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International developments dominate regulatory change

Global Insurance Capital Standard

THE IAIS released a set of high-level principles in September 2014 to be used to guide the development of the global ICS. These were consulted on in December 2014, with only minor revisions made in 2015, following feedback received.

The IAIS consultation document 1 on its first draft proposal of the ICS in December 2014 generated over 1,500 pages of comments. The IAIS has provided its feedback on a piecemeal basis, with updates on June 2, October 3 and November 2015 on key components. While some decisions have been taken, it is evident that further refinement will be made, dependent on the results of current and future field testing.

For ICS purposes, all G-SIIs are considered to be IAIGs.

Timeline and process

THE IAIS has reconfirmed its aim of convergence in global regulatory capital frameworks over time, recognizing the challenges associated with a project of this nature. An ICS Version 1.0 will be released in time for private reporting to supervisors from 2017. However, the version that will be used for public reporting (ICS Version 2.0) will not be adopted until the 2019 IAIS Annual General Meeting.

The IAIS also recognizes the need for an implementation period after adoption, to enable jurisdictions to embed the ICS into local requirements. Further, the IAIS recognizes that some form of transitional measures and phasing-in for certain elements of the ICS may be necessary in some jurisdictions.

Interaction between ICS and existing frameworks

THE IAIS has said little to date regarding any form of jurisdiction recognition process (such as Solvency II's equivalence assessment process) to help supervisory authorities and insurance groups man-

age potential conflicts between the ICS and any local group solvency-calculation requirements. This will be important for groups, as the challenges of managing different group metrics could be significant, especially if they react differently to proposed mitigating actions. Nonrecognition of local group requirements could also introduce competition issues within a jurisdiction between the IAIGs to whom the ICS applies and other insurance groups.

This is a difficult matter to resolve, as the global ICS is intended to enhance comparability across the IAIG population over time, achieving comparable (which has been confirmed means "substantially the same") outcomes across jurisdictions. Nevertheless, we believe a jurisdiction recognition process will need to be included in the final ICS (Version 2.0).

Recognizing that comparability of outcomes will only be achieved over time, the current focus will remain on developing the standard method approach. Variations to this, including the possibility of recognition of internal models will be dealt with later in the development process. In this regard, we note that a partial internal model for catastrophe risk was allowed within the 2015 field test.

Key components of ICS

THE key components of the ICS remain valuation methodology, qualifying capital resources, risk measurement and capital requirements.

■ Valuation approach

A key issue in the development of a global liability valuation approach for the ICS has been the lack of a global insurance accounting standard for insurance contracts. Work on the insurance contract accounting standard (IFRS 4) has continued in parallel, however, the

final standard is not expected to be issued until around the end of 2016, with an effective date unlikely to be before January 1, 2020. This has therefore necessitated development of a stand-alone ICS valuation methodology, designed to broadly reflect the insurance liability valuation requirements of IFRS 4. This basis is known as the market-adjusted valuation basis, however, the IAIS has indicated that further refinement to this basis is likely to be needed for the 2016 field-testing exercise.

An alternative approach based on Generally Accepted Accounting Principles with adjustments (known as GAAP+) is being assessed. This has mainly been

driven by the United States, with the intention of allowing IAIGs to achieve a quasi-market adjusted valuation by applying adjustments to their local jurisdictional GAAP figures.

The IAIS has confirmed that the version of the ICS that will apply from 2017 (ICS Version 1.0) will permit both valuation approaches, although it has not yet reached a decision regarding ICS Version 2.0. While recognizing that the required adjustments will depend on the underlying GAAP adopted, the IAIS has developed a set of principles aimed at encouraging comparability across jurisdictions.

One of the key areas for discussion in relation to the valuation of insurance liabilities relates to whether a margin over current estimate (MOCE) should be required. The inclusion of a MOCE within the valuation of insurance contract liabilities would effectively result in the deferral of profit emergence.

The consultation document included questions regarding its purpose (additional prudence or to reflect the cost of transferring the insurance portfolio), treatment (i.e., as an additional component of insurance liabilities in addition to the current estimate or as part of capital resources) and calculation basis. There

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were mixed responses to these questions, especially regarding its purpose, and the IAIS has confirmed that more work will be required on the MOCE in order to achieve comparability. It has confirmed that the MOCE will also be relevant where the GAAP+ approach is followed, citing ICP 14.7, which requires that the valuation of insurance liabilities should include a MOCE.

Another unresolved issue relates to the definition of insurance contract boundaries. The 2015 field-testing exercise included a number of questions that explored issues with the current definition.

On discount rates, the IAIS has recognized the need to refine the IAIS yield curve methodology. The new methodology is based on a three-segment discount curve. The first segment is based on liquid market information, the second segment is based on extrapolating this up to 60 years maturity and the third segment involves using a long-term forward rate for longer durations. The

IAIS has also confirmed that it expects to develop a fixed methodology rather than simply establishing principles to create the yield curve.

■ Qualifying capital resources

As the ICS capital requirement will be a regulatory Prescribed Capital Requirement (PCR), all IAIGs will need to hold qualifying capital resources that are at least equal to their ICS capital requirement. In the consultation document, the IAIS proposed four broad categories of capital resources as follows:

■ Tier 1 financial instruments for which there is no limit (for example, common/ordinary share capital).

■ Tier 1 financial instruments for which there is a limit (for example, non-cumulative perpetual preferred shares

and certain hybrid instruments).

■ Paid-Up Tier 2 financial instruments (for example, subordinated debt).

■ Non-Paid-Up Tier 2 financial instruments (only with supervisory approval and subject to being capable of conversion into an instrument falling within one of the other categories).

The IAIS has confirmed the general distinction between those elements that absorb losses on a going concern and winding-up basis (Tier 1) and those that only absorb losses in a winding-up situation (Tier 2).

In particular, following the guidance in ICP 17.11, the IAIS will continue to assess capital resources based on their loss-absorbency capacity, considering the capital instrument's subordination, availability, permanence and absence of encumbrances and mandatory servicing cost features. However, the IAIS also confirmed that it will consider the appropriateness of a principal loss-absorbency mechanism for "Tier 1 instruments for which there is a limit".

As a group capital standard, the issue of fungibility of capital remains an important consideration. However, the IAIS has confirmed that cross-sectoral aspects will be dealt with by determining capital resources at a consolidated level (but not capital requirements which will be aggregated by sector).

The proposed deductions from Tier 1 and Tier 2 capital (including intangible assets, goodwill, net deferred tax assets and investment in own assets) will be retained, but the list could be extended depending on the results of the 2016 field-testing exercise, which will also test the proposed capital composition limits.

Finally, the IAIS has stated that it will consider which types of non-controlling

interests can be included in capital resources and how the qualifying amount should be determined.

■ Risk measurement approaches

No changes have been proposed to the list of risks that will be included in the ICS (insurance, market, credit and operational risks), although the IAIS will consider further how to quantify operational risk within the capital requirement. It has also clarified that catastrophe risk is relevant for both life and nonlife insurance and will remain a separate component within insurance risks. For asset concentration risks, the IAIS proposes to use the results from the 2015 field-testing exercise to assess further whether this is required as a module within market risk and, if so, the basis to be applied.

No update has been provided regarding the various approaches for determining the ICS capital requirement by risk measure, so the presumption is that the proposed approach outlined in the consultation document (applying a factor-based approach, stress testing, stochastic modelling and structural modeling or a combination dependent on the nature of the risk) will continue to apply. Similarly, there has been no update regarding the allowance for diversification.

The article was taken from KPMG's publication, entitled "International developments *dominate regulatory change*".

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