

To: Economics and Finance Committee

From: ECOFIN Team

Meeting: 7 December 2018

Reference: ECO-18-118

Subject: The global Insurance Capital Standard (ICS) and ComFrame

Objective

For discussion

Input requested

Members will be invited to advise on the following open questions:

- *Are there any new developments in your discussions with respective markets that would require adjustments to the ICS key messages? If this is not the case, then the secretariat will engage with the IAIS on the basis of its [response to ICS 2.0](#).*
- *Are there any particular issues on which Insurance Europe does not have a (clear) position and should aim to engage members and form a European position? In particular:*
 - *Should the ICS confidential reporting results be discussed in the colleges? Is this an area where members have strong views? (note: this was only briefly discussed in the consultation, but the secretariat understands that some European companies do have strong views against ICS being discussed in the colleges)*
 - *Should the IAIS be asked to make public the global list of IAIGs? (note: the secretariat is aware that the European Commission has been requesting this)*
 - *Should the IAIS prioritise the discussion on defining comparability of outcomes? Can/should the European industry form a proactive view on this?*
 - *Should the 5-year monitoring period be used for ongoing improvements or aim for stability (as currently intended by the IAIS)?*
 - *Could the ICS be a means of achieving a more level playing field internationally or could make it more difficult for European groups to compete?*

Members will also be invited to share information from their engagement with respective NCAs involved in the ICS discussions.

Background

ICS

The ICS is going through its last stages of development ahead of adoption of version 2.0, scheduled in November 2019. Insurance Europe [responded](#) to the extensive consultation on ICS 2.0. Interestingly, CROs from 18 global companies recently wrote a letter ([ECO-18-116](#)) to the IAIS with key principles for the ICS, and these seem very much aligned with the Insurance Europe positions.

Some progress on streamlining options and improving previous proposals has clearly been made. However, it remains a great deal of work for those companies involved and less than one year before adoption, key issues remain unsettled. There are three main scenarios for the coming months:

1. Very **intense negotiations and compromising** between the EU/US/Japan in the coming months – not highly likely, as once things are agreed now, it will be very difficult to change them in the future and all parties seem to have very strong views in particular areas.
2. **Less ambition on the final shape of ICS 2.0** (ie leaving still multiple options for testing – which would concretely mean no progress and burden on companies) – this option is likely, though it would probably not achieve the ambitions of the Kuala Lumpur Agreement, so a new Agreement would be needed.
3. **A delay in finalisation of ICS 2.0** – this is not an option publicly discussed, however this has been mentioned to the secretariat by the Commission.

Unsurprisingly, the **key areas of divergence** and the open questions remain pretty much the same as in the past, namely:

- Valuation: MAV vs GAAP+, but also the calibration of the MAV. Europe appears to be discussing MAV in close cooperation with Japan and appears open to some flexibility to get Japan on board. However, the US stakeholders continue to object to the MAV (at least on the regulatory side, because on the industry side some acceptance by US companies is emerging).
- MOCE: European supervisors and the Commission have been very firm on the need for a MOCE added to liabilities, and EIOPA has even produced “educational material” on the risk margin that it has presented to the IAIS. Japan seems to no longer be opposed to a MOCE, however the Japanese FSA appears to be pushing for a “small” MOCE that has no significant impact on own funds. The US regulators oppose MOCE, and argue that a form of prudence is already embedded in their GAAP valuation of liabilities, and this prudence is equivalent.
- The US aggregation approach – remains work in progress, with no concrete proposals by US regulators, and opposition by European, Japanese and other regulators who argue it is not even achievable. The US regulators are at this stage trying to get on board as many jurisdictions as possible to test the aggregation approach (once it is ready), and they largely target Asia (Japan, Singapore, Hong-Kong), but also Bermuda. It is clear that this approach will not be validated unless tested also by non-US IAIGs.
- Internal models: they are in the scope as optional, and Japan seems to support Europe on this – however they argue that enough time needs to be allowed to companies to reach the level of preparation that Europe already has.

A number of **IAIS meetings** are scheduled at ExCo level in the coming months, including an ExCo retreat in mid-January. Absence of progress in January will give signs of potential delays in delivering the Kuala Lumpur agreement.

On the **European side**, there seems to be wide support from representatives of the Commission, the European Parliament and the NSAs for a global standard, which should be as close as possible to Solvency II. In fact, simply put, there is a clear aim for the European negotiators to position it as “the best” regime in the world.

Insurance Europe recently met with DG FISMA to discuss the ICS developments. The Commission is a permanent observer in the IAIS and is in fact closely monitoring developments at working level and in the decision-making process. The Commission has increasingly raised concerns over a global level playing field and Europe being at a competitive disadvantage. This seems positive, but they appear to consider the ICS as a means to achieve a global level playing field. They appear to strongly support the industry on the issue of internal models as they have indicated that an ICS without internal models cannot even be considered for implementation in Europe. In addition, the Commission raised the ICS in a September meeting with experts from member states, and encouraged them to speak to their supervisor to make sure they are aware of developments. Interestingly, some member states representatives noted in this meeting that they learnt from the EC more in this meeting than they ever learnt from their respective supervisors in the past years.

Insurance Europe also met with supervisors from Japan, Taiwan and Hong-Kong recently, who, while acknowledging that Solvency II is a very sophisticated regime, seem very concerned about an ICS that replicates



the problems of Solvency II in the treatment of long-term business, as well as concerned by its complexity and lack of proportionality.

Looking ahead, Insurance Europe will continue to engage on the basis of its mandate in ICS 2.0. Top-level meetings with the IAIS and the FSB are planned in early 2019.

ComFrame

The full ComFrame package is also expected to be adopted in November 2019, and the IAIS is in the process of reviewing most ICPs. While the ICPs may sometimes appear to be of lower priority, the secretariat is dedicating effort into assessing the extent to which these deviate from Solvency II and asking for alignment. The reason for this is not only the fact that ICPs are a key element of the IMF-World Bank FSAPs, but also because, looking ahead, any form of peer review at IAIS level (which will start soon) will look closely at the ICPs and the extent to which these are reflected in jurisdictional regimes. The objective sought by the secretariat is alignment of ICPs to Solvency II (except where we seek improvements), so that no "suggestions" for changes emerge from the IAIS peer review.

Next steps

- 1 February (Basel): ICS stakeholder event (tbc)
- Summer 2019: consultation on the ComFrame package
- November 2019: adoption of ICS and ComFrame

Appendix: Extract of Insurance Europe's key messages on ICS 2.0

Given the ambition to finalise ICS 2.0 by the end of 2019, there is **significant work needed** to ensure the ICS properly reflects the underlying insurance business models and identifies and measures the risks which they face.

While ICS 2.0's purpose is to test the framework, it is important that the ICS is a risk-based framework which uses a consistent, consolidated approach based on a market consistent valuation. It is key that it is appropriately designed and calibrated so that the results of the testing period are meaningful. In fact, the more appropriate the design of the ICS in the confidential reporting phase, the more likely it is that the adoption of an implementable version of the ICS is achievable.

A number of improvements have been made in the design of the ICS over recent years, and these are very much welcome by the European industry. Continuous dialogue and exchanges with the industry in the coming months are key to allow these improvements to be discussed thoroughly so that decisions are well-informed and flaws are minimised.

In response to the draft ICS 2.0, as presented in the consultation paper, Insurance Europe would like to emphasise the following views:

- With respect to **valuation**:
 - **A market-adjusted valuation approach is supported, but only if the discount rates for liabilities reflect the long-term nature of the insurance business model and the ALM techniques employed by insurers.** When valuing long-term liabilities, an adjustment to the risk-free curve is a prerequisite of a MAV approach.
 - **The proposed methodology for deriving the risk-free yield is appropriate.** The liquid part of the curve should be based on swaps/government bonds and the illiquid part determined by extrapolation towards a Long-Term Forward Rate (LTFR).
 - **The LTFR does not need to be updated annually.** It is intended to be a stable, long-term parameter. Annual updates only serve to introduce spurious accuracy into the framework.
 - **The IAIS should further investigate potential ways of addressing forced selling risk.** Several features of the IAIS's current proposals (application ratios, eligibility criteria, cashflow matching etc.) have been included to address the risk of forced asset sales but there may be better approaches to dealing with this risk.
 - The bucketing concept for valuation has the advantage of enabling IAIGs to calculate portfolio specific adjustments where individual liability characteristics warrant this.
 - **Significant improvements continue to be needed to develop an adjustment** to the risk-free curve which achieves the IAIS's objective of developing an adjustment "to reflect the long-term nature of insurance contracts and mitigate potential excessive volatility in capital resources"
 - **The own assets / own spreads approach is the appropriate proposal for the Top Bucket.** However, some of the eligibility criteria should be relaxed. In particular, there should be an option to use internal credit ratings, and asset eligibility criteria should permit the use of a wider range of long-term assets to back long term liabilities.
 - **The current design of the Middle Bucket provides a good starting point for further development, but significant improvements are required.**
 - The adjustment should recognise the contribution of long-term equity, property, infrastructure and other non-fixed income assets within prudentially sound ALM approaches.
 - The eligibility criteria are too onerous and too narrowly defined.
 - Given the high degree of basis risk inherent in the use of a reference portfolio, **the IAIS should aim to minimise the liabilities that are eligible only for the General Bucket.** The proposed Basis Risk Mitigation Mechanisms are a welcome inclusion in the General Bucket approach.
 - **An adjustment to the LTFR** should also be included which is reflective of the investment returns which insurers can be expected to earn over very long time horizons.
 - **The IAIS should undertake extensive testing of any proposed valuation approaches** to ensure that they work as intended both in the current economic climate but also in stressed market environments.

Testing against periods of financial stress should be performed by the IAIS, with no additional burden on companies.

■ With respect to **MOCE**:

- While Insurance Europe acknowledges the need to ensure an orderly transfer in case of failure, it doubts whether MOCE is the appropriate way to perform this function. Insurance Europe believes that the introduction of a MOCE could lead to potentially unfavourable consequences.
- Insurance Europe does not support the IAIS approach on the C-MOCE aimed at increasing the liabilities for all companies at all times. Instead, if it was decided that MOCE is needed, it should be assessed against the existing capital requirements.
- A company should calculate its MOCE and its MCR; as long as the MCR is higher than MOCE, supervisors should be reassured that MOCE is available to support transfer in case of failure (and supervisory intervention at MCR).