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Aspirations and realities: Gauging the impact of the ICS on capital management

The International Association of Insurance Supervisors' (IAIS) has set ambitious goals for its planned new International Capital Standards (ICS). Can these objectives be met? How much of an impact will they have on capital?

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Introduction: Setting a new benchmark

Welcome to Aspirations and realities: Gauging the impact of the ICS on capital management, the second in our series of perspectives looking at the implications of the planned new risk-based International Capital Standard (ICS) being developed by the International Association of Insurance Supervisors (IAIS) for global systemically important insurers[1] (G-SIIs) and a broader group of internationally active insurance groups[2] (IAIGs)[3].

The IAIS has set ambitious goals for the ICS (Principles 1-10[4]) as it looks to strengthen policyholder protection, financial stability worldwide and introduce a globally comparable risk-based measure of capital adequacy. The potential benefits for your business include a more consistent basis for valuing products, evaluating risk and managing capital across the different markets in which you operate. The ICS should usher in greater transparency and comparability for analysts, rating agencies and group supervisors (the latter through supervisory colleges).

The moves towards international convergence have the political momentum of strong backing from the G20 and Financial Stability Board (FSB) as they look to create the insurance equivalent of banking's Basel III. Yet achieving international consensus on the mechanics of capital evaluation has proved (and will continue to prove) challenging. Current valuation approaches differ significantly from country to country, which creates a strong obstacle to achieving a common methodology. Current proposals are based on two distinct valuation methodologies ('GAAP+' and 'market-adjusted')[5]. The fact that we currently have two approaches highlights the challenges the IAIS has faced in achieving convergence.

Further difficulties were highlighted in a speech earlier in the year by Federal Reserve Governor Daniel K. Tarullo, in which he expressed doubts over the potential use or reliance on existing frameworks such as Solvency II or on the ICS, along with as some frustration with the slow pace of progress. Nonetheless, Governor Tarullo's speech underlines the Federal Reserve's continued readiness to proactively engage in the ICS development process and that the door may still be open for the proposed GAAP+ methodology. Therefore, while there could eventually be sufficient agreement to move towards a single methodology, fundamental differences between (as a minimum) the US and the EU markets must be addressed. Meetings between the 2 regions, such as the EU - US dialogue held on 19 October this year and other meetings chaired by the IAIS will continue to pave the way towards a solution.

1 Once implemented, the ICS will replace the Higher Loss Absorbency (HLA) and Basic Capital Requirement (BCR) for G-SIIs. For an overview of the workings of the BCR and HLA see the FAQ section on the IAIS website (http://iaisweb.org/index.cfm?event=getPage&persistId=9F7EACC2155D89A406627C6FDB286103#)

2 The IAIS defines an IAIG as an insurance group that has total assets of at least $50 billion or gross written premium of at least $10 billion of premiums written in three or more jurisdictions (on a rolling three year average basis), and at least 10% of the group's total gross written premium is written outside the home jurisdiction.

3 'Fusion or confusion? Standardising international capital regulations', PwC, May 2016, our first perspective, explored the differing proposed bases for the ICS ('GAAP+' and 'market-adjusted'), the timetable for consultation, development and implementation, and the main strategic and operational considerations presented by the new standard (http://www.pwc.be/en/news-publications/publications/2016/fusion-or-confusion.html).

4 The IAIS Risk-based Global Insurance Capital Standard (ICS): Ultimate and Interim Goals, Principles for Development and Delivery Process, IAIS, Updated 25 June 2015 (http://www.dgsfp.mineco.es/sector/documentos/IAIS/ICS_Goals__Principles_and_Delivery_Process_(updated_25_June_2015).pdf)

5 The differing proposed bases for the ICS ('GAAP+' and 'market-adjusted'), the timetable for consultation, development and implementation, and the main strategic and operational considerations presented by the new standards are explored in our first perspective, Fusion or confusion? Standardising international capital regulations, PwC, May 2016 (http://www.pwc.be/en/news-publications/publications/2016/fusion-or-confusion.html)

So if a new ICS is coming, what is the likely impact? In this paper, we look at how much will change and how this will affect capital management within your business. In general, the degree of impact will depend on the starting point, appetite for reform of national supervisors and the timing of implementation within the markets in which you operate. Markets that are moving to risk-based regimes for the first time will see a significant shift in how capital is assessed, managed and optimised. Others such as the EU and Australia, which already have well-developed risk-based capital regimes at group level, could see less of an impact. Nonetheless, it will still be important to monitor the level of capital required under the ICS against existing measures.

More broadly, your business faces the challenge of either developing a more integrated and systematic approach to risk, capital and strategic management or introducing another layer in an already complex process. The inclusion of additional demands to demonstrate that appropriate policyholder safeguards are in place will also raise the bar for monitoring, control and transparency.

If you have any queries or would like to discuss any of the issues raised in this paper in more detail, please feel free to get in touch with your usual PwC representative or one of the authors listed at the end of this paper.

Markets that are moving to risk-based regimes for the first time will see a significant shift in how capital is assessed, managed and optimised.

1 The ICS is coming

An interim version of ICS is due to be in place next year. What form will this take?

The second ICS consultation set out the proposed basis for the interim ICS Version 1.0 (for confidential reporting in 2017). Field testing and analysis was carried out in parallel. Once reviewed and revised, Version 1.0 is due to be adopted in the middle of 2017[6].

As views differ on the viability of a market-adjusted liability valuation (see box 'IAIS MA and IAIS GAAP+'), Version 1.0 will be based on two valuation approaches for the base balance sheet and a standard method for calculating the ICS capital requirement. Among the continuing points of contention are the use of internal models and the balance between simplicity and granularity.

IAIS MA and IAIS GAAP+

There are two proposed frameworks for valuation within the ICS. The main difference is the starting balance sheet. IAIS 'market- adjusted' (MA) revalues some major parts of the balance sheet, including insurance liabilities. As part of the calculation, some margins are transferred from reserves to capital, current estimates are used and, under current proposals, a prescribed yield curve is provided by the IAIS to discount insurance liabilities. Fair value is used for financial instruments. The alternative IAIS 'GAAP+' uses the GAAP calculations within each jurisdiction as the basis for the starting balance sheet.

6 Our earlier paper, Fusion or confusion? Standardising international capital regulations, gives more details on the interim versions, timings and eventual goals.

A globally-consistent capital metric would have the benefit of improved transparency and confidence as long as it becomes easier for your business to communicate its capital position and for analysts and regulators to evaluate and compare financial strength with a consistent benchmark.

Clearly, achieving actual global consistency is going to be difficult in practice (at least in the foreseeable future) given the current diversity in GAAP and regulatory approaches. There is also some uncertainty as to how national supervisors will apply the ICS, when they will implement it and any allowance for transitional measures to phase in the requirements. There is also uncertainty on whether different supervisory authorities will apply additional demands on top of the ICS or expect to begin intervention at a higher level.

How this may play out

The IAIS is only seeking comparability of outcomes (i.e. substantially the same) across jurisdictions, rather than consistency in the underlying approaches, which will make it easier to meet its objectives on comparability. However, the differences of view within the international regulatory community mean your business will more than likely continue to face the burden of multiple capital standards in certain jurisdictions.

There is also a danger that the ICS will be set at a very basic level to achieve consensus. This would generate no more than the illusion of consistency by retaining financially significant differences that make comparability difficult or misleading. However, this scenario may not be accepted by the FSB, thus triggering the FSB to set it's own solution upon the industry.

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2

Achieving increased policyholder protection and financial stability

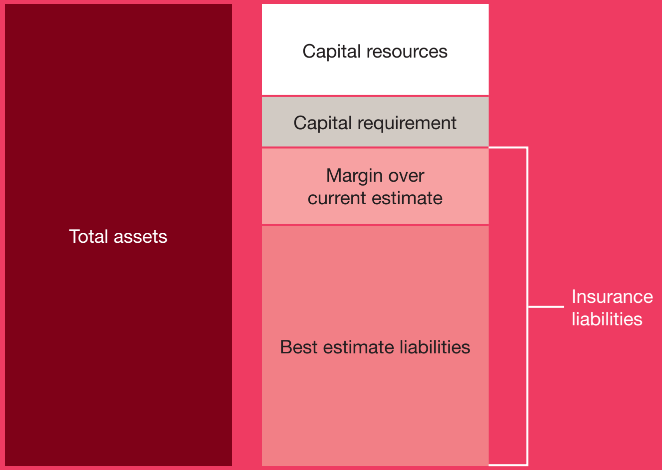
The ICS aims to strengthen policyholder safeguards and insurers' resilience against market downturns and systemic shocks. As such, the aim isn't necessarily more capital so much as greater sensitivity to risk, more effective enterprise risk management (ERM) and more assured availability of capital resources in the event of a crisis. How will this work, how will it interact with other capital priorities and how are businesses likely to respond?

Increasing the quality of capital and level of own funds over and above the core capital requirements ('capital resources') could provide greater assurance that the business can meet policyholder obligations across its global operations. Higher capital resources can also strengthen financial stability by providing a bigger buffer against stresses in the market and reducing the need to call on debtors during a crisis.

Industry capitalisation

The ICS sets out the minimum level of capital (see Figure 1 for the difference between capital resources and required capital) and expectations on the quality of capital used to meet these obligations. Raising the level of required capital doesn't increase assets and in fact capital resources go down. However, a greater capital buffer will arise through the locking in of capital of higher quality and reduced dividends.

Figure 1: Minimum levels of capital



Source: IAIS Public Consultation Document

Moreover, the affect of higher capital standards could be further amplified by local regulators, rating agencies and management's own view where actual capital held is expressed as a ratio of the regulatory minimum. The relative levels of required capital may fluctuate as your risk profile changes and because the capital may be more sensitive to market, credit, insurance and operational risks than the current constraining capital measure. This sensitivity and potential for movements could provide an incentive to raise levels of capitalisation even if the ICS is not the binding constraint. Nonetheless, it will take time to revise strategy, management practice, risk mitigation and capital optimisation to take account of the ICS demands.

Quality of capital

The quality and suitability requirements would cover areas such as subordination, availability, loss absorbency, permanence and absence of encumbrances. In short, how accessible and usable are the instruments when needed? There are likely to be tiers of capital based on quality/suitability, with restrictions on the type of capital that can be used to cover the capital requirements.

By tightening up capital eligibility criteria and increasing the quality of capital, the IAIS believes it will strengthen policyholder protection and financial stability. However, additional capital eligibility criteria may force your business to move away from some type of holdings, which would otherwise have offered the potential for the higher yields needed to offset the low interest rate environment, and provided the opportunity to strengthen or diversify the balance sheet over time. We've already seen potential examples of this following the move to Solvency II, as a result of which many companies reshaped their investment portfolio to avoid high capital loadings or meet the criteria for the matching adjustment. Tellingly, there have been calls to the IAIS from within the industry to treat the impact of low interest rates as a systemic risk. From a management perspective, it's important to balance the level of risk-sensitivity and control that the ICS seeks to introduce with the loss of return potential.

Factoring in volatility

It's also important to consider the impact of increased balance sheet volatility as a result of the move to a broadly market-consistent ICS (see box 'Increased volatility').

Any balance sheet volatility that doesn't impair your ability to meet your liabilities or pay other creditors would do nothing to protect policyholders and could have adverse implications for financial stability. The ICS should be sufficiently risk-sensitive to encourage the right risk management behaviour to address exposures that do genuinely impact policyholder security, but avoid unnecessary volatility or pro-cyclicality. However, where you believe that the balance sheet volatility does not represent the economic substance of your business and may prompt over-reaction or pro-cyclicality, this should be communicated to the IAIS.

The IAIS is currently looking at how to iron out unintended effects stemming from increased balance sheet volatility in a market-consistent ICS valuation. The experience of Solvency II is telling here and can provide lessons for the IAIS. The potential for over-reaction to volatility became a key sticking point and source of delay. Regulators eventually gave ground and introduced the matching adjustment, which can help prevent the full impact of fluctuations in fixed interest spreads from flowing through to the balance sheet. However, it comes with restrictions on the extent to which the portfolio can be traded and a potential loss of diversification credit, at least for businesses using the standard formula. These restrictions have forced many insurers to dispose of some assets or to restructure them. The alternative volatility adjustment comes with less restrictions, but also less of a smoothing effect.

Increased volatility

The ICS is likely to introduce many elements of a market-consistent valuation. Even if a full market-consistent valuation approach isn't introduced it is likely that the valuation will use current estimates. These changes are likely to introduce increased volatility compared to some of the existing capital bases.

Many of the consequences of a full market-consistent approach were experienced in the development of the EU Solvency II regime. The resulting 'matching adjustments' and 'volatility adjustments' are designed to smooth some of the impact.

Management intervention

It's possible that greater consistency in risk and capital evaluation will make it easier for you to value products, manage capital and judge risk-adjusted returns across different markets. You may therefore be able to respond quicker to threats and opportunities. You can also provide a more comparable basis to communicate the performance and potential of your global business.

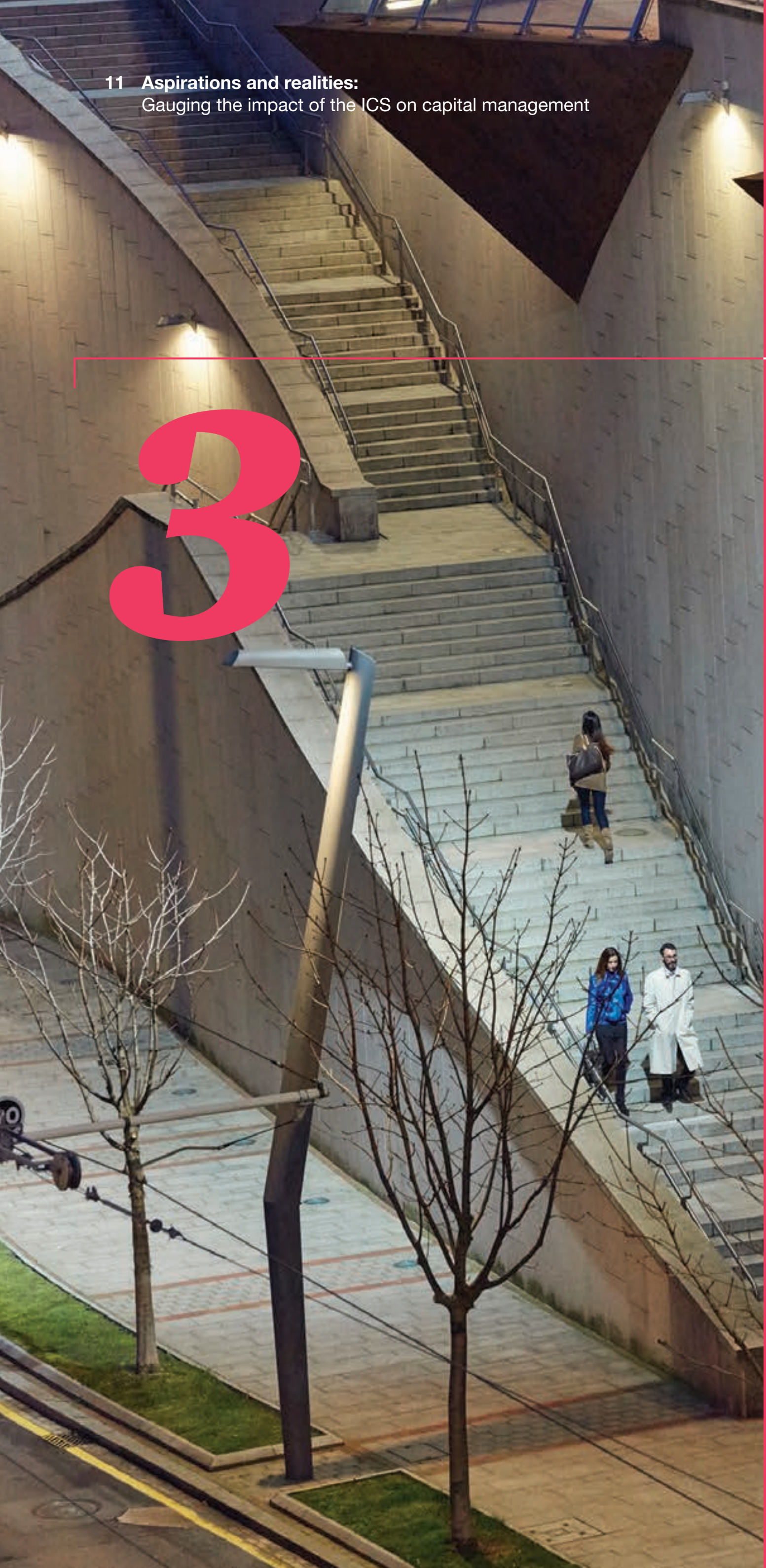
In turn, by promoting more integrated ERM and an active own risk and solvency assessment (ORSA), the ICS and wider ComFrame initiative[7] will embed a more informed, holistic and forward-looking approach to risk and capital management within strategic management. This includes building risk-sensitivities, scenario planning and the impact on capital demands into business planning and evaluation of returns.

Much of what's expected will already be in place if your business has a mature group economic capital framework or is governed by risk-sensitive prudential requirements. If this isn't the case, however, the broad sweep of regulatory and accounting change and standards along with greater level of standardisation and economic valuations may support existing risk management.

Regulatory intervention

In the eyes of the regulatory community, the ICS will provide an opportunity for pre-emptive, thus more effective supervisory intervention. The ability to detect and quickly step in when capitalisation levels deteriorate at a group level would strengthen policyholder security and financial stability, given that the group supervisors could be comparing capital based on one standard, as opposed to multiple different capital measures (in the way that Solvency II has achieved this in the EU). However, it's still important to determine a clear and appropriate point at which supervisors have the power to intervene, act or take control to safeguard the interests of policyholders.

7 The Common Framework (ComFrame) aims to provide the basis for global convergence of the regulatory and supervisory measures for IAIGs. It's split into three modules. Module one focuses on the scope of ComFrame. Module two looks at the guidelines and principles that should apply to IAIG's, which include the ICS. Module three looks at the mandate and operations of supervisors, including the development of colleges to oversee a group's cross-border operations.



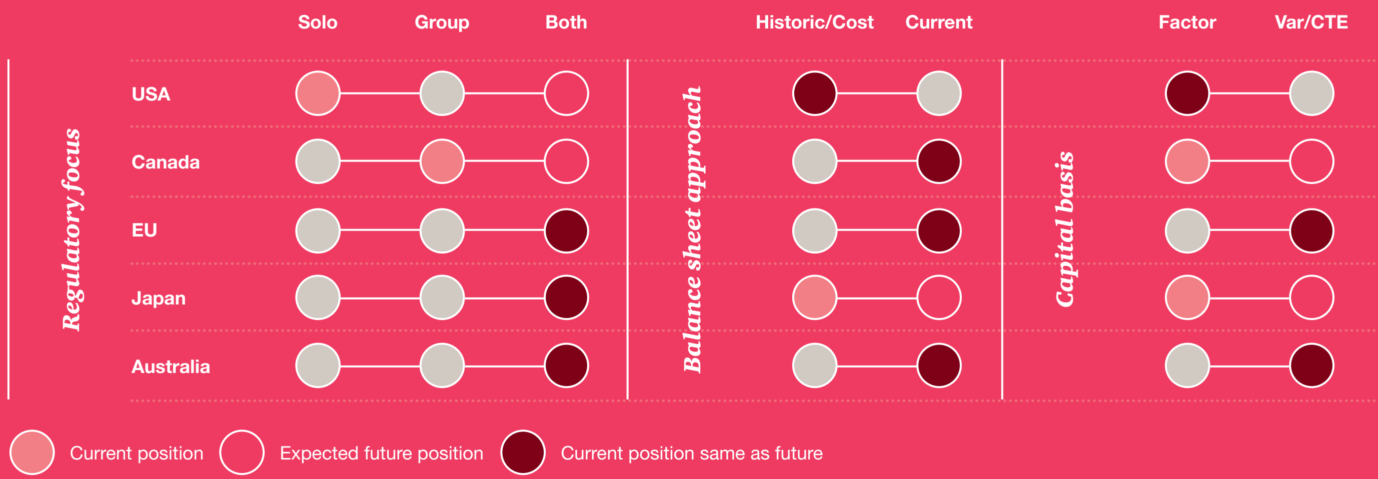
3

Different markets, differing impacts

The level of impact is largely determined by where you start.

If your business is moving to a risk-based group capital requirement for the first time, there could be significant changes in how your capital is calculated and how much you will be required to hold. There may be less change if your business is already subject to risk-based group capital requirements (see Figure 2).

Figure 2: Direction of travel



Source: PwC analysis of current regulation and IAIS proposals

Var/CTE refers to an approach where stresses are applied to the balance sheet to determine the capital requirements.

The formulaic reserves are measured at book value, but the asset adequacy test of reserves is market value and the additional risk-based capital amount uses mostly (but not all) current values.

The Regulatory Focus section in Figure 2 shows whether national regulators currently focus on solvency at the solo/entity level, at the overall group level or on both bases in determining any potential need for intervention. The ICS is clearly focused on solvency on a group-wide basis.

The Balance Sheet Approach sets out whether assets and policyholder liabilities are valued using a historic cost or 'locked-in' approach or whether a current market value approach is followed. The ICS is currently edging towards a current market value approach, although if a GAAP+ approach is followed this will depend on the adjustments made to the balance sheet.

The Capital Basis is often calculated by either applying factors to balance sheet items to determine the capital charge or by applying stresses to the balance sheet for each risk and aggregating the resulting impacts across the risks. The later approach is denoted as 'Var/CTE' in Figure 2 after the statistical techniques used to determine the appropriate levels of stresses applied.

Figure 2 is obviously something of a simplification. For example, the US model is a mix of factors and CTE approaches with, most notably, variable annuities using a CTE approach. Similarly on historic/cost versus current, the US regime is also a bit of a mix. The formulaic reserves are measured at book value, but the asset adequacy test of reserves is market value and the additional risk-based capital amount uses mostly (but not all) current values.

Yet even if your business is already covered by risk-based group capital requirements, ICS will still have an impact. From a capital perspective, this includes the need to ensure the right quality, liquidity and availability of group capital resources in order to safeguard policyholders and cushion your business against market shocks. And as businesses subject to Solvency II have seen, analysts and investors are likely to take a keen interest in how solvency ratios and capital cushions are affected by regulatory changes. This could lead to market pressure to hold more capital.

View from selected markets

In Japan, the regulatory driven field tests were launched in June 2016[8]. Following similar tests conducted in 2010 and 2014, the purpose is to assess a possible method of economic based valuation and its use in supervision. The calculation methods are generally consistent with those being examined under the ICS. Although the regulator has stated that this does not indicate any future direction for supervision in Japan, it does say that this is a consideration.

In Australia, the Life and General Insurance Capital Standards (LAGIC) have been effective since 2013. This is a Var-based approach at the 99.5% confidence level. The Australian Prudential Regulation Authority has indicated that ICS may have little impact if the ICS is initially set below LAGIC[9].

8 http://www.fsa.go.jp/en/news/2016/20160708-1.html

9 http://www.apra.gov.au/Speeches/Pages/1402Views-from-APRA.aspx

4

Solo versus group

The ICS will apply at the group level and not to individual entities within IAIGs and G-SIIs.

Moving to a group-wide consolidated basis can contribute to a level playing field and reduce the possibility of capital arbitrage.

The focus would be on group specific risks, risk concentrations, intra-group exposures, strategy and transactions. The proposals assume that capital can and will be made available from the group to support needs in individual companies when required. It will therefore be important to demonstrate how fungible capital is in reality, which in turn raises questions over entity-level demands and the liquidity of capital instruments.

Some within the supervisory community, notably state regulators within the US, have focused most closely on legal entities rather than the overall group. However, the Federal Reserve Board and the National Association of Insurance Commissioners (NAIC) are now considering a group capital standard for the groups under their responsibility, albeit the timings are still unclear.

At the same time, we can expect regulation at the solo level to be influenced by the ICS, even if this is only because group supervision still remains supplementary to solo in most jurisdictions, and a big difference in regulatory approaches for solo and group levels would be inefficient, burdensome and, potentially misleading.

Conclusion: Time to evaluate, time to engage

It's easy to dismiss the ICS as not being a practical binding constraint on capital levels and therefore a minor concern. But it will have an important influence on how capital is evaluated, how requirements reflect the risks being run, what qualifies as capital and how the safety of your business and the wider market are judged. More broadly. It will also provide the catalyst for important developments in ERM and put the ORSA at the heart of how strategy is set and the business is run.

It's therefore important to assess how the ICS will affect capital management within your business, the implications of the different forms the ICS might take and do all you can to influence the outcome. It's also important to look now at how capital demands might change as a result of the ICS to ensure this is factored into the pricing and return evaluations on long-term business.

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