Higher Loss Absorbency capacity for Global Systemically Important Insurers (G-SIIs)

25 June 2015

Public Consultation Document

Comments due by 21 August 2015

About the IAIS

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International Association of Insurance Supervisors
c/o Bank for International Settlements
CH-4002 Basel
Switzerland
Tel: +41 61 225 7300
Fax: +41 61 280 9151
www.iaisweb.org

Contents

1   Overview and process for responding

1.1   Purpose

1. The purpose of this IAIS Consultation Document is to obtain input regarding the development of the Higher Loss Absorbency (HLA) requirement to apply to Global Systemically Important Insurers (G-SIIs). When the HLA is implemented G-SIIs will be expected to hold regulatory capital that is not less than the sum of the required capital amounts from the Basic Capital Requirements (BCR) and the HLA.

2. The BCR was developed in 2014 and published in October 2014.[1] That document is referred to as the BCR Document.

3. The options and proposals contained in this Consultation Document are preliminary and may not be reflected in future IAIS supervisory material.

1.2   Providing feedback

4. Comments on this Consultation Document are invited by 21 August 2015. The IAIS has committed to deliver a finalised HLA document to the G20 summit in mid November 2015. This deadline should be taken into account when comments are provided. Comments are invited on any aspect of this paper. Responses are most helpful if they:

    - Are clear as to the issue or question being addressed,

    - Provide a clear rationale and basis for comments made, and

    - Describe alternatives proposed for consideration.

5. Comments must be sent electronically via the "Consultations" page (under the "News" tab) on the IAIS website http://iaisweb.org/. All comments will be published on the IAIS website unless a specific request is made for the comments to remain confidential.

6. The Consultation Tool on the IAIS website will allow feedback and comment to be provided with regard to each sub-section of this document, commencing with Section 2. A standard question of the form:

    "Please provide your views on the assessments made and conclusions arrived at in this (sub) section. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached."

    is included in the Consultation Tool for each section. Additional questions are also included in sub-Section 5.7.

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[1]   See *Basic Capital Requirements for Global Systemically Important Insurers,* 23 October 2014.
See   http://iaisweb.org/index.cfm?event=getPage&nodeId=25233   and   then   the   "Financial   Stability   & Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

2 Executive summary

2.1 Overview

7. The Higher Loss Absorbency (HLA) requirement will be a globally comparable group capital requirement that applies to all Global Systemically Important Insurers (G-SIIs). It will take a going concern approach. The HLA has the primary purpose of assisting to reduce the probability and impact on the financial system of the distress or failure of a G-SII.[2] The HLA will apply to all group activities, including non-insurance subsidiaries (as is the case for the Basic Capital Requirements (BCR)). Capital resources supporting the HLA required capital are to be of the highest quality.

8. When the HLA is implemented, G-SIIs will be expected to hold regulatory capital that is not less than the sum of the required capital amounts from the BCR and the HLA.

9. The construction process for the HLA separates Insurance and Non-Insurance (NI) business aspects so that existing global regulatory requirements in non-insurance sectors may be reflected. The overall impact of the HLA is determined by the amounts of HLA from both Insurance and NI business. For the total BCR + HLA required capital, six components of the BCR and HLA are considered.

   For each of Insurance and Non-Insurance the three components are:

   - BCR. These are as specified in the October 2014 BCR Document.

   - Uplift. An amount added to the BCR. The BCR plus its Uplift plays, approximately, the role of a global Prescribed Capital Requirement (PCR) on a globally comparable basis.

   - HLA. Additional capital requirements, over and above the BCR Uplift requirements.

10. The Uplift required capital amounts, for both Insurance and NI, will increase the BCR to reduce the expected gap between the BCR and the future Insurance Capital Standard (ICS). Subject to regulatory requirements specified by global requirements for other sectors (in particular regulated banking), the working assumption for the uplift is 33% of the current BCR.[3]

11. The HLA required capital amounts, for Insurance and NI, will increase the sum of the BCR and Uplift by an amount that does not exceed 20%, on average, for G-SIIs. The HLA NI required capital relating to regulated banking activities will not exceed the relevant regulated banking requirements for those activities.

12. With regard to the HLA required capital, this consultation is open and does not focus on specific formulas. Rather, it provides a structure within which a balancing of three key

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[2] See paragraph 49 of the G-SII Policy Measures paper.
See http://iaisweb.org/index.cfm?event=getPage&nodeId=25233 and then the "Financial Stability & Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

[3] This Uplift is proposed to be achieved by increasing the BCR alpha factor from 100% to 133%. For the NI component of the BCR the same uplift factor as for the Insurance components of the BCR will be applied, subject to the NI component (which may not be negative) of the Uplift relating to regulated banking activities not increasing this component of the NI Uplift beyond the relevant regulated banking sector capital requirement.

policy objectives, risk sensitivity, robustness and simplicity, can be addressed. This leads to a consultation which is more complex than a final outcome will be. The published HLA Principles provide guidance for the development and delivery of the HLA requirement.

13. The HLA will initially build on the foundation of the globally comparable BCR. When the globally comparable ICS is developed, the HLA will then be reviewed as the ICS will replace the BCR in its role as the foundation for HLA.

2.2 Key HLA consultation points

14. It is proposed that the HLA required capital formulas, for both Insurance and NI be factor based. A required capital amount (the outcome) is the product of multiplying two inputs, a factor and an exposure. There are three main issues to consider when specifying HLA required capital formulas:

- Bucketing (to specify which factor to apply to which G-SII). This leads to a choice of how many buckets to have.

- Choice of HLA formulas (to specify the exposure). This leads to a choice regarding the emphasis that can, in practice, be placed on Non–Traditional Insurance (NT) and NI activities as they are represented by their BCR required capital amounts.

- Calibration of outcomes (to specify the size of the factors). This leads to a choice of the extent of the impact that the HLA is to have on G-SIIs, both on average and in particular, recognising that there will be variability around the average as there are underlying differences in G-SII business models.

15. Preferences in each of these three main areas should be driven by the objectives considered important for HLA and the desired incentives (see sub-Sections 3.2 and 3.3.). The overarching policy choice is the level of risk sensitivity sought. Within this, there are trade-offs to be made between risk sensitivity, robustness and simplicity.

16. From a structural perspective, sensitivity can be introduced in two main dimensions:

- By having more than one populated bucket. The buckets are proposed to be determined based on the full scores assigned to G-SIIs in the G-SII assessment methodology. Since the weighting of NT and NI activities in these full scores is 45%, NT and NI activities are strongly reflected in these scores. Increasing the number of buckets more effectively differentiates between G-SIIs which are at the top and the bottom of the ranking of the G-SII full scores.

- By increasing the emphasis of the HLA on the NT and NI activities. Taking the widest exposure available for the HLA formula gives equal importance to Traditional Insurance, NT, and NI activities. This balance can be changed to emphasise NT and NI activities.[4]

- Combinations of these are also possible.

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[4] There may be some practical limitations on the extent to which the emphasis can be increased. For example, there are limitations on NI required capital for regulated banking activities.

17.   The remaining issue to be addressed is the calibration of outcomes. This can be characterised by the choice of the size of the factors for each bucket. As indicated above, considerations should be given to both the impact of an HLA formula on particular G-SIIs and the average impact over the group of G-SIIs. An HLA formula that produces extreme results relative to the average (in either direction, that is overly large or very small HLA required capital outcomes) is likely to be less robust over time than one that does not.

2.3   Reading and responding to this Consultation Document

18.   There are several key areas in which feedback is sought. These have been highlighted above. Details explaining these key areas are provided in the body of this document.

19.   In terms of providing comments on a section by section basis, responses can be provided using the IAIS Consultation Tool, as outlined in the Overview.

20.   The body of this Consultation Document is structured as follows:

- Section 3. This section provides background to the development of the HLA requirement.

- Section 4. This section explains the structure of the BCR + HLA components and proposes the approach to be taken in determining the Uplifts for both Insurance and NI.

- Section 5. This section explains the main issues being consulted on with regard to the HLA required capital and places these issues in a policy context. There are several dimensions to be considered and as a consequence the structure of possible HLA formulas is presented in terms of families of formulas with a key point for consultation being the choice of specific members of those families to be used. Some numerical illustrative examples are provided which highlight the potential impact of some choices of members of these families of formulas.

- Section 6. This section discusses the capital resources needed to support the HLA required capital.

- Section 7. This section discusses some operational matters relating to the management of the process of developing the HLA.

3 Context

3.1 Overview

21. Initial work to lay the foundations for the HLA requirement for G-SIIs concluded in July 2013. Following this, the IAIS determined that the HLA would apply in addition to the BCR and together they will provide a consolidated group-wide capital requirement for G-SIIs only. Capital resources supporting the HLA required capital are to be of the highest quality.

22. Following the global financial crisis, the Financial Stability Board (FSB) and G20 initiated work to identify Global Systemically Important Financial Institutions (G-SIFIs). As part of this broad initiative the IAIS published a framework of policy measures[5] in July 2013 (the G-SII Policy Measures) that should be applied to insurers designated to be G-SIIs.

23. The G-SII Assessment Methodology[6] provided a basis under which the initial cohort of G-SIIs was identified in 2013. The same basis was applied to support the identification of the second cohort of G-SIIs[7] in 2014. A review of the methodology to identify G-SIIs is underway. The results of this review are not yet available.

24. The G-SII Policy Measures identified three main areas of focus: enhanced supervision, effective resolution, loss absorption (addressed by the BCR) and HLA capacity. Progress to date in these areas provides a context and a starting point for work to develop the HLA.

25. The IAIS has completed further work since the G-SII Policy Measures were published in July 2013.

    - In particular, it has developed the BCR in October 2014, which applies to G-SIIs. This was endorsed by the FSB in October 2014 and the G20 Summit in November 2014.

    - Field Testing work conducted to support the development of the BCR and the ICS has provided additional insights.

3.2 The purposes of HLA at July 2013

26. On 18 July 2013, the IAIS and the FSB made the following joint commitment:

    "As a foundation for HLA requirements for G-SIIs, the IAIS will as a first step develop straightforward, backstop capital requirements to apply to all group activities, including non-insurance subsidiaries, to be finalised by the end of 2014."

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[5] See   http://iaisweb.org/index.cfm?event=getPage&nodeId=25233   and   then   the   "Financial   Stability   &   Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

[6] See   http://iaisweb.org/index.cfm?event=getPage&nodeId=25233   and   then   the   "Financial   Stability   &   Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

[7] See   http://www.financialstabilityboard.org/2014/11/fsb-announces-update-of-list-of-global-systemically-important-insurers-g-siis/.

27. This clearly indicates that the scope, with regard to activities covered, of the HLA is the same as that of the BCR, and so includes consideration of all group activities.

28. The G-SII Policy Measures, in paragraphs 48 – 56, provides the IAIS perspective on developing an HLA as at July 2013. See Annex B.

In particular, paragraph 49 provides a summary:

The desired outcomes of HLA capacity, all of which work to reduce the probability of distress or failure and thus the expected impact, include:

- *Internalising some of the costs to the financial system and overall economy, which are otherwise externalities to the insurance group that occur as a result of a G-SIIs distress or failure by making G-SIIs more resilient to low probability, high impact events;*

- *Allowing for earlier supervisory intervention and more time to address emerging risks to the financial system;*

- *Providing disincentives to carrying out activities that pose a threat to the financial system; and*

- *Offsetting any benefit should it arise, such as lower funding costs, associated with the G-SII status.*

3.3 IAIS position on systemic risk

29. A definition of systemic risk[8] is included:

"Systemic risk is the risk of disruption of financial services that is caused by impairment of all or parts of the financial system and has the potential for serious negative consequences for the real economy."

30. The IAIS position on systemic risk in the G-SII Policy Measures can be summarised as:

- Differences between the traditional insurance business model and the banking business model need to be considered when assessing the systemic importance of insurance.

- The time dimension is important in insurance (both in respect of business model and regulatory action) as runs on insurers are uncommon.

- There is little evidence of traditional insurance either generating or amplifying systemic risk.

- NT and NI activities within insurance firms or groups may generate or amplify systemic risk.

- The insurance sector is susceptible to systemic risk generated in (or transmitted through) other parts of the financial sector.

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[8]   See Report to G20 Finance Ministers and Governors, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, October 2009.

- Insurer activities may amplify systemic risk under specific circumstances e.g. through reacting to downturns in capital markets or through unexpected withdrawal of capacity.

31. G-SIIs are designated as such due to an assessment that their distress or failure may result in a systemic risk event. This does not imply that the only possible causes of distress or failure of a G-SII may arise from NT and NI activities. Consequently the HLA may not be restricted to only NT and NI activities. It may, however, emerge that it is appropriate to emphasise systemic risk related issues in accordance with the goal to provide *"disincentives to carrying out activities that pose a threat to the financial system."*[9]

3.4 Relatively small size reported of BCR NT insurance and BCR NI required capital amounts

32. A finding from the IAIS field testing exercise in 2014, reported in the BCR Document, was that BCR capital requirements attributable to NT and NI were low. Based on field testing in 2014, 13% of the total BCR required capital is attributable to NI activities and a further 6% to NT activities.

33. In July 2013, the G-SII Policy Measures[10] paper indicated that the HLA may be calculated based on NT and NI activities with emphasis on the role of NT and NI and the level of systemic risk posed by G-SIIs. This is reflected in the HLA Principles (in Annex C). See HLA Principle 2 (Reflection of drivers of G-SII designation process). However, the outcomes of field testing in 2014 need also to be considered.

34. In the insurance context, a direct arithmetic consequence of the small volume of BCR NT Insurance required capital, and so also the Uplift Insurance NT, is that using these components as a base for a significant amount of HLA Insurance required capital may require a comparatively large multiplicative factor to be used. The use of large factors implies that the impact of any changes in the data the factor is applied to will be magnified.

35. In the NI context, uplifted NI required capital relating to regulated banking activities should not exceed the relevant regulated banking requirements for those activities. This may constrain the capacity to use the BCR NI required capital and the Uplift NI required capital as a base for a significant amount of HLA NI required capital.

36. It is acknowledged that the above commentary necessarily reflects data as at a single point in time. It is therefore possible that the relativities reported may change over time. It is anticipated that, to the extent practical, results from field testing in 2015 will also be considered when the HLA proposal is finalised later in 2015. However, at the time of issuing this Consultation Document, such additional data is not available.

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[9] Refer to Annex B.

[10] See Section 3.6 of the G-SII Policy Measures paper for discussion of the NT-NI additional considerations.

3.5 HLA relationship with the ICS

37. The IAIS has indicated that when the ICS is developed, the HLA will be reviewed and its base changed from the BCR to the ICS. It is acknowledged that this may then require a review of the HLA, both in terms of its structure and calibration. For the purposes of this Consultation Document, neither the development of ICS nor the development of a revised HLA which will use the ICS as its foundation are further considered.

38. There will be interactions between a revised HLA and the ICS on which it will be based in the future. While the development of the current HLA cannot foresee the nature of such interactions, and the ICS is in the early stages of its development, matters that might be identified regarding possible future interactions with an HLA may be considered in the current HLA development work. However, for the purposes of responses to this Consultation Document, it is clarified that responses that discuss the construction of the ICS, or the process by which the ICS is being developed, will be given a low priority in the assessment of feedback received.

39. The current IAIS timeline to review the HLA, for the purpose of replacing the BCR with the ICS as its foundation, is subsequent to the completion of the development of the ICS.

3.6 Principles for development of the HLA

40. Similar to the approach used for the BCR, a number of Principles have been articulated to support the development of the HLA. These were published by the IAIS in September 2014. These are reproduced in Annex C.

3.7 HLA timeframe

41. The time-frame for development of the HLA is as follows:

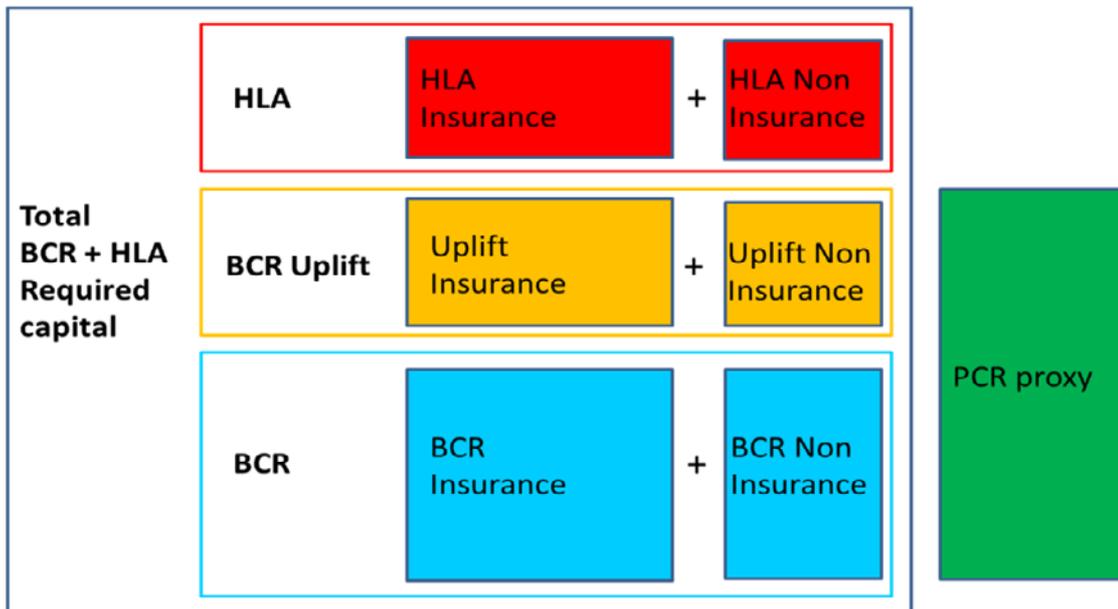| Key Dates	Milestones
25 June 2015	Commencement of consultation period for this HLA Consultation Document
July 2015	Field testing data relevant to development of the HLA due
21 August 2015	Closure of consultation period for this HLA Consultation Document
By October 2015	• Analysis of 2015 field testing input to ongoing development of HLA to extent possible • Review and analysis of HLA consultation responses • Completion and approval of HLA within IAIS • FSB review and expected endorsement of the HLA • HLA Document provided to G20
November 2015	Expected endorsement of HLA by G20 at their Leaders' Summit in Antalya, Turkey (15-16 November)
2016-2018	• From 2016 confidential reporting of HLA with access by the IAIS • Confidential reporting of the BCR (commenced in 2015) with access by the IAIS • Ongoing refinements of the BCR and HLA • Data to support refinement of BCR and HLA will be collected as part of the ongoing broader IAIS field testing program in 2016 - 2018 to support the development of ComFrame (applicable to all IAIGs), including the ICS
From January 2019	BCR and HLA requirements to be applied to all G-SIIs designated in November 2017 and in future years
Late-2019	ComFrame, including ICS, to be adopted by IAIS
Post 2019	• Implementation of ComFrame, including the ICS, by IAIS Members to commence • Following completion of the development of the ICS, the HLA will be reviewed so that an HLA based on the ICS is developed

4   BCR Uplift

4.1   BCR calibration

42.   In the BCR Document it was reported that, for G-SIIs, the average BCR was 75% of the reported average PCR.[11] If the total capital requirements after HLA are intended to be similar under the BCR regime and the subsequent ICS regime, then it would be appropriate to address the difference between the levels at which BCR and ICS are set in the context of the BCR.

43.   It is acknowledged that the level at which the ICS will be set is not yet known and will not be known until sometime after the HLA based on the BCR is developed.   However, the ICS can be expected to be significantly higher than the 2014 BCR.

4.2   Components of total BCR + HLA

44.   The BCR Uplift will essentially be achieved by recalibrating the BCR.   The BCR includes capital requirements for traditional insurance, NT, assets, other financial sectoral capital requirements (NI activities) and for non-financial activities.

45.   NI activities include regulated and unregulated banking activities and other activities. The BCR Document states that where global capital standards are in place for non-insurance sectors, the outcomes from those standards should not be exceeded. Consequently the uplift to the NI component of the BCR Uplift needs to be addressed separately to consider other sectoral global standards.

46.   A graphic summarising the discussion above is given below in Figure 4.1. The total BCR + HLA required capital is split into six components. Each component will be addressed separately. No component may be negative. The total BCR + HLA required capital is the sum of the results from the six components. The total HLA required capital amount is represented by the red boxes, the total BCR Uplift by the orange boxes and the BCR required capital by the blue boxes. The Insurance and NI components are separated within these different colours. The Insurance components include both Traditional and NT.

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[11]   For clarity it is noted that the term PCR is used in this consultation document in the context of a group. A group may include businesses other than insurance businesses. As in the case for the BCR, where a group PCR is needed, but not defined in a jurisdiction, an appropriate proxy is used. The average PCR referred to above is an average taken over group jurisdictional PCRs.

Figure 4.1. BCR, BCR Uplift and HLA components

47. The quality of capital resources required to support the BCR Uplift will be the same as for the BCR.   In particular, Qualifying Additional Capital cannot exceed 50% of uplifted BCR Required Capital.

4.3   Uplifting the BCR

48. Based on 2014 field testing data, the average BCR capital requirement, expressed as a percentage of PCR for G-SIIs, was 75%. To scale the quantum of the aggregate BCR capital requirement up to 100% requires a 33% uplift of the current BCR.

49. The current working assumptions for uplifts to the BCR are:

- **Uplift Insurance.** To increase the BCR calibration factor from its current 100% to 133%.

- **Uplift Non-Insurance.**   To apply a factor of 133% to the BCR NI required capital. The outcome of this would be limited with regard to required capital determined for regulated banks. More specifically, for regulated banks, the sum of portions of the BCR NI component and BCR NI Uplift that relate to regulated banking are subject to a maximum of the Basel III Risk Weighted Assets (RWA) requirements where they apply to some or all of the BCR NI components. Also, the BCR NI Uplift that relates to regulated banking may not be negative.

These factors will be subject to review after analysis of results from field testing in 2015 and a review of consultation responses.

50. In the context of Uplift Insurance, the BCR Document specifically states that the BCR calibration level may be modified depending on the HLA requirements as well as refinement work during the period of confidential reporting. The current BCR plus its Uplifts will generate a new BCR, which is a recalibration of the current BCR.

51. In the context of Uplift Non-Insurance, the BCR Document states that the BCR required capital component for regulated banking reflects the Basel III Leverage Ratio (currently set at 3%). For the purposes of the Uplift Non-insurance it is appropriate to raise this requirement to the lower of 133% of it (that is, a 33% uplift, which currently therefore generates a 4% Leverage Ratio) and the full Basel requirement based on RWA. The appropriate Basel III capital ratio requirement is 8% of RWA (note this excludes any HLA Uplift). See Annex F.

52. In following sections of this Consultation Document the term Uplifted BCR will be used to mean the sum of the BCR required capital amount and the Uplifted required capital amount. Where the Uplifted BCR is limited to Insurance, Traditional Insurance, NT, NI or a specific combination of these then that relevant descriptor will be used.

4.4 Transition period for Uplifts

53. It is proposed that both Uplift Insurance and Uplift NI, be phased in over a transition period. This phase in will be over the period from 2016 until the expected implementation date of HLA (2019).

54. During the transition period the calculation of the HLA insurance component and the HLA NI component would reflect the full amounts computed for BCR insurance Uplift and BCR NI Uplift, rather than the reduced amounts computed for transition purposes.

55. Having a transition period for the Uplifts permits review and possible refinement of the full uplift factors to reflect future data and experience. This recognises that the current proposed uplift factors are based on a single data point from field testing in 2014. The transition period will allow the IAIS to review the Uplift based on field testing data in 2016 and 2017 to avoid potentially overshooting the desired target.

5 Possible HLA required capital formulas

5.1 Overall approach

56. The HLA required capital formulas[12] are factor based. A required capital amount (the outcome) is the product of multiplying two inputs, a factor and an exposure. There are three main issues to consider when specifying HLA required capital formulas:

    - Bucketing (to specify which factor to apply to which G-SII).

    - Choice of HLA formulas (to specify the exposure).

    - Calibration of outcomes (to specify the size of the factors).

57. Choices are influenced by the extent to which they meet policy considerations.

58. Choices for these issues are inter-related due to calibration considerations.

59. The design of the HLA formula needs to reflect the trade-off between risk sensitivity and complexity. The HLA required capital amounts are intended to have sufficient risk sensitivity. Risk sensitivity can be viewed and introduced in a variety of ways. The degree of risk sensitivity may differ among the various components. This is acceptable as long as they contribute to an appropriately risk sensitive outcome.

60. Other policy considerations are the extent to which the total of the BCR and HLA required capital amounts achieve the goals of the HLA as determined by the IAIS (see Section 3.2). The HLA Principles (see Annex C) also provide guidance.

5.2 Bucketing

61. An HLA design that allows for the use of buckets based on how systemic a G-SII is considered to be permits the application of a higher factor to those G-SIIs that are more systemic. Bucketing helps create incentives for existing G-SIIs not to become more systemic. As the number of buckets increases, the incentive on G-SIIs increases as smaller changes in systemic importance can result in moving up or down a bucket so the process is more risk responsive. Having an empty bucket as the highest bucket creates an incentive for the most systemic G-SIIs not to increase their systemic importance.

62. For the purposes of HLA calculations, for both Insurance and NI, it is proposed that:

    - The results used to determine the bucketing are the full scores assigned to G-SIIs in the G-SII Assessment Methodology.

    - The buckets are determined by comparison between the individual G-SII's full score and the average from the assessment methodology for all insurers participating in the assessment (not just the G-SIIs).

    - Allocation to a bucket determines a factor to apply to an exposure for each G-SII.

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12 Where it can be done without ambiguity, phrases such as "HLA required capital formula" are shortened (for example, to "HLA formula"). Where additional specification is needed it will be included (for example, "HLA Traditional Insurance required capital formula").

63. As a working assumption, two choices are currently being considered to determine the buckets:

- Bucketing Choice 1 (three buckets):

  o Bucket 1 – all G-SIIs with a full score below 0.04 [13] in a G-SII Assessment Methodology (where there are 50 participating insurers, hence the average score is 0.02 = 1/50).

  o Bucket 2 – all G-SIIs with a full score between 0.04 and below 0.06 in the G-SII Assessment Methodology.

  o Bucket 3 – all G-SIIs with a full score of 0.06 or above in the G-SII Assessment Methodology.

- Bucketing Choice 2 (two buckets):

  o Bucket 1 – all G-SIIs with a full score below 0.06 in the G-SII Assessment Methodology.

  o Bucket 2 – all G-SIIs with a full score of 0.06 or above in the G-SII Assessment Methodology.

64. Based on G-SII Assessment Methodology outcomes for the 2013 and 2014 designation processes the top bucket in both Choice 1 and Choice 2 would be empty. The difference between Choices 1 and 2 is that Choice 2 is expected to have only one populated bucket. While it is not considered likely that a designated G-SII would have a score below the average for all G-SIIs, such an outcome is theoretically possible due to the possibility that supervisory judgement may be applied as part of the assessment methodology.

65. The boundaries of buckets ultimately used will be resolved following analysis of the data from field testing and with regard to the responses to this consultation.

5.3 Proposed HLA Insurance formulas

66. Sections 3.2 and 3.3 summarise the possible objectives for HLA and the IAIS' view regarding insurer and systemic risk. A focus on the NT and NI exposures,[14] as represented by their BCR required capital amounts, may be appropriate as NT and NI activities within insurance firms or groups are more likely to generate or amplify systemic risk. On the other hand, since the possible causes of distress or failure of a G-SII are not restricted to only NT and NI activities, it may be appropriate to focus on

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[13] The 0.04 boundary from the G-SII assessment methodology can be equivalently represented as 200% of the average score (of 0.02) over the full set of participating insurers. Similarly the 0.06 boundary can be represented at 300% of the average score.

[14] The words "NT exposure" are more correctly and precisely stated as "NT exposure, as represented by its NT BCR required capital." The words "NT exposure" are used as a shorthand for this longer phrase for convenience. The same clarification applies to the words "NI exposure."

the broader Insurance and NI exposures.[15]

67. Many volunteers reported amounts of NT activities for field testing in 2014 that led to relatively modest amounts of Uplifted BCR required capital amounts relating to these activities. Therefore, an HLA based only on these Uplifted BCR NT required capital amounts would require a relatively large factor to be applied in order for the HLA based on these required capital amounts to be a material requirement in comparison to total capital. See also Section 3.4.

68. The view taken on the emphasis that should be placed on NT and NI leads to a range of choices in the emphasis that is placed on the NT and NI exposures on the one hand and the broader Insurance and NI exposures on the other. As a result, a range of exposures are considered to reflect a range of emphases of NT and NI. The choice of exposure leads to a family of HLA Insurance required capital formulas. Formulas have descriptors for the exposure used include in their name to reflect this.

69. The IAIS has explored the following HLA Insurance formulas (the HLA formulas for NI are addressed in the next section):

- Full HLA Insurance formula. A broad based exposure in the Insurance context is the Uplifted BCR amount of required capital. Note that this amount includes the Uplifted BCR NT Insurance amounts of required capital. This exposure is used to generate the full HLA Insurance required capital formula (the full HLA Insurance formula).

- NT HLA Insurance formula. An exposure in the Insurance context that is focused on the NT business is the Uplifted BCR NT Insurance amount of required capital. This exposure is used to generate the NT HLA Insurance required capital formula (the NT HLA Insurance formula).

- Combined HLA Insurance formulas. The full HLA Insurance formula and the NT HLA Insurance formula can be viewed as two extremes. The full HLA formula gives equal importance to the traditional and non-traditional insurance amounts of required capital, while the NT HLA Insurance formula focuses only on the NT insurance amounts of required capital. A family of formulas may therefore be created by taking a linear combination of these two extremes. Members of this family of HLA Insurance required capital formulas are described as Combined HLA Insurance required capital formulas (combined HLA Insurance formulas).

- The parameter gamma (γ) is used to determine the increased emphasis placed on the NT exposure (the Uplifted BCR NT Insurance) over that placed on it in the full HLA formula. As gamma increases this emphasis increases. Gamma may take values between zero and one. When gamma is zero the full HLA Insurance formula is obtained. When gamma is one the NT HLA Insurance formula is obtained. To specify a combined HLA Insurance formula it is therefore necessary to specify the value of gamma used.

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[15] Supervisory monitoring of HLA required capital amounts reflecting a broader footprint may allow for earlier supervisory interventions and hence more time to address emerging risks to the financial system.

In summary, the choice of gamma is a measure of the increase in emphasis desired to be placed on the NT BCR required capital. The full BCR formula includes the NT BCR so any choice of gamma larger than zero represents an increased emphasis on the NT.

The exposures change as the value of gamma in the combined HLA Insurance formula changes. To be able to compare different members of a combined family of formulas it is therefore necessary to introduce a scale factor to ensure the average outcomes are the same. Since the outcome is the product of a factor multiplied by the exposure, as the exposure declines (as gamma increase) the scale factor needs to increase for a given value of the factor. The factor(s) used for the full HLA formula are taken as the given values to be used. The required scale factor can then be determined. See Annex D.

70. A mathematical formulation of this can be given.

HLA Insurance = Scale factor x β_i x [(1 - γ) x Uplifted BCR + γ x Uplifted BCR NT]

where:

β_i is the factor associated with the ith bucket. For example, for the full HLA Insurance formula, β_1 = 10% might be the factor associated with the first bucket and β_2 = 15% the factor associated with the second bucket and so on.

γ describes the weight given to the two formulas. The weighting of (1 - γ) being given to the full HLA Insurance formula and the weighting of γ given to the NT HLA Insurance formula.

As shown in the example in Annex D, the Scale factor is chosen such that the outcome from a combined HLA Insurance formula gives the same outcome on average over the set of G-SIIs as the full HLA Insurance formula on average. This relationship therefore should not be expected to hold for each individual G-SII.

5.4 Calibration of HLA

71. The IAIS proposes that the HLA Insurance formula should produce results up to 20% of the total of Uplifted BCR Insurance required capital amount. Note the full amount of the Uplift Insurance required capital amounts is assumed (not any transitional amounts referred to in Section 4.4).

72. The HLA may be calibrated by specifying the factors associated with each bucket for the full HLA formula. For the full HLA formula, it follows that the outcome HLA Insurance required capital is the same proportion of the Uplifted HLA Insurance exposure as the input factor associated with the bucket the G-SII is in. Consequently, these factors also determine an outcome target calibration level.

73. The following Target Calibration factor choices are currently under active consideration as working assumptions for the full HLA Insurance required capital formula. They are expressed as the percentage factors to be applied to the Uplifted BCR.

Table 5.1. Bucketing Factor choices for Full HLA Insurance required capital

Bucket	Bucketing Factors		
	Choice 1	Choice 2	
Lower	10%	15%	Populated
Upper	15%		Populated
Top	20%	20%	Empty

For example, under Bucketing Factor Choice 1, for a G-SII in the upper bucket, a 15% factor would be applied to the specified exposure for the full HLA Insurance required capital. An explanation of these choices is provided in Annex F of this document.

74. The calibration of the combined and NT formulas follows from the starting point given in Table 5.1 using the process described at the end of section 5.3 (and amplified in Annex D).

75. It is emphasised that the bucketing factor choices currently under active consideration for the full HLA insurance formula are inputs to calculations that determine HLA required capital amounts. It is an integral part of the assessment of the HLA formulas that bucketing factors are reviewed so that HLA required capital amounts are appropriate and consistent with stated objectives (See section 3.2).

76. The factors ultimately attributed to each bucket will be resolved following analysis of the data from field testing and with regard to the responses to this Consultation Document.

5.5   HLA Non-Insurance required capital formulas

77. It is proposed to use the same approach for HLA NI required capital formulas as for HLA Insurance, provided the portion that relates to regulated banking does not exceed the relevant regulated banking HLA requirements and is not negative.

78. Consequently:

- The same bucketing approach and factors would be used as for HLA Insurance.

- The exposure the bucketing factor is applied to is the sum of BCR NI required capital and Uplift NI required capital.

- The regulated banking component of the HLA NI would be capped by the relevant limit derived from the banking HLA regime. This component of the HLA NI relating to regulated banking may not be negative.

79. As with the HLA Insurance required capital formulas, it follows that the bucketing factors proposed are those currently under active consideration.

80. The relevant limit derived from the banking HLA regime for the regulated banking component of the HLA NI is 9% of RWA as detailed in Annex F (adjusting the required 8% by the HLA of 1% RWA applicable for G-SIBs in the lowest bucket).

5.6 Outcomes for a range of combined HLA required capital formulas

81. It is useful to review an example of the combined contribution to the HLA required capital that is attributable to the sum of the NT and the NI activities.

82. For the purposes of the example, it is assumed there is no impact of the possible cap on the NI component of HLA due to regulated banking capital requirements. This means calculations can be made using the combined and NT formulas with role of NT replaced by NT + NI.

83. The following example illustrates the impact of considering various levels of NT and NI contributions. The NT and NI exposures are summed and treated together, with the same scaling factor. A combined formula reflecting this treats NT and NI in the same manner. A combined formula reflecting this also reallocates required capital amounts between the Traditional contribution and the sum of the NT and NI contributions.

84. Details of calculations are provided in Annex D.

85. Following the approach outlined above, the example in Annex D shows the scaling factor and contributions from Traditional (including both Traditional Insurance and Assets), NT and NI required to get the same outcome at different levels of gamma (γ) as when applying the broader footprint full HLA formula.

   - A gamma of zero determines HLA on the broader footprint full HLA formula which applies a factor to the entire Uplifted BCR. Note that the NT and NI are included in the exposure for the full HLA formula.

   - A gamma of one determines HLA only on the basis of NT and NI rather than a factor applied to the entire Uplifted BCR.

   - Gamma between zero and one demonstrate the effect of adding emphasis to NT and NI together at different levels over that of the full HLA formula.

86. The example is not intended to apply to a specific G-SII. It is intended to reflect the outcomes of using the average data over the set of G-SIIs. The specific data used, while consistent with results from field testing in 2014, is hypothetical.

   As stated elsewhere, final results will be subject to review after analysis of data from the field testing and responses to this Consultation Document are available.

87. Results for the example are in the following table.

Table 5.2. Example HLA required capital amounts and proportions

Bucket factor - full HLA formula	15%	15%	15%	15%	15%
Uplifted BCR	133.0	133.0	133.0	133.0	133.0
HLA Required - full HLA formula	20.0	20.0	20.0	20.0	20.0
Combined Formula calculations					
Additional Weighting of NT and NI (Gamma)	0%	25%	50%	75%	100%
Traditional Required Capital	16.0	15.0	13.3	10.0	0.0
NT Required Capital	1.0	1.2	1.7	2.5	5.0
NI Required Capital	3.0	3.7	5.0	7.5	15.0
Total HLA required capital	20.0	20.0	20.0	20.0	20.0
Traditional % Total required capital	80%	75%	67%	50%	0%
NT % Total required capital	5%	6%	8%	13%	25%
NI % Total required capital	15%	19%	25%	38%	75%
Total percentage	100%	100%	100%	100%	100%

5.7   Managing the tension between risk sensitivity, complexity and volatility

88.   In a family of combined formulas as gamma increases (and the average HLA required capital over the set of G-SIIs is maintained constant), the dispersion of results around the average typically increases. Dispersion around the average is a consequence of different G-SIIs holding different NT and NI exposures. Dispersion may also vary over time.

On one hand, increasing dispersion suggests increasing risk sensitivity. On the other hand, an increase in gamma may lead to an increase in the volatility of results if the underlying NT and NI exposures are small. This in turn would imply an increasing reliance on the precision with which the NT and NI exposures[16] are determined. Hence, there may be a tension between increasing risk sensitivity and the robustness of the calculation of the HLA required capital amount.

89.   The need to manage this tension is recognised in the set of HLA Principles published to support the development of the HLA, Principle 7 in particular. See Annex C.

90.   This tension could be managed with a variety of approaches with regard to different components of the design and calibration of the formula. For example through:

- The number of populated buckets used for the calibration,

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[16]   The same comment also applies to the determination of components of these exposures. This is particularly relevant in the case of NI where the regulated banking component needs to be treated differently when the caps from the regulated banking sector capital requirements are applied.

- The size of gamma,
- The calibration level of all the factors,
- The introduction of ceilings and floors on the results for the G-SIIs, or
- A combination of the above.

91. In addition, some of these approaches may lead to an increase in the complexity of the HLA required capital formula. This suggests there is a need to strike an appropriate balance between various characteristics, such as risk sensitivity, complexity and volatility.[17] This leads to a number of specific consultation questions.

92. These questions will be resolved following analysis of the field testing and with regard to the responses to this Consultation Document.

Question 1: The IAIS is currently considering putting G-SIIs into one or two populated buckets when determining the HLA required capital. How many buckets should the IAIS consider selecting to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

Question 2: Should the IAIS consider selecting the size of gamma to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

Question 3: Should the IAIS consider selecting the calibration levels of the factors to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

Question 4: Should the IAIS consider introducing ceilings and/or floors on results for G-SIIs to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

Question 5: Should the IAIS consider using a combination of the above approaches to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

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[17] A useful discussion of many of the issues involved is given in a BCBS Discussion paper, *The regulatory framework: balancing risk sensitivity, simplicity and comparability*, July 2013. See http://www.bis.org/publ/bcbs258.pdf.

> **Question 6:** Should the IAIS consider using other approaches to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.

5.8 Coverage ratios using various calibration reference points

93. To compare results between G-SIIs it is necessary to use ratios rather than absolute numbers since G-SIIs are of different sizes. The denominators in the ratios shown below are required capital amounts. The numerators are called calibration reference points and are a measure of scale of the G-SII from various perspectives.

94. There are known imperfections in using a group PCR as a calibration reference point. Indeed, these imperfections drove the development of the BCR to provide a globally comparable base on which to build the HLA. The alternative calibration reference points of BCR + Uplift, capital resources and core capital will be used.

95. At an aggregate level an indication of the overall impact of the BCR + HLA can be seen by looking at the set of results obtained by taking the ratio of the calibration reference point over the Uplifted BCR + HLA required capital (including both Insurance and NI) for each insurer considered and then looking at percentiles of that set.

Taking the 90th and 10th percentile gives an approximate measure of dispersion of results. The 50th percentile gives a measure of the mid-point of the results.[18]

Specifically a "coverage ratio" result for an insurer is computed as:

$$\frac{\text{Value of calibration reference point of the insurer}}{\text{Uplifted BCR + HLA required capital of the insurer}}$$

The calibration reference points considered are:

- Uplifted BCR. By construction this plays, approximately, the role of a PCR[19] on a globally comparable basis.

- Capital resources. While capital resources may not be directly comparable between insurers, since they may have different risk appetites and business objectives, it still provides a useful indication of the impact of the Uplifted BCR + HLA required capital.

- Core capital. A more conservative perspective on capital resources. The definition from the BCR Document is used.

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[18] Note that in general the 50th percentile and the arithmetic average (mean) are not the same. The mean may be either higher or lower than the 50th percentile depending on the "shape" of the set of results, with them only being equal if the results are from a symmetric distribution. The set of results examined here is not symmetric. If the 50th percentile is closer to the 10th percentile than to the 90th percentile this may be interpreted as suggesting that the "tail" of the distribution is longer amongst the high percentiles than amongst the low ones.

[19] As noted previously, the term PCR is used in the consultation document in a group wide context. While PCRs exist in some form in virtually all jurisdictions with respect to Insurance businesses, they are not necessarily defined in a group context.

- PCR. As noted elsewhere PCRs are not considered to be adequately globally comparable for HLA purposes. However, they exist in some form in all jurisdictions and so BCR + HLA outcomes relative to them are of interest and are commonly sought.

96. The same basis for calculations as used in sub-Section 5.6 is used here.[20] The same simplifying assumptions made need to be recognised. Results are reported on the basis of using the full HLA formula.

97. Results are reported as percentiles from the group of field testing volunteers in 2014, which includes all G-SIIs. The coverage ratio is computed as the value of the calibration reference point of the insurer divided by the Uplifted BCR + HLA required capital of the insurer.

Table 5.3. Coverage ratios using various calibration reference points

Calibration Reference Point	90th percentile	50th percentile	10th percentile
Uplifted BCR	90%	90%	90%
Capital resources	410%	280%	180%
Core capital	360%	230%	140%
PCR	140%	90%	60%

Comments on Table 5.3:

- All entries are rounded to the nearest 10%.

- Definitions for capital resources and core capital are those used for BCR purposes.

- The Capital resources result for the 50th percentile shows the capital resources, at the 50th percentile of results, are 280% of the required total BCR + HLA capital requirement, a coverage ratio of 2.8.

- The capital resources and core capital rows having results above 100% at the 10th percentile suggest that no volunteer has a result below 100%.

- The corresponding results for the smaller set of G-SIIs (included in the set of volunteers) are consistent to those reported above.

- The results for the Uplifted BCR follow from the construction of the Uplifted BCR and the HLA in the simplified context of these illustrative calculations. In the illustrative calculations the Uplifted BCR coverage ratio is 133% / 153% = 87% by design.

- The results for the PCR row are expressed as the inverse of how they are often presented for consistency with the other rows.

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[20] The total BCR + HLA required capital is used, so the relative allocation between Traditional, NT and NI does not impact the outcome.

6 HLA capital resources

6.1 BCR and HLA capital resources

98. The IAIS has determined that, for the purposes of the development of the HLA, the definitions of Core and Additional capital as used for BCR purposes will also apply to the HLA. It is noted that when the HLA is reviewed to be based on the ICS, that the definitions of capital the HLA uses would be included in that review.

99. The HLA capacity requirements are to be met by the highest quality capital. In the context of the above discussion this means Core capital as defined for BCR purposes. Annex E provides further detail on the IAIS position regarding capital resources for BCR and HLA purposes.

100. Taking the results from the illustrative calculations in sub-Section 5.6, the capital resources to support the total uplifted BCR and HLA required capital of 153 units would need to be made up of at least 86.5 units of Core capital and at most 66.5 units of Additional capital. This requirement applies in all the Combined HLA formulas considered in those illustrative calculations.

7 Operational matters

7.1 HLA interaction with G-SII designation process

101. The IAIS is currently reviewing some aspects of the G-SII Assessment Methodology. Since the BCR and HLA are applicable to G-SIIs, there is the potential for some of this work to be relevant to the development or future refinement of the HLA.

102. The results of this review are not yet available. Consequently, this Consultation Document has been developed on the basis of the current established and applied G-SII Assessment Methodology. If future changes are made to the G-SII Assessment Methodology that impact the HLA, they will be reviewed and incorporated as appropriate.

7.2 Field testing in 2015

103. The development of the proposed HLA has, to the extent practicable, been informed by field testing in 2014.

104. The proposed HLA will also be reviewed with regard to the responses to this consultation document.

105. The proposed HLA will also be informed by field testing in 2015.

7.3 HLA reporting process

106. It is proposed that the same confidential reporting process as used for BCR will be applied for the HLA.

7.4 BCR and HLA review process

107. As discussed earlier, the BCR was published in October 2014 and was endorsed by the G20 in November 2014.

108. The BCR outcomes will be monitored and reviewed by the IAIS and, if appropriate, may be refined. This review and refinement process will be informed by the field testing, which is scheduled to continue through to 2018.

109. The review and refinement process used for the HLA will be the same as that used for the BCR. It is not the intention of the IAIS to review the parameters for the HLA required capital amounts on a regular annual basis.

110. As the BCR and HLA are closely related, any changes made need to be considered in an integrated manner.

Annex A: Glossary of abbreviations

Abbreviation	Meaning
BCBS	Basel Committee on Banking Supervision (also Basel Committee)
BCR	Basic Capital Requirements
BCR Document	The document published by the IAIS on 23 October 2014 titled *Basic Capital Requirements for Global Systemically Important Insurers*
BCR Capital Resources	This is the amount of qualifying capital resources for BCR purposes
BCR Required Capital	This is the amount of required capital to satisfy the BCR
ComFrame	The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups
FSB	Financial Stability Board
G-SIFI	Global Systemically Important Financial Institution
G-SIB	Global Systemically Important Bank
G-SII	Global Systemically Important Insurer
G-SII Policy Measures	The document published by the IAIS in July 2013 titled *Global Systemically Important Insurers: Policy Measures*
G20	Group of Twenty Countries
HLA	Higher Loss Absorbency
HLA Capital Resources	This is the amount of qualifying capital resources for HLA purposes
HLA Required Capital	This is the amount of required capital to satisfy the HLA
IAIG	Internationally Active Insurance Group
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICPs	IAIS Insurance Core Principles
ICS	Risk–based global Insurance Capital Standard
NI	Non-Insurance
NT	Non-Traditional insurance

NTNI	Non-Traditional Insurance and Non-Insurance combined
PCR	Prescribed Capital Requirement as defined by ICP 17
RWA	Risk Weighted Assets as specified by the BCBS for Basel III standard purposes
Uplifted BCR	Sum of BCR Required Capital plus the Uplifts described in Section 4.3

Annex B: Extract from G-SII Policy Measures paper of July 2013

The following is quoted directly from the IAIS G-SII Policy Measures paper[21] and is directly related to the development of the HLA.

"3.6.1 General description and purpose

> *48 G-SIIs should have higher loss absorption capacity to reflect the greater risks that they pose to the global financial system and the global economy. … the objectives of these policy measures for G-SIIs are to reduce the probability and impact on the financial system from distress or failure, and to discourage firms from becoming more systemically important. One direct policy measure to achieve these two objectives is the requirement to hold more capital – that is, to require HLA capacity.*

> *49 The desired outcomes of HLA capacity, all of which work to reduce the probability of distress or failure and thus the expected impact, include:*

> - *Internalising some of the costs to the financial system and overall economy, which are otherwise externalities to the insurance group that occur as a result of a G-SIIs distress or failure by making G-SIIs more resilient to low probability, high impact events;*

> - *Allowing for earlier supervisory intervention and more time to address emerging risks to the financial system;*

> - *Providing disincentives to carrying out activities that pose a threat to the financial system; and*

> - *Offsetting any benefit should it arise, such as lower funding costs, associated with the G-SII status.*

> *50 For non-regulated financial entities the requirement of HLA will mean that they must also be subject to "loss absorbency" or base capital requirements. These should be the backstop capital requirements or the Basel III rules if the entity's activities fall within the scope of Basel III. This will result in a more level playing field across G-SIIs and G-SIBs and prevent regulatory capital arbitrage.*

> *51 Group-wide supervisors also may consider the use of regulatory restrictions and limitations to achieve reductions in systemic risk. If restrictions and limits reduce systemic risk sufficiently that the insurance group is no longer deemed a G-SII, then it would eliminate the need for HLA as well as other G-SII related requirements.*

> *52 The method of calculating the amount of required HLA may take into account whether the insurance group has demonstrated effective separation. Wherever the G-SII can demonstrate effective separation of NTNI activities from traditional insurance activities, the HLA uplift may be calculated based on the base capital*

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[21] See http://iaisweb.org/index.cfm?event=getPage&nodeId=25233 and then the "Financial Stability & Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

requirements for the NTNI activities conducted. This is in line with the principle for HLA to be targeted, where possible, at activities that have the potential to generate or aggravate systemic risk. Where NTNI is not effectively separated, and some insurers will choose not to do so, if group-wide supervisors allow, then the HLA uplift may be calculated according to the base capital requirements of NTNI activities in the combined insurance entities and the interconnectedness score.

53 *The approach taken to achieve HLA capacity recognises that there is no current global accounting or solvency standard for insurance groups. As such, HLA will initially be based on the backstop capital requirements until a more comprehensive framework is established. For the purpose of this document the delineation of base capital requirements is described below.*

54 *The HLA assessment may take into account any capital charges imposed by a national regulatory framework to mitigate the systemic risk of that insurer.*

3.6.2 Methodology for calculating the HLA "uplift"

Components of HLA

55 *Building on the LA capacity requirements described above (until a more comprehensive framework is available) and after public consultation, the IAIS will develop by the end of 2015 the implementation details for HLA that will apply to designated G-SIIs, taking into account a sufficient transitional period for the introduction of this measure. HLA implementation is scheduled to begin from 2019 (see section 4). The IAIS will also consult on related issues (including the scope of the G-SII group on which HLA will be assessed).*

56 *HLA may be calculated as the multiplication of two components: the required base capital amount and a percentage uplift or increase to that base capital. The base capital requirement may be based on the amount of NTNI activities, excluding non-financial activities. Note that this approach assumes that all NTNI activities are subject to some base capital requirement. In this manner, the capital uplift is focused on those activities that are the most direct drivers of systemic importance. While traditional and non-financial activities do not directly impact the HLA requirement, they do indirectly impact the HLA calculation via the interconnectedness score of the group."*

Annex C: HLA Principles

A set of ten HLA Principles to support the development of the HLA was published by the IAIS in September 2014.[22] These, with their explanatory comments, are reproduced below:

"The following principles will be followed in the development of Higher Loss Absorbency (HLA) for Global Systemically Important Insurers (G-SIIs).

HLA Principle 1 – Comparability. Outcomes should be comparable across jurisdictions.

This implies the need to minimise distortions, including those arising from differing levels of conservatism included in valuation or other relevant processes or requirements. The level of discretions that may be applied or introduced should be minimised across jurisdictions and over time. 'Comparable' implies results should be similar and consistent across jurisdictions, but does not require that they be identical.

HLA Principle 2 – G-SII risks. The HLA should reflect the drivers (but is not restricted to only those drivers) of the assessment of G-SII status.

These drivers are indicative of the risks intended to be addressed by the HLA. The HLA should reflect individual characteristics of each G-SII.

HLA Principle 3 – Internalise costs. The failure or distress of a G-SII may result in costs to the financial system and overall economy. The HLA should internalise some of these costs that are otherwise external to that G-SII.

G-SIIs should be required by their group-wide supervisors to hold higher levels of regulatory capital than would be the case if they were not designated as G-SIIs. The HLA should be set at a level that offsets any advantage that may be expected to arise from the G-SII designation. Through internalising external costs, HLA may lead to a reduction in systemic activities as they become more expensive and therefore less attractive.

HLA Principle 4 – Resilient. HLA should work, and remain valid, in a wide variety of economic conditions (including a stressed macro environment).

In order to reflect the impact of major drivers of economic experience that are relevant to the scope of HLA, the adopted approaches should be able to be tested against historic data and circumstances.

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[22] See http://iaisweb.org/index.cfm?event=getPage&nodeId=25233 and then the "Financial Stability & Macroprudential Policy & Surveillance" section under the "Supervisory Material" tab.

HLA Principle 5 – Going concern. *The HLA, and its foundation, assume G-SIIs are 'going concerns'.*

In practice this requires that the capital requirement given by the sum of the foundation requirement and the HLA requirement is set reflecting a 'going concern' perspective, not a 'gone concern' perspective. The current foundation for the HLA is the BCR, but it is intended to replace the BCR with the ICS when the ICS is developed.

HLA Principle 6 – Quality of capital. *The HLA capital requirement is to be met by the 'highest quality capital'.*

HLA Principle 7 – Pragmatic. *The design of the HLA needs to be pragmatic and practical, with an appropriate balance between granularity and simplicity.*

The form of presentation of the HLA, focusing on meaningful communication to external parties, should be practical yet sufficiently granular for the results to be fit for purpose. The HLA should utilise the minimum number of parameters and data requirements while attaining valid and robust outcomes with a focus on material issues.

HLA Principle 8 – Consistent. *The structure of the HLA should be consistent and be applicable over the range of insurance and non-insurance entities it will need to cover and over time.*

HLA Principle 9 – Transparent. *The level of transparency, particularly with regard to the final results provided and the use of public data, should be optimised.*

HLA Principle 10 – Refinement. *The HLA will be refined in light of experience and data gathered by the IAIS in the course of Field Testing exercise."*

Annex D: Calculations of outcomes using combined HLA required capital formulas

1. This Annex provides details of the calculation of results for the example presented in sub-Section 5.6.

Obtaining comparable results for members of combined HLA family of formulas

2. To obtain comparable results for a member of the combined HLA family of formulas the bucketing factors used for a full HLA formula are scaled up to achieve the same average outcome (that is, required capital amount) over the set of 2014 G-SIIs as the full HLA formula.

3. The process to obtain the relevant factors for a member of the combined HLA family which is not the full HLA formula is as follows:

   - Determine the outcome under the full HLA formula.

   - Determine the outcome under the combined HLA formula using the same factors as for the full HLA formula.

   - Scale the factors used, to obtain adjusted factors for the combined HLA formula, by the ratio of the outcome under the full HLA formula divided by the outcome from the combined HLA formula using the same factors as the full HLA formula. It then follows that the outcome from this adjusted combined HLA formula must be the same as the outcome attained when the initial full HLA formula was used.

4. In summary, therefore, the HLA insurance required capital formulas currently under active consideration are:

HLA Insurance Formula	Exposure	Bucketing
Full	Uplifted BCR	Choice 1 or 2 Factors: From Table 5.1
Combined	$(1-\gamma) \times$ Uplifted BCR + $\gamma \times$ (Uplifted BCR NT Insurance + Uplifted BCR NI)	Choice 1 or 2 Factors: Scaled up as above
NT	Uplifted BCR NT Insurance + uplifted BCR NI	Choice 1 or 2 Factors: Scaled up as above

The parameter γ (gamma) is used to determine the increase in emphasis placed on the NT and NI exposures (the Uplifted BCR NT Insurance and Uplifted NI) relative to that already included in the full HLA formula. As gamma increases this additional emphasis increases. Gamma may take values between zero and one. When gamma is zero then the full HLA formula is obtained. When gamma is one the NT HLA formula is obtained (noting that in this case the role of NT has been replaced by NT and NI summed together).

Detailed calculations

5. This example shows the impact of different levels of gamma (γ) when it is required that the outcome is the same as is obtained for the full HLA formula ($\gamma = 0$).

6. Calculations are reported for when the NT and NI exposures are summed and treated together. The HLA required capital is calculated using the approach outlined above.

7. Explanation of example calculations.

    The factor applied in full HLA formula = 15%.

    Assumptions about the average G-SII outcome required capital amounts:

    *   The BCR is 100 units:

        *   BCR Traditional being 80 units made up of BCR Traditional Insurance and BCR Assets

        *   BCR NT being 5 units

        *   BCR NI being the remaining 15 units

    *   Uplifted BCR = 133 (that is BCR of 100 x 1.33)

    *   Uplifted BCR Traditional = 80% of total Uplifted BCR = 106.4

    *   Uplifted BCR NT = 5% of total Uplifted BCR = 6.7

    *   Uplifted BCR NI = 15% of total Uplifted BCR = 20.0

    The HLA would be 20 units using the full HLA formula (that is 133 x 15%)

    This example uses $\gamma = 50\%$. That is, the exposure for the Combined Formula is obtained from the sum of the Uplifted BCR exposure multiplied by 50% (1 – 0.5) and the NT + NI exposure multiplied by 50%.

    The calculations below show the combined formula gives the same outcome for HLA as the full HLA formula on applying the Scaling Factor.

    Determine the Scaling Factor:

    Scaling Factor = Total exposure for the full HLA formula / Total Exposure for the specific combined formula

    Total exposure for the full HLA formula

    = 133 (from Traditional (106.4) + NT (6.6) + NI (20.0))

    Total exposure for the combined formula[23]

    = (1 - γ) x Traditional + NT + NI

    = (1 - 0.5) x 106.4 + 6.7 + 20.0

    = 53.2 + 6.7 + 20.0 = 79.9

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[23] The NT+NI exposure is included in the Uplifted BCR exposure. The NT+NI exposure is therefore multiplied by (1- γ) + γ =1, and the Traditional exposure by (1 - γ).

Scaling Factor = 133 / 79.9 = 1.67

Determining HLA required capital with the Combined Formula using γ of 0.5

HLA = Scaling Factor x [15% x (1 - γ) x Traditional + 15% x (NT + NI)]

      = 1.67 x [15% x (1-0.5) x 106.4 + 15% x (6.7 + 20.0)]

      = 1.67 x [15% x 53.2 + 15% x 6.7 + 15% x 20.0]

      = 13.3 + 1.7 + 5.0

      = 20

Table D1. HLA required capital outcomes for a range of illustrative Combined HLA formulas (including scaling of NI)

Bucket factor - full HLA formula (1)	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Uplifted BCR	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0	133.0
HLA Required - full HLA formula	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Combined Formula calculations													
Additional Weighting of NT+NI (Gamma) (2)	0%	10%	20%	25%	30%	40%	50%	60%	70%	75%	80%	90%	100%
Scale Factor (3)	1.00	1.09	1.19	1.25	1.32	1.47	1.67	1.92	2.27	2.50	2.78	3.57	5.00
Traditional													
Uplifted BCR (Traditional) (4)	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4	106.4
Required Capital (5)=(1)x(3)x(1- γ)x(4)	16.0	15.6	15.2	15.0	14.7	14.1	13.3	12.3	10.9	10.0	8.9	5.7	-
Traditional % of Total Required Capital	80%	78%	76%	75%	74%	71%	67%	62%	55%	50%	44%	29%	0%
Non-Traditional (NT)													
Uplifted BCR (NT) (6)	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7
Required Capital (7)=(1)x(3)x(6)	1.0	1.1	1.2	1.2	1.3	1.5	1.7	1.9	2.3	2.5	2.8	3.6	5.0
NT % of Total Required Capital	5%	5%	6%	6%	7%	7%	8%	10%	11%	13%	14%	18%	25%
Non Insurance (NI)													
Uplifted BCR (NI) (8)	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Required Capital (9)=(1)x(3)x(8)	3.0	3.3	3.6	3.7	3.9	4.4	5.0	5.8	6.8	7.5	8.3	10.7	15.0
NI % of Total Required Capital	15%	16%	18%	19%	20%	22%	25%	29%	34%	38%	42%	54%	75%
Total Combined HLA Required Capital	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
NT+NI % Total Required Capital	20%	22%	24%	25%	26%	29%	33%	38%	45%	50%	56%	71%	100%
Factor applied to NT+NI (1)x(3)	15%	16%	18%	19%	20%	22%	25%	29%	34%	38%	42%	54%	75%

Annex E: Capital resources for BCR and HLA

1. The IAIS position stated in the G-SII Policy Measures of July 2013 regarding capital resources for HLA purposes (page 9) is:

    "HLA capacity requirements should be met by the highest quality capital; namely, permanent capital that is fully available to cover losses of the insurer at all times on a going-concern basis."

2. The IAIS ICPs provide some guidance. ICP 17.11.34 provides an example of broad categorisation of capital resources as follows:

    "a. Highest quality capital: permanent capital that is fully available to cover losses of the insurer at all times on a going-concern and a wind-up basis.

    b. Medium quality capital: capital that lacks some of the characteristics of highest quality capital, but which provides a degree of loss absorption during on-going operations and is subordinated to the rights (and reasonable expectations) of policyholders.

    c. Lowest quality capital: capital that provides loss absorption in insolvency/ winding-up only."

3. The BCR Document provides the following guidance:

    "45. The BCR defines Qualifying Capital Resources as either Core or Additional.

    46. The G-SII's core capital is comprised of qualifying financial instruments and capital elements other than financial instruments that contribute to financial strength, absorb losses both on a going-concern and winding-up basis and otherwise contribute to survival through periods when the G-SII is under stress.

    47. The G-SII's additional capital is comprised of qualifying financial instruments and capital elements, other than financial instruments, that protect policyholders in winding-up. The key characteristics of capital instruments that qualify as additional capital are subordination and availability to absorb losses in winding-up.

    …

    48. ….Capital composition limit: For the purposes of the BCR Ratio, Qualifying Additional Capital cannot exceed 50% of Required Capital (for BCR).[20]

    ([20] This limit will be re-examined once HLA is developed.)

    …

    49. The data collected from G-SIIs during field testing shows that the majority of capital resources is classified as core rather than additional capital. On average, approximately 83% of G-SII GAAP capital resources are classified as core."

4. Effectively, the BCR Document equates its Core capital resources with 'highest quality' capital resources of ICP 17.11.34.

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Annex F: Context for calibration of HLA required capital

1.   A high level aggregate sense of the size of the HLA over and above the BCR can be obtained by reviewing average data provided by the BCR and applying some other approximate indicators.

2.   A cross-sectoral comparison, drawing on experience in the banking sector review may provide some perspective on an uplift of the average PCR to attain an average BCR + HLA capital requirement. This cross-sectoral review should not be interpreted as an endorsement of that approach in an insurance context. It is the magnitude of the banking uplift that is of interest.

3.   An approach to the calibration of HLA is to consider cross-sectoral consistency. To the extent that systemic institutions in other sectors carry out comparable business to the G-SII the capital charge for both should be similar to avoid cross-sectoral arbitrage. The IAIS regards the appropriate comparison for G-SIIs as being with the Global Systemically Important Banks (G-SIBs) in the lowest bucket rather than any of the higher buckets.

4.   A comparison between the G-SIBs and G-SIIs can be considered. While this is not precise enough to imply a sharp cut-off point for the G-SII list, it can be taken to suggest that the highest scoring insurers in the IAIS ranking are typically comparable in terms of potential systemic risk impact with the G-SIBs of the lowest banking group. The G-SIBs in the lowest group must hold an additional 1% of Risk Weighted Assets (RWA) to their Basel III capital ratio of 8 % of RWA, giving a total capital ratio of 9 % of RWA. This is a 12.5% (1 / 8 = 0.125) relative increase in their capital requirements. For the second lowest group of G-SIBs, the corresponding increase is 1.5% of RWA or 18.8% of the capital requirement.

5.   Following the above logic, if we assume that the Basel III capital requirement is comparable to a PCR requirement in insurance, then a similar uplift of about 10% to 20% could apply to the ICS (or a BCR scaled to anticipated ICS levels) for the insurers designated as G-SII in order to prevent cross-sectoral arbitrage.

6.   As implied above, the IAIS considers G-SIIs are different from G-SIBs. This is attributed to a number of factors, including "in part because the traditional insurance business model is not inherently systemically important."[24] Further factors include the ex-ante payment of insurance premiums relative to the occurrence of insurance claims, the long term nature, often including guarantees of some significant types of insurance product (including those that support provision of retirement income streams to retirees), and the wide variety of structures and activities of insurers. Differences between large insurers and banks are reflected in the differences between the G-SII and G-SIB designation methodologies currently in place.

7.   Consequently, the systemic impact of the distresses or failures of a bank and an insurer of similar (asset) size may differ. That difference may be expected to vary depending on the nature and activities of the specific bank and insurer being compared. Thus the 12.5% to 18.8% uplift for G-SIBs being put forward as broadly

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[24] See paragraph 6 of the G-SII Policy Measures Document. Subsequent comments also reflect this document.

comparable may be either an over or under estimate, depending on more specific circumstances. However the point of the above discussion is not to make comparisons between banks and insurers, but rather to provide some context within which calibration discussions may occur. It would likely be inappropriate for the calibration of the HLA to knowingly generate arbitrage opportunities, in either direction, between banks and insurers. As there are some significant lines of business in which both may offer products, this is not an incidental consideration.

8. In summary a reasonable indicative HLA required capital outcome, in aggregate, is one which applies a factor or factors to the exposure of (BCR + Uplift BCR) of up to 20% applicable to the empty bucket for G-SIIs with lower factors for populated buckets.