

# **Global CRO Proposals for ICS Version 2.0**

February 1, 2019

AIG

Allianz

Aviva

Manulife

Met Life

Protective Life/Dai-ichi Life

Prudential Financial

# Overview

- In slides that follow, we outline substantive proposals a global group of CROs have developed to address topics the IAIS identified as opportunities for engagement ahead of 2019 field testing
  - ❑ *Enhancing the bucket criteria to increase accessibility while retaining an appropriate degree of prudence*
  - ❑ *Identifying data sources to support recognition of a spread term structure*
- While these changes would result in incremental improvement to the ICS, further efforts to align the framework with ALM and risk management principles and practices are necessary to ensure it promotes sound behavior while minimizing inappropriate pro-cyclical behavior
- We believe a simplified ICS with transparent application of supervisory prudence is the appropriate approach (rather than implicit conservatism that is embedded opaquely throughout the construct)
  - ❑ *Valuation should reflect the insurer's own assets*
    - ✓ Aligns with insurer ALM, eliminates need for bucket criteria, and resolves lack of data and granularity
  - ❑ *MOCE should be removed*
    - ✓ Improves transparency of the risk assessment and recognizes how business transfers occur in practice
  - ❑ *Required capital stresses should be properly designed and calibrated*
    - ✓ Ensures a focus on the drivers of risks and serves as a transparent and meaningful guardrail for further incentivizing appropriate practices by insurers
    - ✓ Gets to credible outcomes, enhances risk-sensitivity and reduces incentives for arbitrage & non-economic behavior
  - ❑ *If necessary, further supervisory prudence should be incorporated into the calibration of required capital*
    - ✓ Maintains transparency of the risk assessment and could be applied through a simple overlay on-top of required capital or, ideally, outside of the ICS formula (e.g., expectations for ICS coverage ratios)

# Remaining Issues with the 3 Bucket Approach

- We welcome the IAIS' interest in changing the bucket criteria and recognizing a spread term structure; however, we note that there are a number of material issues to address with respect to the valuation of insurance liabilities:
  - 1. Failure to recognize a spread term structure** – spreads vary by tenor, currency and rating to reflect their underlying risk; the ICS should be sensitive to this
  - 2. Insufficient granularity in asset classes recognized** – insurers invest in a far broader range of assets than currently captured in the valuation methodology; the ICS should be sensitive to this
  - 3. Overly simplistic approach to risk correction** – expected defaults vary by jurisdiction/currency; the ICS should be sensitive to this
  - 4. Overly prudent treatment of equity/alternative investments** – they play an important role in backing liability exposures beyond the investable horizon and are a stable component of insurer asset portfolios; the ICS should recognize the role these assets play in insurer ALM rather than disincentivize sound practices
  - 5. Ignoring supervisor and internal ratings** – overstates risk and is inconsistent with regulatory practice in many jurisdictions; the ICS should recognize practices that enhance risk sensitivity
  - 6. Overly simple approach to setting long-term forward rates and spread add on** – greater differentiation is needed for the LTFRs and a realistic spread should be recognized
  - 7. Using application ratios** – embeds additional credit risk charges in the liability valuation (i.e., beyond the risk correction and required capital for credit risk); liability valuation should reflect a true current estimate

# Enhancing the Bucket Criteria

- As a general comment, we note the importance of distinguishing between capital and liquidity concerns and applying appropriate policy measures to address each respective issue; the Top Bucket criteria conflate the two and should be revised – e.g., the exclusion of products with cash value/surrender option
- The following proposed changes would increase bucket accessibility while retaining an appropriate degree of prudence

Criterion	Proposal	Rationale
Criterion b	<ul style="list-style-type: none"> <li>• Clarify text so IAIGs understand ALM at a segment level satisfies the criterion</li> </ul>	<ul style="list-style-type: none"> <li>• Volunteers interpreted this criteria as requiring strict ring-fencing at a product level which is inconsistent with how insurers conduct ALM</li> </ul>
Criterion c	<ul style="list-style-type: none"> <li>• Base the carry forward amount on liability out flows rather than net liability cash flows</li> <li>• Allow indefinite carry forward of excess cash</li> <li>• Allow for use of key rate DV01 matching as an alternative to cash flow matching for the Middle Bucket</li> </ul>	<ul style="list-style-type: none"> <li>• Use of net liabilities results in an overly conservative exposure base; premiums should be thought of as asset cash flows</li> <li>• DV01 matching would serve as an alternative basis that aligns with how insurers conduct ALM in practice and is consistent with the spirit of the criterion</li> </ul>
Criterion d	<ul style="list-style-type: none"> <li>• Top Bucket – permit liabilities that include future premiums that are contractually fixed.</li> <li>• Middle Bucket – permit liabilities that include future premiums that can be reasonably projected</li> </ul>	<ul style="list-style-type: none"> <li>• This adjustment would increase the potential for certain products (e.g., universal life, deferred annuities) to qualify, in particular for the Middle Bucket.</li> </ul>
Criterion e	<ul style="list-style-type: none"> <li>• Middle Bucket: eliminate this criterion</li> </ul>	<ul style="list-style-type: none"> <li>• The circular nature would raise implementation challenges and we disagree with the notion that the discounting approach should be dependent on results under a 1-in-200 year lapse event</li> </ul>

# Data for Recognition of a Spread Term Structure

- Recognition of a spread term structure is relevant, especially for currencies supported by a sufficiently developed credit market and readily available spread data; one method to assess relevance for currencies is to evaluate

- the size of the debt securities market
- the availability of long maturity corporates
- the availability of diversified issuers

- Currencies meeting the above criteria are USD, CAD, JPY, EUR, and GBP
- This list can be updated periodically to account for the further development of credit markets during and after the monitoring period
- Initially, for developing markets with limited credit market information, the starting point could be risk free rates with an addition for spread over risk free where appropriate

## Additional Notes

[1] Data source: Summary of debt securities outstanding from BIS (<https://www.bis.org/statistics/c1.pdf>)

[2] Based on the population included in Barclays corporate bond index for each currency

Currency	<u>Criteria 1: Size of debt market</u> Total outstanding non-government debt securities > \$1 trillion <sup>[1]</sup>	<u>Criteria 2: Availability of Long Maturity Corporates</u> The amount of 10Y+ Corporates is at least 10% of all corporate bonds or \$0.1 trillion <sup>[2]</sup>	<u>Criteria 3: Availability of well diversified issuers</u> The number of issuer > 50 <sup>[2]</sup>
AUD	X		
BRL			
CAD	X	X	X
CHF			
CLP			
CNY	X		
COP			
CZK			
DKK			
EUR	X	X	X
GBP	X	X	X
HKD			
HUF			
IDR			
ILS			
INR			
JPY	X	X	X
KRW			
MXN			
MYR			
NOK			
NZD			
PEN			
PHP			
PLN			
RON			
RUB			
SAR			
SEK			
SGD			
THB			
TRY			
TWD			
USD	X	X	X
ZAR			

# Data for Recognition of a Spread Term Structure

- The table below summarizes examples of spread data available from data vendors which could be used as part of a more granular WAMP approach. Such sources could be further refined based on the jurisdictional expertise of regulators and industry participants over the monitoring period as more robust data become available and identified

Currency	Source	Details
USD	Barclays Live	<p>Barclays LIVE web site (<a href="https://live.barcap.com">https://live.barcap.com</a>).</p> <ul style="list-style-type: none"> <li>Requires login credentials to access data</li> <li>Once logged in, for USD AAA 1Y spread, go to “Series” -&gt; Credit -&gt; Sector -&gt; Corporate Sector Spreads -&gt; USD -&gt; AAA -&gt; All Sectors -&gt; 1Y -&gt; Fitted ParSpreadTreasury</li> <li>Credit spreads for other ratings and tenors can be obtained similarly</li> </ul>
CAD	Bloomberg <sup>1</sup>	<p>Tickers: <b>BVCSCPXX Index</b> (AA-rated), <b>BVCSCDXX Index</b> (A-rated), <b>BVCSCMXX Index</b> (BBB-rated)</p> <ul style="list-style-type: none"> <li>XX can be substituted with 01, 02, 03, 04, 05, 07, 08, 09, 10, 15, 20, 25, or 30 corresponding to the maturity in years</li> </ul>
JPY	Bloomberg <sup>1</sup>	<p>Tickers: <b>JBRAAXX Index</b> (AA-rated), <b>JBRAXX Index</b> (A-rated), <b>JBRBBBXX Index</b> (BBB-rated)</p> <ul style="list-style-type: none"> <li>XX can be substituted with 01, 02, 03, ..., 14, or 15 corresponding to maturity in years</li> <li>Credit rating is based on Japan’s local agency rating</li> </ul>
EUR	Bloomberg <sup>1</sup>	<p>Tickers: <b>BVCSECXX Index</b> (AA-rated), <b>IGEEVCXX Index</b> (A-rated), <b>BVCABCXX Index</b> (BBB-rated)</p> <ul style="list-style-type: none"> <li>XX can be substituted with 01, 02, 03, 04, 05, 07, 08, 09, 10, 15, 20, 25, or 30 corresponding to the maturity in years</li> </ul>
GBP	Bloomberg <sup>1</sup>	<p>Tickers: <b>BVCSGEXX Index</b> (AA-rated), <b>BVCSAEXX Index</b> (A-rated), <b>BVCSABXX Index</b> (BBB-rated)</p> <ul style="list-style-type: none"> <li>XX can be substituted with 01, 02, 03, 04, 05, 07, 08, 09, 10, 15, 20, 25, or 30 corresponding to the maturity in years</li> </ul>

**Additional Notes:** [1] All these Bloomberg tickers provide par yields from which risk free rates need to be deducted to derive credit spreads

# Proposal for Further Middle Bucket Enhancement

- To further enhance the Middle Bucket and reduce operational complexity we propose the spread on the insurers actual fixed income assets backing their liabilities be used instead of IAIS prescribed WAMP spreads
  - ✓ Eliminates complexity maintaining granular WAMP data, including duration as well as rating
  - ✓ Would be simple and more effectively reduce asymmetry between the valuation of insurance liabilities and the corresponding assets backing them
- This is **strictly a re-calibration** – i.e. only changes to spreads used in the WAMP calculation
  - ✓ No changes to Middle Bucket methodology are proposed
  - ✓ No new technical specifications are required
- This is the **simplest version of the Middle Bucket** calculation
  - ✓ Does not require IAIS additional data sources to support WAMP spreads
  - ✓ Creates consistency with Middle Bucket criteria – i.e., the spread on fixed income assets backing liabilities is already used as part of the cash flow matching criterion
- This method **more closely aligns with actual ALM practices** and will naturally address many of the basis risk issues discussed in the Miami meeting
  - ✓ Will automatically capture term structure of spreads, internal ratings (which should analogously be permitted in the Top Bucket) and investment in non-Corporate fixed income assets

# 2019 Field Testing

- The 2019 Field Test should be used as an opportunity to collect data that can inform refinements to the calibration of the ICS ahead of adoption of Version 2.0 in November and during the monitoring period
- Enhancing the Bucket Criteria (proposals on slide 4)
  - ❑ To achieve the objective of increasing Top and Middle Bucket accessibility the IAIS needs data – different permutations of the criteria should be assessed
  - ❑ We will translate our proposals into technical specifications and develop a template that can be included in the 2019 Field Test to facilitate this data collection; we will deliver these supporting materials by EOD February 12
  - ❑ In addition to data, the qualitative questionnaire should include targeted questions to further assist the IAIS with this objective (e.g., which criteria restrict which products)
- Alternative Approach to Middle Bucket/WAMP Spreads (proposal on slide 7)
  - ❑ The alternative approach we have proposed will provide a valuable point of reference regarding the importance of fixed income spreads earned by IAIGs on their actual assets versus those assumed in the WAMP calculation
  - ❑ No changes to Middle Bucket methodology are proposed and no modification to or new technical specifications are required
- Additional data points that may illuminate potential sources of procyclicality and implications of the current degree of conservatism should also be explored (e.g., the impact of permitting the use of internal ratings or recognizing equity/alternative investments on valuation)
- Our companies stand ready to provide data on the distribution of outcomes under reasonable alternative approaches and proposals – other field test volunteers have historically expressed similar support for more fulsome field testing



# Closing Thoughts

- The original objective of the ICS was to provide comparability at the global/group level for purposes of facilitating supervisory discussion – not to serve as an additional requirement or to infringe on national sovereignty
- Enhancing comparability and supervisory insight would best be achieved through a lens that focuses on real economic outcomes, which could facilitate the overall comparability of ICS
- A simple and transparent framework is the appropriate approach to achieve this objective and minimize the potential for unintended consequences that inhibit our ability to prudently manage risks
  - ❑ Valuation should reflect the insurer's own assets – would align with insurer ALM and significantly simplify the construct, with required capital serving as a prudent guardrail
  - ❑ MOCE should be removed – would improve transparency and recognize how business transfers occur
  - ❑ Required capital stresses should be properly designed and calibrated – would ensure a focus on the drivers of risks and economic outcomes, serve as a transparent and meaningful guardrail, and reduce incentives for arbitrage
  - ❑ If necessary, further supervisory prudence should be incorporated into the calibration of required capital – would maintain transparency of the risk assessment in a simplified manner
- We believe this is the appropriate structure for the ICS however, substance over form is what ultimately matters; the current ICS construct can be enhanced to achieve similar outcomes

## Closing Thoughts (continued)

- Through these slides we have offered substantive elements for consideration in the development of ICS Version 2.0
- More broadly, the CROs note their commitment to collaborating with the IAIS to ensure that the ICS aligns with and supports the shared objective of promoting sound risk management and behavior while minimizing inappropriate pro-cyclical behavior
  - ❑ We would welcome the opportunity to engage in detailed discussions and workshops on methods for measuring risks as a means for supporting further enhancements to the ICS
  - ❑ We would be happy to commit our resources, share insights from our years of experience modeling and managing risks and take the time needed to make sure the ICS appropriately and accurately assesses the risks we have underwritten
- Consistent with this goal, we look forward to continuing engagement with the IAIS in the forthcoming months
- We welcome broader stakeholder feedback on and support for the proposals discussed today and would be happy to address any questions you may have

Thank you