Public

# ICS Consultation Document – Responses to Comments on Capital Resources (Section 6)

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.

# 6 Capital Resources

**Question 18.** Are there other key principles not included above that should be considered when assessing the quality of financial instruments for regulatory capital purposes? If so, please suggest other principles and the rationale for including them.

AMF, EIOPA, MAS, OSFI and six other Members support the key principles as stated in the CD.

BAFIN suggested an additional principle: Absence of incentives to redeem.

NAIC commented that senior debt issued at the holding company and downstreamed into the operating company should be included in qualifying capital resources.

A few stakeholders commented that the key principles were sufficient, while others suggested changes to the key principles (see next slide).

**IAIS Response:** The key principles are consistent with guidance in ICP 17.11, which describes the characteristics considered in assessing the ability of elements of capital to absorb losses. However, in light of the comments received, the IAIS will review the key principles.

# 6 Capital Resources

**Question 18.** Are there other key principles not included above that should be considered when assessing the quality of financial instruments for regulatory capital purposes? If so, please suggest other principles and the rationale for including them.

| **Themes from Responses** | **Proposed Resolution** |
|---|---|
| Senior debt issued by a holding company that is then down-streamed as equity into an insurance subsidiary should be classified as Tier 1 or Tier 2 capital resources since it is structurally subordinated to policyholders. | The IAIS will assess the characteristics of senior debt against the principles for capital resources, in particular, the ability of such instruments that are structurally subordinated to absorb losses on a going concern basis and in winding-up. |
| The issues of fungibility of capital (and capital residing where the risk is) should be considered. | The ICS is a group capital standard. The issue of fungibility of capital remains under consideration. |
| The IAIS should expand on the definition of availability to consider availability in a stressed situation. | The IAIS will review the principles for capital resources and consider including wording to this effect. |

# 6 Capital Resources

| **Question 18.** Are there other key principles not included above that should be considered when assessing the quality of financial instruments for regulatory capital purposes? If so, please suggest other principles and the rationale for including them. |
|---|

| Themes from Responses | Proposed Resolution |
|---|---|
| Only one principle is needed: the ability to pay policyholders in liquidation. | As stated in guidance for ICP 17.2, capital resources protect the interests of policyholders by meeting the following two objectives. They:<br>• reduce the probability of insolvency by absorbing losses on a going-concern basis or in run-off; and/or<br>• reduce the loss to policyholders in the event of insolvency or winding-up. |

# 6 Capital Resources

**Question 19.** Should qualifying capital resources be classified in more than one or more than two tiers of capital? How many? And, if different from above, what key criteria should be used to determine tiering?

AMF, BMA, BAFIN, Central Bank of the Russian Federation, MAS, NAIC, OSFI, PRA and one other Member support two tiers of capital resources.

EIOPA and 4 other Members support three tiers of capital resources.

Most stakeholders commented that there should be no tiering of capital and the focus should be on the policyholder protection provided by the capital resource. However, several stakeholders did comment that a two tier approach is appropriate.

**IAIS Response:** Consistent with ICP 17.11, the IAIS will maintain two tiers in order to recognise the distinctions between those elements that absorb losses on both a going concern basis and in winding-up and those that only absorb losses in winding-up.

# 6 Capital Resources

**Question 20.** If qualifying capital resources are classified in two or more categories of capital, should the ICS capital adequacy be expressed using only one, two or more ratios? Why?

BAFIN, EIOPA, MAS, NAIC and five other Members support the use of one ratio.

CIRC, OSFI and Central Bank of the Russian Federation support the use of two ratios (Tier 1 and total).

Office of the Commissioner of Insurance (Hong Kong) and one other Member support the use of a ratio for each defined tier of capital.

Most stakeholders commented that one ratio is sufficient and the use of more than one ratio will add unnecessary complexity to the ICS.

**IAIS Response:** Similar to the BCR, the IAIS will proceed with one ratio, and appropriate limits within the tiers of capital, for the development of ICS Version 1.0.

# 6 Capital Resources

**Question 21.** Should any amount of non-paid-up items be included in qualifying capital resources? Why? If yes, how should these be classified and should there be limits? Should there be an additional limit on non-paid-up elements that give rise to paid-up Tier 2 elements as opposed to those that give rise to paid-up Tier 1 elements? Please give reasons for your answer.

BAFIN, Central Bank of the Russian Federation, CIRC, EIOPA and five other Members support the inclusion of non-paid-up capital.

AMF, MAS, NAIC, OSFI and one other Member do not support the inclusion of non-paid-up capital.

Most stakeholders commented that non-paid-up capital resources should be included in qualifying capital resources.

**IAIS Response:** The IAIS will assess the characteristics of non-paid-up items against the principles for capital resources, in particular, its ability to absorb losses in both going concern and in winding-up.

# 6 Capital Resources

**Question 21.** Should any amount of non-paid-up items be included in qualifying capital resources? Why? If yes, how should these be classified and should there be limits? Should there be an additional limit on non-paid-up elements that give rise to paid-up Tier 2 elements as opposed to those that give rise to paid-up Tier 1 elements? Please give reasons for your answer.

| **Themes from Responses** | **Proposed Resolution** |
|---|---|
| The focus should be on whether a non-paid-up item would be available in a stressed situation with sufficient certainty. | The IAIS will assess the characteristics of non-paid-up items against the principles for capital resources, in particular, its ability to absorb losses in both going concern and in winding-up. |
| Non-paid-up items may not be available in a severely stressed situation. It appears inconsistent to disallow senior debt proceeds contributed to an insurance subsidiary, while permitting non-paid-up items, such as letters of credit, to be included in capital resources. | The IAIS will assess the characteristics of potential capital resources against the principles for capital resources, in particular, the ability of items to absorb losses in both going concern and in winding-up. |

# 6 Capital Resources

**Question 22.** If non-paid-up capital items were permitted, should the capital composition limit for non-paid-up Tier 2 items be based on a percentage of Tier 1 capital resources, on ICS capital requirement or determined on another basis?

AMF, BAFIN, Central Bank of the Russian Federation, EIOPA, OSFI and five other Members support a limit expressed as a percentage of the ICS capital requirement.

CIRC supports a limit expressed as a percentage of Tier 1 capital resources.

A few stakeholders commented that limits on non-paid-up capital items are unnecessary, while one stakeholder commented that non-paid-up capital items should not be included in capital resources.

**IAIS Response:** The IAIS continues to consider the use of limits within the ICS in order to appropriately reflect the quality of capital resources and their ability to absorb losses. The IAIS plans to explicitly test limits in 2016 Field Testing.

# 6 Capital Resources

**Question 23.** Should the residual amount of GAAP insurance liabilities in excess of current estimate plus consistent MOCE (as referred to in paragraphs 53 and 89) continue to be considered as part of Tier 1 capital resources? If so, should it be all in Tier 1 for which there is no limit, or at least partially recognised in Tier 1 for which there is a limit? If it is not all recognised in Tier 1, should it be recognised in Tier 2, and if so, which part of Tier 2? Should any part of the residual amount of GAAP insurance liabilities not be recognised at all in qualifying capital resources, and therefore effectively be deducted from qualifying capital resources?

BMA, BAFIN, CIRC, EIOPA, MAS, NAIC, OSFI and six other Members support the inclusion of the full residual amount in Tier 1 capital resources for which there is no limit.

AMF supports the inclusion of the full residual amount in Tier 2 capital resources.

Most stakeholders commented that the full residual amount should be included in Tier 1 capital resources.

**IAIS Response:** The IAIS continues to develop a consistent and comparable MOCE, and will consider the appropriateness of including the residual amount within capital resources. This issue will also be assessed in conjunction with other elements of the framework, such as contract boundaries.

# 6 Capital Resources

**Question 24.** Should reserves that are set up under regulatory requirements to cover specific types of risks, and that can be unappropriated under supervisory approval, be considered unrestricted and therefore be included in Tier 1 capital?

AMF, BAFIN, CIRC, MAS, OSFI and two other Members support the inclusion of these reserves in Tier 1.

EIOPA and four other Members do not support the inclusion of these reserves in Tier 1.

Most stakeholders commented that these reserves should be included in Tier 1. A few stakeholders commented that they should not be included in Tier 1 since supervisory approval to unappropriate the reserves is uncertain.

**IAIS Response:** The IAIS will collect more detailed data in order to gain a better understanding about the purpose of such reserves in each jurisdiction, the process and conditions for de-allocation and the historical precedent for such action. Based on this information, the IAIS will consider a set of principles under which a regulatory reserve could be included in capital and what form of capital such reserves would represent. In addition, as part of the overall calibration effort, the IAIS will consider whether there should be any limit to this form of capital.

# 6 Capital Resources

**Question 24.** Should reserves that are set up under regulatory requirements to cover specific types of risks, and that can be unappropriated under supervisory approval, be considered unrestricted and therefore be included in Tier 1 capital?

| **Themes from Responses** | **Proposed Resolution** |
|---|---|
| Regulatory basis reserves such as the Asset Valuation Reserve should be included in Tier 1 capital. Also, mutual companies derecognise Interest Maintenance Reserve (IMR) through surplus and should obtain full credit for IMR as Tier 1 capital. | The AVR and IMR will be evaluated as part of the overall analysis to determine the possible principles under which regulatory reserves could be recognized as capital. |
| Reserves that may be unappropriated under supervisory approval and have a proven track record of being unappropriated should be included. | The IAIS will perform follow up analysis to substantiate these statements and better understand the conditions or restrictions under which such releases have occurred in order to inform the principles to be drafted. |
| These reserves may be ring-fenced in a crisis and therefore not be available to the rest of the group. | This would be true for any capital under a legal entity structure,  however the IAIS will evaluate this as a possible issue in developing the set of principles. |

# 6 Capital Resources

**Question 25.** Should Tier 1 instruments for which there is a limit be required to include a principal loss absorbency mechanism that absorbs losses on a going-concern basis by means of the principal amount in addition to actions with respect to distributions (e.g. coupon cancellation)? If so, how would such a mechanism operate in practice and at what point should such a mechanism be triggered?

BAFIN, MAS and two other Members support the requirement of a principal loss absorbency mechanism.

AMF, CIRC and OSFI do not support the requirement of a principal loss absorbency mechanism.

EIOPA and four other Members commented that the impact should be assessed through field testing before a decision is made.

All but one stakeholder commented that a principal loss absorbency mechanism should not be required. One stakeholder suggested that it should only apply to Tier 1 instruments that are classified as a liability on the balance sheet.

**IAIS Response:** The IAIS continues to explore the appropriateness of a principal loss absorbency mechanism for Tier 1 instruments for which there is a limit.

# 6 Capital Resources

**Question 26.** Should any value with respect to DTAs, computer software intangibles and defined benefit pension plan assets be included in Tier 2 capital resources?

| | Support inclusion in Tier 2 | Do not support inclusion in Tier 2 |
|---|---|---|
| DTAs | AMF, BAFIN, EIOPA and three other Members | MAS, OSFI and one other Member |
| Computer Software | AMF | BAFIN, MAS, OSFI and one other Member |
| DB Pension Asset | AMF | BAFIN, MAS, NAIC and one other Member |

Most stakeholders commented that DTAs should be included in capital resources, whether Tier 1 or Tier 2 because DTAs have value in a going concern and retain some value in winding-up.
A few stakeholders commented that DB pension surplus and computer software intangibles should be included in capital resources, while a similar number commented that these items should not be included in capital resources.

**IAIS Response:** The IAIS will assess the characteristics of these items against the principles for capital resources, in particular, the ability of these to absorb losses in both going concern and in winding-up.

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# 6 Capital Resources

**Question 27.** Is it appropriate to include in Tier 2 add-backs from items that are deducted from Tier 1 capital resources (i.e. DTAs, computer software intangibles, defined benefit pension plan assets)? What methodology could the IAIS use to determine an objective realisable value in a stress scenario for these items or should the IAIS adopt a more arbitrary approach such as permitting a percentage of the amount deducted from Tier 1 capital resources to be included in Tier 2 capital resources? If Tier 2 add-backs are included, how could the ICS capital requirement work in relation to the amounts added back?

Very few Members provided a response. AMF commented that those items that have realized value upon winding-up could be included in Tier 2 capital at their expected value upon winding-up which could be reduced.

Very few Stakeholders provided a response. A few suggested that a limited amount of these items should be included, while a few commented that there should not be a limit on these items. A few stakeholders commented that it is too premature to discuss limits.

**IAIS Response:** Due to uncertainty as to the realisable value of these items in a stress situation, the IAIS will explore an approach that allows for limited recognition in Tier 2.

# 6 Capital Resources

**Question 28.** What objective methodology could the IAIS use to determine the amount of a non-controlling interest that is not available to the group for the protection of policyholders of the IAIG?

OSFI and one other Member support a methodology similar to the Basel III approach.

EIOPA and four other Members support the inclusion of the non-controlling interests up to the contribution of the specific legal entity to total ICS required capital.

CIRC commented that local supervisors should be able to develop a methodology.

**IAIS Response:** The IAIS is reconsidering which types of non-controlling interests should be recognised in ICS capital resources and how the qualifying amount should be determined. The IAIS intends to include a new approach in 2016 Field Testing.

# 6 Capital Resources

**Question 29.** Should other items be deducted or should some of the above items not be deducted? Please provide details and explain your answer.

EIOPA, OSFI and six other Members support the list of items to be deducted.

The following additional deductions were suggested by Members: DB pension plan deficits, elimination of the impact of cash flow hedges that are as a result of hedging items not held at fair value, elimination of unrealised gains and losses due to changes in own creditworthiness, significant investments in other financial institutions, foreseeable dividends and distributions.

AMF commented that own-use property should not be deducted.

Stakeholders commented that the following items should not be deducted: non-qualifying reinsurance, encumbered assets, DTAs, intangibles.

**IAIS Response:** The IAIS will retain the list of deductions as published in the consultation document. Other deductions may be included in 2016 Field Testing.

# 6 Capital Resources

**Question 30.** Instead of treating the above elements as deductions to Tier 1 capital resources, should some or all of these elements be included in the ICS capital requirement? Please provide details and explain your answer.

EIOPA, OSFI and six other Members support using a deduction approach rather than applying a risk charge.

Most stakeholders commented that the deduction approach is appropriate.

**IAIS Response:** The IAIS will retain the deduction approach rather than applying a capital charge to these items.

# 6 Capital Resources

**Question 31.** Instead of treating the above elements as deductions to Tier 2 capital resources, should some or all of these elements be included in the ICS capital requirement? Please provide details and explain your answer.

AMF, EIOPA, OSFI and six other Members support using a deduction approach rather than applying a risk charge.

Most stakeholders commented that the deduction approach is appropriate. One stakeholder noted that to the extent that an item is not deducted, a risk charge should apply.

**IAIS Response:** The IAIS will retain the deduction approach rather than applying a capital charge to these items.

# 6 Capital Resources

**Question 32.** Should the ICS contain capital composition limits? Why?

AMF, BAFIN, EIOPA, MAS, NAIC, OSFI and six other Members support capital composition limits.

Approximately half of the stakeholders support the use of capital composition limits to appropriately reflect the quality of qualifying capital. Approximately half of the stakeholders commented that the ICS should not contain capital composition limits because the focus of capital resources should be policyholder protection and the ability to pay claims in winding-up.

**IAIS Response:** The IAIS continues to consider the use of limits within the ICS in order to appropriately reflect the quality of capital resources and their ability to absorb losses. The IAIS plans to explicitly test capital composition limits in 2016 Field Testing.

# 6. Capital Resources

**Question 33.** If it were to contain limits, what would be an appropriate limit for Tier 1 capital instruments that satisfy the criteria set out in Section 6.3.3 (i.e. Tier 1 capital resources for which there is a limit)? How should this be expressed? If it were expressed as a percentage of Tier 1 capital resources, net of regulatory adjustments and deductions, what would an appropriate limit be?

EIOPA, MAS and five other Members support a limit expressed as a percentage of the ICS capital requirement.

BAFIN, CIRC, OSFI and one other Member support a limit expressed as a percentage of the Tier 1 capital. These Members suggested a limit in the range of 15-30% of Tier 1 capital.

Most stakeholders commented that they do not agree with tiering and capital composition limits or that it is too premature to discuss limits. One Stakeholder commented that any excess of Tier 1 limited above the limit should then drop down to Tier 2.

**IAIS Response:** The IAIS continues to consider the use of limits within the ICS in order to appropriately reflect the quality of capital resources and their ability to absorb losses. The IAIS plans to explicitly test capital composition limits in 2016 Field Testing.

# 6 Capital Resources

**Question 34.** If the ICS were to include a capital composition limit on Tier 2 capital resources, how should it be determined? If it were set as a percentage of the ICS capital requirement, what should the limit be? Please include reasons for your answer.

BAFIN, EIOPA and six other Members support a limit expressed as a percentage of the ICS capital requirement.

CIRC supports a limit expressed as a percentage of Tier 1 capital resources.

EIOPA and four other Members commented that the total of Tier 1 (limited) and Tier 2 capital resources should be less than 50% of the ICS required capital.

BAFIN commented that Tier 2 capital resources should be less than 50% of the ICS required capital.

Stakeholder responses varied: a limit expressed as a percentage of the ICS capital requirement, a limit expressed as a percentage of Tier 1 capital resources, and a limit expressed as a percentage of total capital.

**IAIS Response:** The IAIS continues to consider the use of limits within the ICS in order to appropriately reflect the quality of capital resources and their ability to absorb losses. The IAIS plans to explicitly test capital composition limits in 2016 Field Testing.

# 6 Capital Resources

**Question 35.** If GAAP with adjustments were used as an alternative valuation approach for the ICS, are the definitions of capital resources detailed above appropriate? Please describe key differences and any complications that may emerge under a GAAP with adjustments approach to valuation.

EIOPA and five other Members commented that no further adjustments should be required.

BAFIN commented that a reconciliation reserve may be required.

OSFI commented that retained earnings may need to be restated.

Most stakeholders commented that no further adjustments should be required.

**IAIS Response:** As the GAAP with adjustments approach is further developed, interactions with and implications for capital resources will be considered.

# 6 Capital Resources

**Question 36.** Should the IAIS consider transitional arrangements for financial instruments that do not meet the ICS qualifying criteria? If so, what transitional arrangements would be appropriate?

BAFIN, CIRC, EIOPA, NAIC, OSFI and six other Members support transitional measures for non-qualifying financial instruments.

Members suggested transition periods that ranged from five to ten years.

All stakeholders commented that transitional arrangements are necessary. Suggested transition measures included full grandfathering, grandfathering to the first call date, grandfather for ten years and transition the non-qualifying instruments out over a period of five to ten years.

**IAIS Response:** The IAIS recognises that transition measures and phase-in periods for certain elements of the ICS may be necessary in some jurisdictions. This is an important issue and will be addressed prior to the finalisation of ICS version 2.0.