IAIS

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

Public

ICS Consultation Document - Responses to Comments on Asset Concentration & Credit Risks (Sections 9.2.4-5)

9 March 2016

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.

Glossary of Member Acronyms/ Shortened Names

AMF	Autorité des Marchés Financiers, Quebec, Canada
BaFin	Federal Financial Supervisory Authority, Germany
BMA	Bermuda Monetary Authority
CIRC	China Insurance Regulatory Commission
EIOPA	European Insurance and Occupational Pensions Authority
Hong Kong	Office of the Commissioner of Insurance
IVASS	Instituto per la Vigilanza sulle Assicurazioni, Italy
MAS	Monetary Authority of Singapore
NAIC	National Association of Insurance Commissioners, United States
OSFI	Office of the Superintendent of Financial Institutions, Canada
Russia	Central Bank of the Russian Federation

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9.2.4 Asset Concentration Risk

Question 139. How should the issue of asset concentration be addressed for the purpose of the ICS capital requirement? Please provide detailed considerations and rationale.

BaFin, EIOPA, and four other Members support applying specific capital charges, with most noting there is some work to do on specific treatments (e.g. exemptions for exposures towards sovereign risk) and the need to explore if a stress approach would be more appropriate to reflect the aggregate impact of a defined scenario of losses on the larger asset exposures of the IAIG over its liabilities as well.

MAS stated it may not be necessary to prescribe hard limits for insurers in the same way as done for banks, and asset concentration can be better addressed as part of IAIGs' risk management framework as the assets held depend largely on the nature and type of business written and supervisory process. MAS recommended any excess beyond defined prudential thresholds to be (a) deducted from capital resources or (b) subject to capital requirements, instead of prescribing specific hard limits.

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9.2.4 Asset Concentration Risk

Question 139. How should the issue of asset concentration be addressed for the purpose of the ICS capital requirement? Please provide detailed considerations and rationale.

Stakeholders provided a wide range of responses, including:

- Addressing asset concentrations outside of the ICS, such as through 'Pillar 2' types requirements, similar to the Basel banking approach/ standards;
- Use internal models;
- Use a factor based approach for exposures beyond a specified limit.

Other suggestions included: exclude sovereign risks, don't use OECD classification, consider in Pillar 3.

IAIS Response: For 2015 field testing, the IAIS proposed a factor based approach for asset concentrations beyond a specified threshold, using both total assets and qualifying capital resources as the basis for determining the threshold. The most notable change in design from the consultation paper is that the approach excluded sovereign exposures.

For 2016 field testing, the IAIS does not intend to make many significant changes to the proposed ICS asset concentration risk charge design and calibration.

9.2.4 Asset Concentration Risk

Question 140. Should the large exposure limit be based on qualifying capital resources, or should the limit be based on other measures such as assets?

BaFin, EIOPA, and five other Members support limits defined on the basis of total assets. The key consideration was that using a capital resources limit would risk introducing pro-cyclicality without a real change in the asset concentration risks.

AMF supported using limits based on qualifying capital resources, also suggesting that a limit should be imposed on bank deposits in OECD countries.

OSFI noted that limits on exposures to single names and connected groups are usually expressed as a percentage of capital resources, as this directly limits the proportional impact on capital if the single name defaults. However, more general limits on investment types, categories and classes may be expressed either as a proportion of capital resources or of assets, as there is less potential for sudden, extreme losses for a diversified portfolio within a particular asset class.

Russia supported limits based on qualifying capital resources, otherwise a situation may arise when the exposure limit for the insurance group with substantial assets and low capital is higher than the exposure limit for a group with relatively small assets and a similar amount of capital.

9.2.4 Asset Concentration Risk

Question 140. Should the large exposure limit be based on qualifying capital resources, or should the limit be based on other measures such as assets?

Most stakeholders supported a large exposure limit based on assets, with many indicating concerns with potential volatility if it were based on capital measurements.

Some stakeholders supported limits based on capital resources, one stakeholder noted it was more appropriate as the limits are intended to help ensure idiosyncratic risks do not endanger solvency.

A few stakeholders provided other suggestions, such as: a limit based on liabilities, and the limit should be applied to assets backing technical provisions plus required capital only.

One stakeholder objected to including asset concentration limits in the ICS. Another stakeholder indicated that such risks should not be an issue for IAIGs, and so the IAIS should collect data during field testing to determine whether there is a need to proceed.

IAIS Response: For 2015 field testing, the IAIS proposed a factor based approach for asset concentrations beyond a specified threshold, using both total assets and qualifying capital resources as the basis for determining the threshold.

For 2016, the IAIS plans to only field test a threshold based on total assets, as there is significant potential volatility in the qualifying capital resources metric due to unresolved policy considerations.

9.2.5 Credit Risk

Question 141. Should the ICS credit risk factors vary by maturity?

AMF, BaFin, EIOPA, MAS, OSFI, and six other Members indicated that ICS credit risk factors should vary by maturity.

About half of the stakeholders supported having the credit risk factors vary by maturity - many indicated that the impacts of the risks vary with maturity.

A few stakeholders suggested it would depend on the time horizon and risk metric.

Some stakeholders indicated that the ICS credit risk factors should not vary by maturity, reasons included: the ratings of securities and loans already include credit risk, assets held by non-life companies have a relatively short duration, difficult to assess for reinsurance exposures, and potential double-counting between credit risk charge and spread risk within the market risk category.

IAIS Response: In 2015, the IAIS field tested ICS credit risk factors that varied by maturity. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 142. Are there any other major asset classes that this list has omitted? Should some of the classes in this list be further segmented or merged? Why?

EIOPA and 4 other Members provided a list of exposures within two groups:

(1) Risk-mitigation contracts including reinsurance, special purpose vehicles, insurance securitisations and derivatives, cash at bank, deposits with ceding firms, commitments received by an insurer which have been called up but are unpaid, legally binding commitments which the insurer has provided or arranged and which may create payment obligations depending on the credit standing or default on a counterparty including guarantees, letters of credit, and letters of comfort which the insurer has provided.

(2) Receivables from intermediaries, policyholder debtors, mortgage loans, deposits with ceding firms.

BaFin noted credit derivatives that cannot be recognized as risk-mitigation techniques, as these may increase in value when spreads widen, and their risks may not be captured in the other scenarios.

CIRC stated classification of asset types should be consistent with requirements of local regulators, especially classification of assets with debt features. In China, default risk for such securities is often backed by government, and they are typically only rated by local rating agencies or have no rating. Local regulators have more knowledge about these investments and more specific requirements on their risk capital charge. CIRC suggested including rating agencies from developing countries.

9.2.5 Credit Risk

Question 142. Are there any other major asset classes that this list has omitted? Should some of the classes in this list be further segmented or merged? Why?

Some stakeholders indicated that the proposed segmentation was reasonable.

However, the majority of stakeholders provided suggestions, including: more classes (infrastructure/ project finance, leases, special finance, bonds issues by government sponsored entities), splitting certain classes (reinsurance and OTC derivatives, municipal bonds and corporate bonds, reinsurance into two components – with and without collateral), consider securitisations separately, use residential/ commercial property backed rather than residential/commercial mortgages.

Other comments included: use a zero risk charge on sovereign risk, leverage off of existing frameworks, build a ratings agency subject to supervisory governance (similar to NAIC construct).

IAIS Response: In 2015, the IAIS field tested a segmentation approach similar to, but not the same as, the proposal provided within the consultation document. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 143. Are there are any proposed alternatives for assessing credit quality that do not rely on rating agencies or on internal models?

BaFin proposed a combination of assessments from (various) external rating agencies and additional internal assessments from the insurer.

MAS drew a distinction between (i) internal models used to compute credit risk charges (similar to IRB approach allowed under Basel framework) and (ii) internal credit assessment models that derive credit quality categories broadly equivalent to that of external rating agencies, which then adopt the prescribed risk charges under the ICS standard method credit risk module. They noted there is quite a high volume of bonds that are unrated but of good quality, and so the IAIS could explore the feasibility of allowing internal credit assessment models with some safeguards in place on their use.

CIRC noted the credit risk of products issued by financial institutions can be reflected by the capital adequacy ratio of the issuers in addition to characteristics of the products themselves.

NAIC suggested an alternative to relying exclusively upon the rating agencies is to assess the credit risk of investments through an independent, supervisor-driven process. As an example, the NAIC created what is now called the Investment Analysis Office (IAO) to assess the credit risk of insurer investments. The IAO assigns an NAIC Designation, a measure of credit risk, to each investment.

9.2.5 Credit Risk

Question 143. Are there are any proposed alternatives for assessing credit quality that do not rely on rating agencies or on internal models?

Most stakeholders did not propose alternatives that did not rely on ratings agencies or on internal models. However, some of those stakeholders supported allowing use of internal ratings at least where securities are unrated by international credit rating agencies.

Other stakeholder responses suggested consideration of: Basel III Standardized Approach proposals that focus on risk drivers, reference to market spreads, calibrations based on the solvency ratio of the IAIG, allowing use of the NAIC's Security Valuation Office, and building a ratings agency subject to supervisor governance similar to the NAIC ratings construct.

IAIS Response: In 2015, the IAIS field tested an approach for assessing credit quality that relied on established ratings agencies. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 144. Are the Basel II standardised credit risk weights an appropriate basis for the ICS credit risk charges? If yes, what modifications should be made to the factors? If no, what other basis is appropriate?

AMF, BaFin, EIOPA, MAS, NAIC and five other Members noted that differences to the Basel II factors will be necessary to ensure the approach is reflective of the different target criteria and/ or appropriate for the specificities of the insurance business.

OSFI noted a more granular approach than the Basel standardized risk weights is necessary for the ICS standard method if the IAIS wishes to achieve greater risk sensitivity without resorting to models.

Hong Kong stated that over-reliance on external credit ratings should be avoided, and risk charges due to compliance with mandatory regulations at jurisdictional level (such as Asset-Liability Matching requirements that require holding bond assets in the same currency of that of insurance liabilities) should be appropriately addressed given these insurance groups may have little investment flexibility.

CIRC responded similarly as to Question 142, suggesting consistency with requirements of local regulators, who have more knowledge about local investments and more specific requirements on their risk capital charge, and suggesting inclusion of rating agencies from developing countries.

IVASS stated the ICS credit risk measurement should follow closely principles or policy choices made in the Basel II framework. In particular, the ICS should not impose capital charges on sovereign risks.

9.2.5 Credit Risk

Question 144. Are the Basel II standardised credit risk weights an appropriate basis for the ICS credit risk charges? If yes, what modifications should be made to the factors? If no, what other basis is appropriate?

Most stakeholders did not view the use of Basel II standardised credit risk weights as an appropriate basis for ICS credit risk changes, reasons included: spread risk not considered, a stress approach is preferable, diversification is not considered, and the Basel framework is currently under review.

Of the stakeholders that did indicate some support for the use of Basel II standardised credit risk weights, many also suggested modifications be made, such as: increase exposure classes, use loan-to-value and debt service coverage ratios to differentiate credit risk charges, include a low volatility category, and allow authorities discretion to lower risk weights irrespective of external rating grades.

IAIS Response: In 2015, the IAIS field tested an approach based on a reduced version of the Basel II internal ratings-based (IRB) model. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 145. Are there any proposed risk segmentations of residential and commercial mortgages that are possible to apply internationally to differentiate the credit risk charge?

EIOPA and four other Members do not believe it possible to define risk segmentations of residential and commercial mortgages which could apply internationally, as the markets are too different.

BaFin suggested the segmentation was not necessary.

CIRC responded similarly as to Question 142, suggesting consistency with requirements of local regulators, who have more knowledge about local investments and more specific requirements on their risk capital charge, and suggesting inclusion of rating agencies from developing countries.

Most stakeholders did not identify any risk segmentations of residential and commercial mortgages that could be applied internationally to differentiate the credit risk charge.

Some stakeholders provided suggestions including the use of: loan-to-value ratios, interest cover ratios, debt service cover ratios, averaged unexpired lease term, location, and a different approach for securitisations (stress the underlying securities with the credit loss for any specific asset based on the structure of the securitisation).

IAIS Response: In 2015, the IAIS field tested an approach that used only the broad segmentation categories of residential and commercial mortgages. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 146. Should a different approach be used for reinsurance exposures than is used for other credit risk exposures?

AMF, EIOPA, MAS, OSFI and five other Members indicated the same approach should be followed. OSFI further noted particular attention may possibly need to be paid to large credit exposures that may arise from transactions with reinsurers. AMF further noted the shock factor should reflect that insurers cannot diversify their reinsurance counterparties as much as implicitly embedded in other credit risk shocks.

BaFin referred to their response to Question 141, which notes a PD-LGD approach seems more feasible where an insurer is mainly exposed to defaults of counterparties (e.g. reinsurer).

NAIC highlighted further risks that a reinsurance recoverable is subject to. First, there is the greater risk of coverage disputes; these should either be reflected in the charge for credit risk or as part of operational risk. Second, appropriate treatment of collateral requirements for reinsurance differs from that of other credit risks. Finally, reinsurers are exposed to similar risks as their insureds.

9.2.5 Credit Risk

Question 146. Should a different approach be used for reinsurance exposures than is used for other credit risk exposures?

The majority of stakeholders indicated that a different approach should be used for reinsurance exposures, reasons included: different loss-given default, subject to supervisory oversight and capital, reinsurance treaties typically have protective features such as offset and recapture rights, and the Basel approach fails to consider collateral properly.

Some stakeholders provided suggestions, including: use of lower factors, considering reinsurer solvency ratios, and considering the correlation between reinsurer default and catastrophe losses.

IAIS Response: In 2015, the IAIS field tested an approach which treated reinsurance exposures similarly to corporate credit exposures. The IAIS is currently reviewing the changes, if any, to be made to this approach for 2016 field testing.

9.2.5 Credit Risk

Question 147. If GAAP with adjustments were used as an alternative valuation approach for the ICS, detail those adjustments, if any that would be required to produce a comparable credit risk charge to those produced using the market-adjusted valuation approach under the credit risk charge described in this section.

EIOPA and four other Members indicated the methodology for calculation of ICS capital requirements should not be tied to a given valuation methodology. Irrespective of the valuation method being used to determine current estimate insurance liabilities, it should bring the assets and liabilities to a sufficiently comparable position in order to allow for the application of one common methodology for the purpose of determining capital requirements (one single ICS standard method, no multiple parallel frameworks).

9.2.5 Credit Risk

Question 147. If GAAP with adjustments were used as an alternative valuation approach for the ICS, detail those adjustments, if any that would be required to produce a comparable credit risk charge to those produced using the market-adjusted valuation approach under the credit risk charge described in this section.

Generally, stakeholders did not provide detailed responses to this question for reasons such as they were unclear on the GAAP with adjustments approach or they did not think the differences were significant.

A couple of stakeholders suggested that it may feasible by reverting to a market-adjusted approach (requiring investments be at market value). Another stakeholder suggested that, if GAAP with adjustments is essentially cost accounting or an unlocked book value gross premium valuation approach, the use of a factor-based approach would be necessary but would be approximate due to the fact that credit risk impacts only one side of the balance sheet.

IAIS Response: In 2015, the IAIS did not field test a credit risk capital approach based upon a GAAP with adjustments valuation methodology. The IAIS plans to do so in 2016 field testing.