way?

MAS (Singapore) noted that more specifications or guidance can be provided on the following aspects of MAV:

- to the extent that paragraph 55(d) exclude such products as universal life, it should be considered;
- in setting insurance assumptions such as mortality, morbidity, lapses, and expenses;
- in implementing replicating portfolio, for example how the credit risks inherent in these portfolios can be excluded in arriving at the corresponding liability values; and
- in setting non-life liabilities, such as IBNR (incurred but not reported) and OSLR (outstanding loss reserves) as no guidance has been provided so far.

MAV - Other refinements

Question 10. Are there any other aspects of the market-adjusted approach that would benefit from further enhancement or greater specificity or other changes in any way?

Stakeholders provided a range of responses, the most common themes were:

- Concerns with use of IAIS yield curve are most important to address;
- More guidance was needed in various areas (e.g. deferred taxes, valuation of future bonuses and other discretionary benefits);

A number of North American stakeholders highlighted their objections to MAV.

IAIS Response: For 2015 field testing purposes, the IAIS:

- Continued to focus on increased comparability of the main elements of an insurance group's balance sheet. In the field testing Questionnaire, various questions were developed to further explore valuation issues for many items on the MAV balance sheet;
- Provided additional instructions to increase clarity in many areas. However, based upon the subsequent questions received from field testing volunteers, more refinement of the guidance may be necessary for the 2016 exercise.

The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results.

MAV - Other refinements

Question 11. What refinements, if any, should be made to the market-adjusted approach as currently formulated in regards to the treatment of long-term business?

AMF-Quebec, EIOPA, BaFin (Germany), MAS (Singapore) and four other Members highlighted the need to refine particular elements of the IAIS yield curve (e.g. the flat curve after 30 years, the methodology for the Adjustment).

The NAIC suggested using an IAIS yield curve based upon the IAIG's asset earning rate.

One Member indicated a preference for use of close to risk-free rates for the IAIS yield curve.

OSFI Canada suggested allowing the use of amortized cost in certain cases where fixed income instruments support long-tem liability cash flows.

Almost all stakeholders highlighted the need to refine the IAIS yield curve, with many pointing to issues with the flat curve after 30 years and the need to effectively consider a higher spread in the methodology for the Adjustment.

MAV - Other refinements

Question 11. What refinements, if any, should be made to the market-adjusted approach as currently formulated in regards to the treatment of long-term business?

IAIS Response: For 2015 field testing purposes, the IAIS:

- Maintained the same Adjustment approach, but developed various questions to further explore the issues around the methodology. In addition, the IAIS asked volunteers questions on various proposals to change the Adjustment approach; and
- Developed a new methodology based on a 3 segment discount curve (liquid market information; extrapolation; long term forward rate), the start of the third segment occurs at the maturity of 60 years.

The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing data and questionnaire results.

MAV - IAIS yield curve

Question 12. What enhancements could be made to the IAIS prescribed yield curve used to discount insurance liabilities? In particular, what enhancement could be made to further consider pro-cyclicality with reference to ICS Principle 7?

EIOPA, NAIC and four other Members referred to their responses to question #11. Other responses included:

- One Member indicated that IAIGs are better placed to answer this question;
- OSFI Canada: An illiquidity premium should be added to the risk-free curve;
- AMF-Quebec: The prescribed yield curve should represent the risk related to the insurance liabilities, i.e. a risk-free rate plus illiquidity premium;
- CIRC (China): IAIS yield curve should be based from principles, not be a fixed approach;
- BaFin (Germany): Adjustment should be smoothed over different reference maturities;
- One Member indicated that, if demonstrated ability to hold to maturity assets that match CFs of illiquid liabilities, then discount rate could be more closely aligned to actual asset returns;
- MAS (Singapore): Adjustment should be based on bucketing by degree of illiquidity, using a % of term spreads, with reference to developed market bonds, and allowing for different adjustment rates for different markets.

MAV - IAIS yield curve

Question 12. What enhancements could be made to the IAIS prescribed yield curve used to discount insurance liabilities? In particular, what enhancement could be made to further consider pro-cyclicality with reference to ICS Principle 7?

Most stakeholders suggested enhancements to deal with the flat curve after 30 years and to effectively consider a higher spread in the methodology for the Adjustment. Other responses included:

- IAIGs should develop yield curves based on IAIS principles, not a fixed approach;
- Use a rate as close as possible to a pure risk-free market curve;
- Develop a Solvency II type volatility adjustment;
- Discounting should not be required for non-life business;
- Maintain consistency with IFRS 4 Phase 2.

IAIS Response: See response to question #11. Also, for the yield curve the IAIS expects to:

- Develop a fixed methodology, not simply establish principles;
- Review the methodology used for the calculation of the adjustments;
- Address emerging market issues where considered appropriate.

MAV - IAIS yield curve

Question 13. Is the methodology for determining the IAIS yield curve under the market-adjusted approach appropriate for and consistent with the business models of insurers that write long-term business? If not, how should it be adjusted? Please explain.

EIOPA, MAS (Singapore), NAIC and four other Members indicated the IAIS yield curve needs refinement, specifically referring to their answers to questions #11 or #12 for particular details.

OSFI Canada and AMF-Quebec indicated that a method based on a projection to a long term rate should be used.

CIRC (China) suggested that the IAIS should just set the principles to the discount curve, for example, based on public data and transparent approach. The discount curve should then be compiled by local regulators.

One Member indicated that the derivation of the yield curve should more closely reflect the actual asset holdings of IAIGs. The extent to which this is necessary or appropriate will depend on the nature and predictability of the long term business, and whether it is possible to explicitly identify a pool or hypothecated set of assets that are held to back this business.

MAV - IAIS yield curve

Question 13. Is the methodology for determining the IAIS yield curve under the market-adjusted approach appropriate for and consistent with the business models of insurers that write long-term business? If not, how should it be adjusted? Please explain.

Almost all stakeholders responded that the IAIS yield curve needs refinement , with many highlighting concerns with potential inappropriate volatility, especially for very long-term business. Many stakeholders reiterated their previous responses on how the IAIS yield curve requirements should be refined.

IAIS Response: See response to question #11. Also, for the yield curve the IAIS expects to:

- Develop a fixed methodology, not simply establish principles;
- Review the methodology used for the calculation of the adjustments;
- Address emerging market issues where considered appropriate.

GAAP with adjustments approach to valuation

Question 14. Would your IAIG/jurisdiction be likely to consider the use of a GAAP with adjustments valuation approach, and why?

Question 15. For the purpose of determining ICS qualifying capital resources, what adjustments, if any, should be made and to which local jurisdictional GAAP financial statements?

Question 16. For the purpose of determining the ICS capital requirement, what adjustments, if any should be made to which local jurisdictional GAAP financial statements?

Question 17. Please describe how the above adjustments should or could be calculated, using GAAP or readily available information, so that the results could be most comparable to the market-adjusted valuation approach, after application of the ICS. Please also comment on the likely or potential variations of the results of the adjustments using the GAAP with adjustments approach compared to the market-adjusted valuation approach.

GAAP with adjustments approach to valuation

Questions 14, 15, 16, and 17- continued

Two Members indicated they needed more information on the GAAP with adjustments approach.

EIOPA and four other Members indicated that they also needed more information on the approach, but that it was unlikely that such an approach would be adopted in their jurisdictions.

OSFI Canada, AMF-Quebec, BaFin (Germany) and MAS (Singapore) indicated they could use a GAAP+ approach if it was comparable to MAV.

The NAIC indicated that they were fully supportive of using a GAAP+ approach.

Most stakeholder responses were caveated by the need to know more about the GAAP with adjustments (GAAP +) approach.

There were clear regional preferences expressed, with U.S. based stakeholders favouring GAAP+ and most European stakeholders favouring the MAV approach. Stakeholders from other areas were more mixed in their responses.

Some stakeholders commented that it would be worth field testing the GAAP + approach to see if it could be shown to be comparable to MAV.

GAAP with adjustments approach to valuation

Questions 14, 15, 16, and 17- continued

IAIS Response: For 2015 field testing purposes, the IAIS developed a GAAP+ valuation approach in addition to the MAV approach. Field testing volunteers were provided with instructions for calculating a GAAP+ approach, with examples for volunteers using applicable GAAPs within Canada, Europe, Japan and the U.S. (including for statutory accounting principles relevant for U.S mutual insurers). Further, detailed questions were developed to explore the issues around the GAAP+ approach.

The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing results for these alternative approaches.

GAAP with adjustments approach to valuation

Questions 14, 15, 16, and 17 - continued

Themes from Responses : Stakeholders suggested various adjustments to local jurisdictional GAAP financial statements for purposes of determining ICS qualifying capital resources, including:

- Report investments at market values (with some U.S. life firms noting that there should be consistent treatment of assets and liabilities)
- Discount of non-life reserves (some for, some against)
- A number of respondents in favour of adjustments to capital resources for goodwill, deferred taxes, DAC, VOBA, debt instruments with equity characteristics.
- Life liabilities – adjust to current estimates using loss recognition testing (U.S.) or liability adequacy test (IFRS); some mentioned the significance of the chosen discount rate, e.g., whether based on the firm's experience.
- Pre-event catastrophe reserves
- Remove MOCE for comparability
- Reinsurance risk transfer (different treatment across local GAAPs)
- Address statutory accounting (for U.S. mutual insurers)

GAAP with adjustments approach to valuation

Questions 14, 15, 16, and 17 - continued

IAIS Response : While the adjustments may necessarily differ depending on the local GAAP or IFRS reporting basis that is used as a starting point for GAAP+, the IAIS developed a set of principles for GAAP+ adjustments in order to encourage comparability amongst the regional examples of GAAP+ (including for statutory accounting principles relevant for U.S mutual insurers).

With respect to the specific adjustments proposed to capital resources, the IAIS has collected relevant data on these through the 2015 field testing exercise. The IAIS will decide on next steps after conducting a comprehensive analysis of the field testing data and questionnaire results.