7.9 Expense risk

Q85 Section 7.9 The Field Testing Technical Specifications specify expense inflation stresses that grade down to 1% for China, Emerging Markets and Other Developed Markets. Is this appropriate? If “no”, please provide suggestions on the appropriate stresses and grading period together with the supporting rationale. Please explain with sufficient detail and rationale. If “yes”, please comment whether this design is consistent with the approach used to determine the LTFR, where differentiated long-term inflation assumptions are used between jurisdictions, without any convergence.

Organisation	Jurisdiction	Confidential	Answer	Answer Comments
China Banking and Insurance Regulatory Commission (CBIRC)	China	No	Yes	This design is not contradictory with the approach used to determine the LTFR. The inflation assumed in LTFR is the expected level of inflation, while the inflation shock assumed in expense risk represents the volatility of the expected inflation. We analysed historical inflations for a number of developed markets, and observed a trend of reduced inflation volatility when the economy gradually matures, therefore we support grading down the inflation volatility in later years in the projection.
European Insurance and Occupational Pensions Authority (EIOPA)	EIOPA	No	No	We appreciate that a higher inflation level does not automatically imply higher inflation volatility. Insofar the grading down of inflation stresses could be consistent with the approach used to determine the LTFR. However, we would like to see some evidence that supports this approach.
Insurance Europe	Europe	No	Yes	

Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Germany - BAFIN	No	No	We do not have a strong view here. On the one hand, we appreciate that a higher inflation level does not automatically imply higher inflation volatility. Insofar the grading down of inflation stresses could be consistent with the approach used to determine the LTFR. On the other hand, we would like to see some evidence that supports this approach.
General Insurance Association of Japan	Japan	No	Yes	As the interest rate converges with the LTFR, its volatility decreases. Inflation rate volatility can also be considered as decreasing as well. Therefore, an approach that specifies expense inflation stresses grade down to 1% is consistent with the approach used to determine the LTFR.
Financial Supervisory Service (FSS) & Financial Services Commission (FSC)	Korea (Republic of)	No	No	A comparative analysis of Korea's price index volatility and the central bank's target inflation rate with the major developed markets such as Europe, North America and Japan shows no material difference. For this reason, we propose to change the expense inflation stress for Korea to 1% as is the case for the major developed countries.
Legal & General	UK	No	Yes	This seems broadly sensible to us. Expense inflation is not necessarily directly equivalent to economy inflation and so it does not seem to be a clear inconsistency.
Property Casualty Insurers Association of America (PCI)	USA	No	Yes	PCI´s yes or no response was simply required in order to open the text box and file comments. We believe this question to be best addressed by field test volunteers who have the ability to do so with the benefit of actual data for support and context. The absence of a response by PCI should not be taken one way or the other with respect to the subject of the question.
National Association of Insurance Commissioners (NAIC)	USA, NAIC	No	Yes	There is an apparent/possible dichotomy in that the long term inflation rate inherent in the expense risk is not consistent with the inflation rate in the computation of the LTFR. This may cause some observers concern. On the other hand insurance companies have more control over their expense inflation than general inflation and moreover, as insurers in developing jurisdictions grow in size, their experience is likely to stabilize and their expense level as well as expense fluctuation will moderate.

Q86 Section 7.9 Are there any further comments on Expense risk that the IAIS should consider in the development of ICS Version 2.0? If "yes", please explain with sufficient detail and rationale.

Organisation	Jurisdiction	Confidential	Answer	Answer Comments
China Banking and Insurance Regulatory Commission (CBIRC)	China	No	Yes	The inflation risk mainly relates to economic and market factors, while the level of expense more relates to the operation of individual companies. As such, the increase of inflation does not lead to an increase of non-inflation linked expenses The correlation is not 100% and we suggest a lower correlation factor, for instance 50%.
European Insurance and Occupational Pensions Authority (EIOPA)	EIOPA	No	No	
Insurance Europe	Europe	No	No	Insurance Europe notes that in practice companies are able to manage expense levels, therefore it is unrealistic for the inflation stress to continue indefinitely.
Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Germany - BAFIN	No	No	
Global Federation of Insurance Associations	Global	No	Yes	The discount rate should change according to the prevailing inflation rate.
Dai-ichi Life Holdings, Inc.	Japan	No	Yes	If the rise in the inflation rate would be taken into consideration, the discount rate should be fluctuated consistently.
General Insurance Association of Japan	Japan	No	No	Risks to the unit expense component and expense inflation component manifest due to different causes. Therefore, the correlation factor between the two components should be set at zero.

The Life Insurance Association of Japan	Japan	No	Yes	• As for future costs, there is a lot ofroom deal with management action, so it is necessary to make constructive discussions based on the clarification of evidence regarding the needs and scope of Expense risk. Both the base (6%) and inflation rate (1% each year) are assumed to occur simultaneously, but the IAIS needs to consider the avoidance of excessive stress, as these factors are not always linked. In addition, if the IAIS takes into account the increase of inflation rate, it should change the discount rate consistently with such an increase. • The correlation factor between lapse and medical risk is set at 50% in this consultation document. Regarding Lapse risk and Mobility risk, the LIAJ recognises that insurers are able to manage mid- and long-term expenses, although there are possibilities of short-term increase of costs. Given this, the correlation factor should be lower than the proposal.
Financial Supervisory Service (FSS) & Financial Services Commission (FSC)	Korea (Republic of)	No	No	
Aegon NV	The Netherlands	No	Yes	We think that it is unrealistic and punitive for the inflation stress to continue indefinitely. This both ignores the ability of companies to manage expense levels and suggests that insurer's cost structure could become ever-increasingly bloated. We suggest applying the expense per policy stress inflation stress only for a fixed period, such as five years.
Legal & General	UK	No	No	We are broadly comfortable with the calibration and structure of expense risk capital from 2018 field testing.
National Association of Mutual Insurance Companies	United States	No	Yes	The ICS is not yet fit for purpose. Significant additional work is needed to achieve an appropriate global capital standard and it may be completely unachievable. Expense risk and all other risks and their factors should be determined by the local jurisdictional supervisor. NAMIC disagrees with the mandate of a standard method, the 99.5% VaR calibration level and the IAIS dictating the factors to be used in the formula. Jurisdictional flexibility is the appropriate way to capture these risks with mutual recognition and shared understanding of the jurisdictional approach at supervisory colleges.

Prudential Financial, Inc.	United States of America	No	Yes	As expense risk is managed directly and in a manner that places it within a firm's control, holding capital for expense risk could be considered excessive and should not be part of the IAIS framework. Prudential Financial believes that if an adverse expense scenario occurred it is likely that management actions to materially reduce expenses would occur, which would mitigate the impact of the scenario. If expense risk is to be included in ICS Version 2.0, we believe it is excessive to run both unit expense and expense inflation stresses simultaneously. Prudential Financial believes the two stresses should be treated as independent as the drivers are different. Also, the correlation between expense and other insurance risks are excessive and should be investigated further.
Liberty Mutual Insurance Group	USA	No	Yes	Liberty Mutual repeats its comments in earlier ICS consultations that an expense risk charge is unwarranted, because the expense risk is outside the risk for claims. Therefore, it is not material.
MetLife, Inc	USA	No	Yes	The expense risk charge, both in the one-time shock and the inflation shock overstates the actual risk due to the absence of permitted management actions. The shock should be of much shorter duration (such as just the single year), and an inflation shock is not needed at all. We believe the level of stresses is too high. Expense Risk is commonly included in the Operational Risk category. This is due to the fact that firms can and do manage and control expenses through various management actions, such as non-guaranteed rate or premium increases, budget reductions, dividend reductions, etc. With the appropriate control options in place for management with this type of risk, long term risks can be avoided and controlled.
Property Casualty Insurers Association of America (PCI)	USA	No	Yes	PCI´s yes or no response was simply required in order to open the text box and file comments. We believe this question to be best addressed by field test volunteers who have the ability to

				do so with the benefit of actual data for support and context. The absence of a response by PCI should not be taken one way or the other with respect to the subject of the question.
National Association of Insurance Commissioners (NAIC)	USA, NAIC	No	Yes	Insurers' expense structure is in a state of flux. Their mode of transacting business is changing fast in the employment of technology in general for instance, the use of big data, use of internet and mobile devices and less resource intensive medical testing. Also, greater use is made of direct marketing rather than agents. All of this may well lead to restructuring of their expenses and their volatility. Because this is an area where companies do have much larger possibility of control, the expense stresses should be reviewed frequently with a presumption that change is possible.

End of Section 7.9