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Insurance Capital Standard: An opportunity for German insurers

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The insurance industry contributes to economic growth, triggers innovation and development and brings financial stability. To do that, they need a highly sophisticated and effective regulatory regime. Solvency II prudential framework is that standard in the European Union.

Likewise, it is essential to achieve a global regulatory framework. The IAIS has developed a group-wide supervision framework including governance requirements and a risk-based capital standard for international insurers: the Insurance Capital Standard (ICS).

The German insurance industry considers the ICS as a good opportunity to ensure the comparability among groups worldwide. The key demands regarding the implementation of the ICS are:

→ Achieving **sophisticated and effective regulatory regime such as Solvency II**, e.g. the application of Market-Adjusted Valuation (MAV) and capital requirements

→ **Allowing internal models** in the calculation of the ICS Capital Requirements

→ Design of a **consistent and compatible** approach for the risk margin

DIE DEUTSCHEN VERSICHERER

Introduction: A global market needs a world-wide consistent framework

Insurers play an essential role in the global economy as part of the financial sector. They provide risk coverage for countless commercial and private risks, **long-term guarantees** for saving products, promote **sustainable investments** and trigger innovation. Because of this economic and social importance, in recent years an increasing amount of attention has been devoted to the development of international standards to regulate and supervise their activity.

The Lehman Brothers collapse shook economies worldwide in 2008. As a result of that, and after the subsequent sovereign debt crisis after 2010, different bodies such as the Financial Stability Board (FSB) determined the need to establish a **global supervision framework**. Since then, the financial sector should be carefully supervised at international level to ensure its correct functioning and thus to prevent future financial crises.

Who develops the global supervision framework?

The **International Association of Insurance Supervisors** (IAIS)[1] develops the Insurance Capital Standard (ICS). This consists of a risk-based regulation framework that will initially be applicable to Internationally Active Insurance Groups (IAIGs). Subsequently, the ICS may be applied at the level of individual entities by different national regulators and has the potential to become a true global capital standard.

1 Further information on IAIS's website.

International Association of Insurance Supervisors (IAIS)

Established in 1994, the International Association of Insurance Supervisors (IAIS) defines the international standards for insurance supervision. The IAIS represents insurance regulators and supervisors of more than 200 jurisdictions in more than 130 countries, constituting 97% of the world's insurance premiums. Its objectives are to:

- promote effective and globally consistent supervision of the insurance industry, and;
- contribute to global financial stability in order to ensure fair, safe and stable insurance markets for the benefit and protection of policyholders.

Source: IAIS

Who is affected by the ICS?

The IAIS in its role as an international association with a mandate to establish standards of regulation and supervision of the insurance activity and to contribute to the financial stability has been working in the elaboration of harmonized frameworks for the financial supervision.

In this sense, the IAIS aims to **develop a common framework for the supervision of IAIGs, "ComFrame"**[2], which incorporates, as one of its key elements, an international standard of capital calculation risk-based regulation: the Insurance Capital Standard (ICS). The latest version, ICS 2.0, should be applicable to IAIGs that fulfil the following criteria:

- i at least 50 billion dollars of assets or 10 billion dollars in premiums;
- ii activity in at least three jurisdictions, and
- iii at least 10% of the premiums written outside the jurisdiction of origin.

What is the objective of the ICS?

The main objective of the ICS is the **protection of the policyholders**. Another important aspect is the contribution to **financial stability**. To do that, it is important to have a global standard to reflect all material risks to which an IAIG is exposed. This standard should **minimise inappropriate procyclical behaviour** in the insurance

2 ComFrame is the Common Framework for the Supervision of Internationally Active Insurance Groups. Further information on IAIS's website.

The main objectives of the ICS

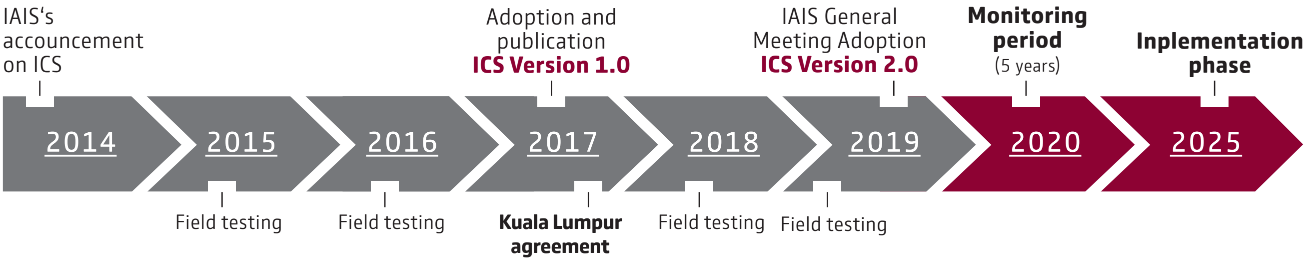
The ICS is based on the following objectives

- A common methodology to achieve comparable outcomes across jurisdictions
- Protection of policyholders
- To contribute to financial stability
- To reflect all material risks to which an IAIG is exposed
- To provide understanding of, and greater confidence, in cross-border analysis of IAIGs among group-wide and host supervisors
- To minimise inappropriate procyclical behaviour by supervisors and IAIGs
- An appropriate balance between risk sensitivity and simplicity

Source: IAIS

ICS Version 2.0: Timeline

Chart I **· Unified Path to Convergence on ICS 2.0**



Source: IAIS

market by allowing internal models in the prudential framework. In sum, the ICS will provide comparability of results across jurisdictions and therefore promotes confidence in analyses of IAIGs among different markets.

ICS Timeline

Since the beginning of the development of the ICS in 2014 many milestones have been reached. Thus, in early November 2017, the IAIS Executive Committee reached in Kuala Lumpur **an agreement on the unified path to convergence** towards a final standard (ICS Version 2.0). The schedule of the ICS preparation process is illustrated in the chart above. The adoption of ICS Version 2.0 is scheduled for the end of 2019, and has been elaborated from ICS Version 1.0. It still contains some options that have been subject to a field testing, before a final decision will be made on this. Once adopted, the implementation would be carried out in two phases: a first phase of a monitoring starting in January 2020 followed by an implementation phase.

Phase 1 – mandatory confidential reporting

The monitoring period will last five years. In this time, the ICS will be applied from 2020 for **confidential reporting** to the group supervisor and for discussions in supervisory colleges. It will be calculated using **market-adjusted valuation (MAV)**, a standard method for capital requirements, and converged criteria for qualifying capital resources. GAAP Plus valuation figures and internal model-based capital requirements can also be reported.

The main aim of this phase is to define which alternative approaches, including GAAP Plus and **internal models**, should be incorporated into the ICS by the end of the monitoring period. During this time, ICS results will not be used by national supervisors as a basis to trigger action. On the contrary, this phase will allow group-wide supervisors to discuss and assess the ICS in comparison with existing group capital standards.

Phase 2 – implementation as a "Prescribed Capital Requirement" (PCR)

At the end of the monitoring period, the second phase will be the "**implementation of the ICS as a group-wide PCR**". It is clear that the "Prescribed Capital Requirement" will be a measure of capital adequacy for IAIGs.

To become effective, it needs to be **adopted into European law**. However, it remains unclear how the capital standard will interact with, or function parallel to, existing capital standards such as Solvency II. High priority of German insurers is that the monitoring period is used to find a consensus in key topics such as valuation methods or internal models.

Different valuation approaches in ICS 2.0

One important decision not yet finalized relates to the **valuation of assets and liabilities**. The IAIS will allow in the monitoring phase insurers to create their balance sheets according to two different valuation methods: the "Market-Adjusted Valuation approach (MAV)", in line with Solvency II, and the "GAAP Plus".

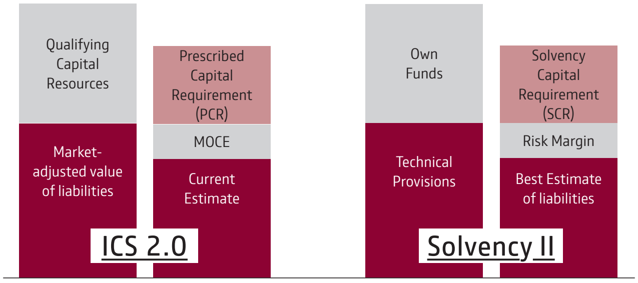
- **The MAV approach**: The MAV approach is based on the market value of assets, and on the current estimates for insurance liabilities. An IAIS-yield curve is used to project and discount the liability cash flows. The MAV provides consistency and comparability in economic and risk assumptions and ensures economically-driven valuations.
- **GAAP Plus**: This valuation method is based on amounts, processes and systems that are subject to existing audit systems such IFRS rules or US GAAP.

In sum, the difference that can arise between the two methods relies on the methodology for the discount of cash flows in the valuation of the insurance obligations. In the future, this could lead to material differences that would bring one of them closer to what would be a system of regulation based on pure risks.

The German insurers support a **market-adjusted valuation approach** as valuation method in the ICS 2.0.

A Comparison between ICS 2.0 and Solvency II

Chart II · **Liabilities side of the balance sheet**



Source: IAIS, EIOPA, GDV

ICS Capital Requirements

After the adoption of the ICS 2.0 in November 2019, it will be ready for monitoring purposes by supervisors. This version allows also 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 or variations of the standard method).

Standard method

The standard method specifies the appropriate treatment of specified categories of risk, and addresses the treatment of risk mitigation techniques and aggregation or diversification.

The ICS capital requirement, calculated using **a risk-based method**, is the amount of capital resources needed to cover losses that are exceeded only once in 200 years, i.e. a Value at Risk (VaR) with a 99.5% confidence level over a one-year period. The **ICS ratio** (the measure of capital adequacy, comparable to the Solvency Coverage Requirement (SCR) in Solvency II) is determined by comparing the amount of qualifying capital resources to the ICS capital requirement using the following ratio:

$$\textit{ICS ratio} = \frac{\textit{qualifying capital resources}}{\textit{ICS capital requirement}}$$

Each risk is measured individually using either a stress approach or a factor-based approach as in Solvency II. The correlation matrices are provided by the IAIS.

Internal models

Internal models are an integral aspect to capture a real picture of the IAIG's risk profile, thus determining key risk exposures and allowing regulators to detect risky performances. For this reason, **internal models** are a key part of a global supervision framework. Besides, its approval allows insurers to use their current expertise and infrastructure for Solvency II to calculate the ICS capital requirements.

During the monitoring phase, all IAIGs are allowed to use internal models in the calculation of the ICS capital requirements, subject to supervisory approval. The outcomes during the monitoring phase will be very important in providing a detailed look at the advantages they can offer.

GDV Positions

The development of the international risk-based standard brings **opportunities for the international insurance groups**. The key positions of the German insurers for the upcoming monitoring phase are:

- Achieving **sophisticated and effective regulatory regime such as Solvency II**, e.g. a Market-Adjusted Valuation method (MAV) and the Prescribed Capital Requirement (PCR) in the ICS standard formula,
- the support of **internal models** in the calculation of the ICS Capital Requirements, and
- the design of a **consistent and compatible** risk margin (MOCE).

The ICS 2.0 should promote a level playing field for financial institutions and enhance financial stability. In particular, the introduction of the global standard in the insurance sector will be helpful to avoid potential discrepancies between different jurisdictions, thus guaranteeing that international groups compete on equal conditions to offer consumers everywhere the widest and the best possible services.

In sum, the upcoming five-year monitoring phase presents a good chance to test and develop a worldwide consistent framework.

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