Pressure from the G20 means that an international capital standard (ICS) is increasingly likely. But how far could the search for agreement compromise convergence and comparability? Will the benefits of the proposed ICS outweigh the potential disruption? What are the strategic and operational implications?

May 2016
Fusion or confusion? Standardising international capital regulations
Contents

4  Introduction: A bear market for regulation
6  The search for consensus
10 Gauging the strategic and operational implications
12 Conclusion: ICS is at a critical juncture
14 Contacts
Introduction: A bear market for regulation

Insurance is facing what has been described as a ‘regulatory bear market’. Some of the most far-reaching developments centre on the G20’s push for a more harmonised, risk-based framework for international capital regulation within the insurance industry worldwide, which mirrors its approach to banking in the wake of the global financial crisis.

While the G20 and Financial Stability Board (FSB) have delegated the development of new supervisory accords and capital standards to the International Association of Insurance Supervisors (IAIS), they’re keeping a close eye on progress. And while the IAIS doesn’t have the authority to make individual countries implement the new regulatory standards, it can rely on pressure from the G20 to make change happen, if it hasn’t already taken place at a local or regional level.

Packed agenda

The IAIS has a packed agenda at present, which includes the following prudential regulatory developments:

• Further updates to the common framework (ComFrame) for the supervision of internationally active insurance groups1 (IAIGs), with another public consultation expected during 2016

• Ongoing developments and testing of the risk-based International Capital Standard (ICS) for IAIGs

• Completing the work on the definition of non-traditional non-insurance (NTNI) activities (e.g. derivatives and institutional lending)

• Ongoing developments in recovery and resolution planning (RRP), including the IAIS Resolution Working Group and draft RRP provisions in ComFrame

On top of these developments coming out of the IAIS, Solvency II is now up and running in the EU and both China’s Risk Orientated Solvency System (C-ROSS) and South Africa’s Solvency Assessment and Management (SAM) will soon go live. There are also ongoing developments in the US and in most parts of Asia, covering both prudential and conduct regulation. It’s therefore little wonder that 94% of the insurance leaders taking part in our latest Annual Global CEO Survey see over-regulation as a threat to their growth prospects, more than any other sector in the survey, including banking3.

Introduction: A bear market for regulation

1 The IAIS defines an IAIG as an insurance group that has total assets of at least US$50bn or gross written premium of at least US$10bn 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.

2 From 2019, G-SIIs will be expected to hold qualifying regulatory capital that is not less than the sum of the required capital amounts from the BCR and HLA. 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=9F7EAC2155DB9A406827C6FDDB2861039)

3 101 insurance CEOs were interviewed for PwC’s 19th Annual Global CEO Survey (http://www.pwc.com/ceoinsurance)
Global regulation for a globalised sector

So why does international regulation matter? With the exception of the EU, insurance regulation is and will continue to be a primarily domestic matter; and in the case of the US, largely a state-orientated matter. But this is also an increasingly global market. For example, AIG operates in more than 100 countries worldwide. The top 25 EU-based insurers generate nearly 60% of their revenue outside their home territory, much of it in the US and, increasingly, fast growth Asian markets. In turn, a number of large emerging market groups are looking to develop a global footprint.

Some within the industry believe that the move to an agreed risk-based system under the ICS would make capital management across an IAIG more straightforward and reward effective risk management. They also believe it could improve comparability and make it easier for IAIGs to develop and market common products across different territories. As many of today’s formulaic solvency systems are accompanied by tight controls on product design and investments, the ICS may in turn provide a catalyst for greater commercial freedom.

But harmonisation and change in international capital regulation could also have significant implications for both the level of capital requirements and how easily funds could be moved around your group. How would you manage the international versus local capital requirements? Are there areas of your business that could become more capital-intensive or even unviable under the new regime?

You could also face challenging operational and market reporting demands, especially if your group or subsidiaries within it are moving to a risk-based regime for the first time. The challenges are highlighted by the significant amount of money Solvency II has cost the industry to implement.

Uneasy compromise

The big question is what this final harmonised international framework will look like and how it will be adopted by individual policymakers around the global market. The search for equivalence and ongoing discussions regarding the ‘covered agreement’ highlight the conceptual differences between the EU and the US. The variance in view has necessitated two very different proposed approaches for the valuation aspects of the ICS from the IAIS, though it eventually plans to bring the two together. The risk is that in seeking to bridge the divide, the eventual ICS will be an awkward and difficult to apply compromise, or necessarily pitched at such a high level as to have little practical impact or value.

Further questions centre on how to make sure that the ICS fits both mature and fast-growth markets. Some less well-resourced national supervisors may not be equipped to implement and oversee a highly sophisticated risk-based system. The experience of Solvency II highlights the challenges for supervisors. Moreover, given the double-digit market growth and often highly volatile equity markets in many emerging markets, fixed point in time solvency evaluations can give a distorted view of the capital requirements. Could stress testing address this and can we expect it to be a feature of the ICS?

In the first of a series of papers looking at the ICS and its impact, we explore the different options on the table and how your business can begin to address the strategic and operational implications. Further papers in the series over 2016 will explore the impact on capital, interaction with other metrics, impact on cash availability and some of the practical implications.

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 on page 14.

5 Cross-border insurance in Europe, Duisenberg School of Finance, 2014
The IAIS developments for prudential regulation broadly fall into two main strands (excluding developments around the ICPs). One relates to the nine designated G-SIIs and the other to the some 50 IAIGs. However, experience of comparable developments in banking suggests that regulations developed for global systemically important institutions can soon trickle down to their national systemically important counterparts, and eventually the market as a whole.

Through a combination of more sophisticated and focused capital standards, recovery and resolution plans (RRPs) and enhanced supervision, the IAIS wants to ensure that G-SIIs have a combination of sufficient capital cushions and well-developed scenario analysis and response plans to manage the impact of a severe economic event. The capital aspect of this vision, the HLA and BCR, should in theory be reported (in private) to group supervisors on an annual basis from 2016 onwards. RRPs (the ‘living wills’ required by insurers to ensure an orderly wind-up) are already well established in the majority of the G-SIIs and several other IAIGs.

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 IAIGs, which include the ICS. Module three looks at the mandate and operations of supervisors, including the development of supervisory colleges to oversee a group’s cross-border operations. The ICS is the aspect of ComFrame that is likely to require the most effort to develop, agree and implement.

ICS aims
The ICS is designed to improve comparability of outcomes across jurisdictions. The IAIS wants it to foster mutual understanding and increase confidence in cross-border analysis of IAIGs among group-wide and host supervisors. Once finalised and agreed, the ICS will be a measure of capital adequacy for IAIGs. The ICS will be the minimum standard and one which the supervisors represented in the IAIS are expected to implement in their respective jurisdictions (implementation issues are still under discussion). Supervisors will have the option to adopt additional arrangements that set higher standards or higher levels of minimum capital to the IAIS ICS.

The search for consensus

The search for a globally agreed ICS demands a difficult balance between comparability and acceptability, validity and viability. What are the prospects for consensus and are there other routes towards convergence that could be explored?
Once finalised and agreed, the ICS will be a measure of capital adequacy for IAIGs. The ICS will be the minimum standard and one which the supervisors represented in the IAIS are expected to implement in their respective jurisdictions. (Implementation issues are still under discussion.)

Competing approaches
There are two proposed approaches for the ICS framework:

1 Market-adjusted basis
A market-adjusted approach broadly comparable to Solvency II, in which some major parts of the balance sheet, including long-term life insurance liabilities, would be revalued and most margins transferred from reserves to capital.

The approach has the virtue of being broadly in line with the economic capital modelling used by many G-SIIs and IAIGs.

Insurers in the EU would see little change from this proposed basis for the ICS compared to Solvency II, though EIOPA has signalled its readiness to make adjustments to Solvency II in the future if necessary. There are also some concerns within Europe over whether the IAIS measures would sufficiently address macro-prudential risks, including measures to reduce procyclical.

Insurers and regulators operating in many of Asia’s less mature solvency regimes face considerable operational challenges in bringing their systems up to speed with a risk-based ICS. This includes the development and embedding of sophisticated risk and capital modelling capabilities and the supervisory scope and expertise to oversee them. But given the growing level of cross-border business and M&A within Asia’s insurance industry, there may be advantages to a more harmonised model across this region. There could also be opportunities to release some of the capital tied up in what can be highly prudent regulations. Other potential benefits include bringing solvency systems into line with the giant Chinese market, which under C-ROSS would have some comparable features to Solvency II and proposed ICS standards.

The C-ROSS regime seeks to address some of the asset price volatility and pace of growth in the market through modifications to the yield curve and basing solvency evaluations on a three-year average. As the risk-based system opens up greater flexibility in pricing and investments, insurers face the challenge of how to strengthen risk management. For managers who’ve been used to the fixed prices and conservative investment strategies dictated by regulation, the greater flexibility ushered in by C-ROSS also highlights the shift in mindset needed to build key risk indicators into decision-making, and align capital and financial considerations within a risk-adjusted view of performance.

At a time of sustained low and even negative interest rates within mature markets, many insurers are concerned about the impact of the balance sheet rules on guarantees and other long-term liabilities. The move to Solvency II in the EU highlighted the capital impact on these types of products – hence the need for the long-term guarantee package to iron out some of the balance sheet volatility and ease the transition into the new regime. Japan is one of the countries that is looking to update its solvency system following an earlier review of its application to the applicable ICPs. The treatment of the duration gap and other adjustments within the system are likely to provide an important marker for how regulators and insurers address the vexed issue of guarantees.

2 GAAP+ basis
The US National Association of Insurance Commissioners (NAIC) has reservations about a market-adjusted framework. The IAIS has responded to NAIC concerns through a second proposed framework, known as ‘GAAP +’ which would use GAAP accounting values for the opening balance sheet, but would project cash flows on an economic basis thereafter. By avoiding revaluation, GAAP+ would largely negate the potential capital ‘shocks’ for long-term liabilities.

The industry within the US is more equivocal about ICS than their regulatory community. Some insurers have misgivings over the impact on the opening balance sheet, while others see an opportunity to develop a more consistent approach across their international operations.

The third and highly influential stakeholder is the Federal Reserve, which faces the challenge of how to reconcile its international responsibilities as a member of the FSB with the practical need to align domestic prudential regulation with its Comprehensive Capital Analysis and Review (CCAR) programme. The Federal Reserve is likely to have the final say over both the timing and nature of the eventual response to the IAIS developments within the US. And there’s unlikely to be any resolution until legal challenges over the systemic risk designation are resolved. Further procedural hurdles could come from proposed legislation that would increase the requirements for public notification, review and approval of international insurance regulations impacting the US market.

8 Solvency II long-term guarantee package, PwC, 2015 (http://www.pwc.co.uk/assets/pdf/olpapp/hot-topic-solvency-ii-long-term-guarantee-package.pdf)
**Developments ahead**
Figure 1 sets out the timeline for the phased development and roll-out of the ICS.

**Figure 1: ICS timeline**

- **20 May 2016**
  - Launch of 2016 Quantitative Field Testing. Test to be run in 2 phases over the course of the Summer

- **Mid July 2016**
  - Publication of ICS Consultation document for a 3-month period

- **15 September 2016**
  - Data due for phase 2 of Field Testing

- **21 July 2016**
  - Data due for phase 1 of field test

- **31 October 2016**
  - Data due for phase 2+ of field test

- **c May 2017**
  - Launch of 2017 Quantitative Field Testing

- **May/June 2017**
  - ICS V.1.0 to be adopted for confidential reporting

- **May/Jun 2018**
  - Consultation on ICS V.2.0

- **IAIS 2019 AGM**
  - Adoption of ComFrame including V.2.0 ICS

Source: PwC analysis of IAIS announcements
ICS Version 1.0
The next milestone (ICS Version 1.0, adopted by June 2017) is the delivery of an ICS for confidential reporting purposes, which would be based on the two identified valuation approaches and a standard method for calculating the ICS capital requirement.

Upon completion of ICS Version 1.0, there are plans to consider other methods of calculation of the ICS capital requirement. Notably, this includes the use of internal models (partial or full), external models or variations of the standard method.

The IAIS wants all IAIGs to participate in the 2017 round of field tests. To maximise the input, group-wide supervisors will be encouraged to identify IAIGs in their jurisdiction and require them to participate.

ICS Version 2.0
The next milestone (ICS Version 2.0, for adoption within ComFrame in 2019) is the delivery of a more complete version of the ICS, which is ready for implementation by supervisors. ICS Version 2.0 may still include the two valuation approaches, but would aim to reduce differences in valuation. It may also allow for both the standard method for calculating the ICS capital requirement and other methods of calculation including the use of internal models (partial or full), external models or variations of the standard method (subject to ongoing discussions in these topics).

End goal
The ultimate goal (no final date as yet proposed) is a single comparable ICS based on a common methodology. The ongoing work is intended to lead to improved convergence over time on the key elements of the ICS.

Bringing it all together
The central challenge for the development of the ICS is how to bring the seemingly polarised market-adjusted and GAAP + approaches together. But there may be more grounds for constructive compromise than many presume. A clear starting point is the ORSA, which users see as a strong basis for aligning solvency and strategic management, and which employed in both the EU and the US. Other avenues for convergence include risk quantification and projection, with the cash flow approaches within GAAP + creating room for the use of internal models.

Alternatives
However, if common ground is difficult to find, are there alternatives that would satisfy the different constituencies? An option being developed by the American Council of Life Insurers would follow local solvency rules within each operating territory, and then aggregate the results with some small adjustments at group level. This option has the virtue of conceptual simplicity and allowing each country to maintain its own distinctive approach.

An alternative would be to develop a relatively simple and therefore easily applied factor-based approach for foundation capital requirements and then augment this with defined stress tests to determine the risk profile, sensitivities and capital adjustments within larger and more complex groups. The ‘foundation plus stress’ approach would provide a reasonable reflection of the true risk profile of the business, while being broadly in line with the Federal Reserve’s approach to CCAR.
Gauging the strategic and operational implications

It’s important to make your voice count on the ICS. As a lot of the business you write today will be affected by the eventual ICS, it’s also important to assess the impact of the different outcomes on prices and future capital.

Deliberations over the ICS are continuing. With the IAIS still playing its cards close to its chest, it’s important to look at the impact of the different potential outcomes on your particular portfolio and business strategy, and then use all the opportunities to constructively engage with supervisors and influence the shape of the eventual standard. This includes looking at the interactions with other capital metrics and assessing the need for any additional capital. Participating in the field tests would also provide a useful indication of both the operational and capital implications. We at PwC are doing all we can to gauge the impact of the different scenarios and put the views of our clients to people within the regulatory community.

With so much of the controversy over ICS centring on the valuation of long-term liabilities, it’s also important to assess the potential capital implications of the different ICS outcomes on the business you’re writing now.

With so much of the controversy over ICS centring on the valuation of long-term liabilities, it’s also important to assess the potential capital implications of the different ICS outcomes on the business you’re writing now.

It’s also important to assess the operational implications of the move to more sophisticated risk-based capital evaluation (see Figure 2). Clearly, the starting point depends on where you are in the world. The moves to SAM, C-ROSS and Solvency II not only highlight the systems challenges, but also the work needed to source the necessary data and develop valid management judgements. The underlying challenge is how to industrialise capital evaluation, validation and reporting and embed the new capital metrics into your business behaviours. And even if prudential regulation is already advanced within your operating territories, the IAIS developments will require you to think more about capital supervision at a group as well as entity level.
### Figure 2: Operational demands

There are a number of implementation issues that companies will face.

<table>
<thead>
<tr>
<th>Should the process be standalone or built on existing processes?</th>
<th>What level of systems development will be required?</th>
<th>To what extent are models, systems and processes designed and built at group versus reporting unit level?</th>
<th>What is the implementation cost and business case and are knowledgeable resources available?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Valuation</strong></td>
<td><strong>Required capital</strong></td>
<td><strong>Available capital</strong></td>
<td></td>
</tr>
<tr>
<td>• Assess and enhance data requirements for best estimate valuation.</td>
<td>• Material risk identification.</td>
<td>• Identification of capital tiers and ability to tag.</td>
<td></td>
</tr>
<tr>
<td>• Additional data for stochastic option and guarantee valuation.</td>
<td>• Risk variable time series data.</td>
<td>• Capital database for ongoing monitoring.</td>
<td></td>
</tr>
<tr>
<td>• Capability for current demographic assumption setting process.</td>
<td>• Risk variable correlation data.</td>
<td>• Asset data requirements.</td>
<td></td>
</tr>
<tr>
<td>• Timely access to current economic assumptions.</td>
<td>• Defining stress testing assumption calibration.</td>
<td>• Assumptions to forecast available capital.</td>
<td></td>
</tr>
<tr>
<td>• Yield calculation and extrapolation methods.</td>
<td>• Allowance for policyholder action.</td>
<td>• Asset assumptions where data not available.</td>
<td></td>
</tr>
<tr>
<td>• Approach to defining contract boundaries.</td>
<td>• Management actions assumptions.</td>
<td>• Mark to model valuation assumptions.</td>
<td></td>
</tr>
<tr>
<td>• Risk margin method and calibration.</td>
<td>• Risk capital calculation methods.</td>
<td>• Classification methods.</td>
<td></td>
</tr>
<tr>
<td>• Best estimate liability cash flow models.</td>
<td>• Tail risk modelling methods.</td>
<td>• Methods used to assess asset characteristics.</td>
<td></td>
</tr>
<tr>
<td>• Stochastic option and guarantee models.</td>
<td>• Allowance for management actions.</td>
<td>• Methods to value/assess non-marketable assets.</td>
<td></td>
</tr>
<tr>
<td>• Risk margin calculations.</td>
<td>• Internal model development.</td>
<td>• Assessment of loss absorbency.</td>
<td></td>
</tr>
<tr>
<td>• Identification of capital tiers and ability to tag.</td>
<td>• Model approval &amp; governance.</td>
<td>• Calculation of tier limits &amp; constraints.</td>
<td></td>
</tr>
<tr>
<td>• Capital database for ongoing monitoring.</td>
<td>• Standardised approach models.</td>
<td>• Capital ratios and forecasting.</td>
<td></td>
</tr>
<tr>
<td>• Asset data requirements.</td>
<td>• Allowance for management actions.</td>
<td>• Material risk identification.</td>
<td></td>
</tr>
<tr>
<td>• Assumptions to forecast available capital.</td>
<td>• Classification methods.</td>
<td>• Methods used to assess asset characteristics.</td>
<td></td>
</tr>
<tr>
<td>• Asset assumptions where data not available.</td>
<td>• Mark to model valuation assumptions.</td>
<td>• Methods to value/assess non-marketable assets.</td>
<td></td>
</tr>
</tbody>
</table>

Source: PwC
The challenge for insurers is how to ensure that the ICS is workable and useful rather than a costly headache. This includes ensuring that the regime is proportionate enough to minimise implementation costs and avoid needlessly tying up capital.

The further challenge is working out what the different ICS scenarios mean for your organisation and building this into decisions over the design and underwriting of long-term business.

It’s therefore vital that your business takes time to understand and engage with these important developments by contributing to consultations and taking part in the field tests.

ICS could be yet another hurdle in an already crowded regulatory agenda. But it could also be an opportunity for greater consistency in the regulation and supervision of the insurance industry. While a harmonised approach to global capital standards may make capital management within an IAIG more straightforward, it’s important that regulatory developments minimise significant capital and operational burdens.

Conclusion: ICS is at a critical juncture

Fusion or confusion? Standardising international capital regulations
Fusion or confusion? Standardising international capital regulations
Contacts

Mark Train
Partner
PwC UK
mark.train@uk.pwc.com
+44 (0) 20 7804 6279

Ellen Walsh
Partner
PwC US
ellen.walsh@us.pwc.com
1 646 471 7274

Ed Barron
Director
PwC UK
ed.barron@uk.pwc.com
+44 (0) 20 7213 3398

Brian Paton
Director
PwC UK
brian.w.paton@uk.pwc.com
+44 (0) 131 260 4378

Henry Essert
Managing Director
PwC US
henry.essert@us.pwc.com
646 471 4400

Richard de Haan
US Actuarial Services Life Leader
PwC US
richard.dehaan@us.pwc.com
+1 646 471 6491

Koichi Uzuka
Director
PwC Japan
koichi.u.uzuka@jp.pwc.com
+81 80 3755 2909

Hideki Takeuchi
Director
PwC Japan
hideki.h.takeuchi@jp.pwc.com
+81 80 4067 1232

Grace Jiang
Partner
PwC China
grace.jiang@cn.pwc.com
+86 (21) 2323 3576

Katherine Martin
Director
PwC Australia
katherine.martin@au.pwc.com
+61 (2) 8266 3303

Saskia Bosch van Rosenthal
Director
PwC Hong Kong
Saskia.bosch.van.rosenthal@hk.pwc.com
+852 2289 1805

Chris Hancorn
Partner
PwC Hong Kong
chris.a.hancorn@hk.pwc.com
+852 2289 1177
At PwC, our purpose is to build trust in society and solve important problems. We’re a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwC does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.