Insurance comprehensive risk framework

Alberto Corinti

Member of the Board of Directors,
Italian Insurance Supervisory Authority (IVASS)

Is ICS "globalising" some of the alleged flaws of Solvency II?

In designing a prudential framework, the valuation approach on which to base the determination of both the available and required capital is arguably the most difficult issue to resolve. The IAIS has taken an important step in this challenge by agreeing to use the Market Adjusted Valuation approach (MAV) as a benchmark for the Insurance Capital Standard (ICS). The MAV is conceptually similar to Solvency II and many other accounting frameworks, which should allow many insurers, particularly in Europe, to leverage their existing regulatory reporting data.

It is apparent, however, that the IAIS project could result in a global standard that departs to a variable extent from the current European framework, depending on its detailed finalization. From a European perspective this could imply two somehow contradicting undesired effects.

> *"The right way forward depends on a careful balance between diverging objectives."*
>
> \- ALBERTO CORINTI

Some are concerned that the global standard might depart so much from the Solvency II principles that it would fail to achieve the main prudential objectives of Solvency II. At the same time, this would create an additional burden for the European industry.

Others are concerned that the global standard could be so similar to Solvency II that it might replicate some of its alleged flaws. This would mainly depend on its market consistent approach, and in particular on the excessive volatility of the related solvency metrics, which could end up penalizing long-term business and the crucial role of insurance in supporting and stabilizing the economy.

From the supervisor's perspective the right way forward depends on a careful balance between diverging objectives. In my view the ICS should not abandon a market consistent valuation framework. This valuation approach facilitates proper >>>

>>> prudential consideration of all the main risks an insurance company is exposed to and, in particular, it allows for the sufficiently early detection of any materialization of these risks. The Solvency II experience shows that this approach also fosters enhanced risk governance within the insurer's organization as well as increased transparency in solvency reporting. At the same time, however, the framework should be adjusted so as not to unduly penalize long-term business.

In fact, based on the current proposal, the reference ICS relies on a MAV. The adjustments are a critical feature of the ICS valuation framework with the objective to reflect the long-term nature of insurance contracts. They aim is to mitigate potential excessive volatility in capital resources by avoiding reflecting changes in market conditions that do not affect the insurer's solvency. Hence, they acknowledge the asset liability management and its investment consequences.

At the same time, the ICS aims to include all the quantifiable risks and provides a quantitative measure of the actual exposure of the insurer to these risks. As such, the objective is neither to incentivise nor to penalise particular insurance markets or asset classes, but rather to ensure adequate capital coverage for the specific risk profile of an insurer, based on a predefined prudential measure.

The IAIS uses all available data in an open dialogue with the stakeholders to calibrate the risk charges. One example is the ICS's treatment of infrastructure investments: the IAIS will use the monitoring period to review the available information and to assess whether there should be a differentiated treatment for these investments.

The challenge is to properly design and calibrate these adjustments and capital charges without departing from a market consistent valuation and a risk sensitive capital determination. This is not an easy balance to be found, and indeed the main flaws of the current Solvency II framework, in my view, stem from not having found the right balance of these objectives yet. The current Solvency II review aims to address exactly these flaws. It focuses mainly on the so called "long-term measures" and on the calibration of the capital requirements. It is evident that developing and improving such a complex framework needs its time.

In this context, obviously, it is crucial that the Solvency II review and the ICS develop towards these objectives, in order produce a regulation which protects policyholders and, at the same time, do not constraints the social and economic role of insurance.

Joseph L. Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife, Inc.

The G20 challenge – what role for insurers in a single ICS world?

All sectors have important roles to play in facing the G20 global challenge to foster economic growth. Insurers in particular can play a leading role in providing long-term protection products which naturally lead to the growth of capital markets. In ageing societies, we can help governments meet important public policy goals via both our products and investments.

Among the many important topics covered by the Declaration is the G20 commitment to "strong, sustainable, balanced and inclusive growth." Insurers are uniquely placed to assist with this challenge. They offer protection tailored to the needs of individuals and families against adverse events that could otherwise have severe economic consequences. Protection of these most fundamental societal units against severe financial setbacks supports enhanced productivity for all and a collective contribution to inclusive economic growth and a strong social fabric.

The Declaration underscores the challenge of funding aging societies and maintaining a well-functioning fiscally sustainable social safety net. The long-term products many insurers offer play a critical role in assisting governments meet this huge challenge with both accumulation and decumulation products. >>>

>>> Long-term products are gifts that go on giving. They promote economic growth through liability-driven investments in capital markets. Long-term liability-driven investments can stabilize the financial system; their illiquid nature encourages buy and hold strategies that can ride out turbulence that may force other investors to sell into falling markets. Data from the 2008 financial crisis bears this out.

As the foregoing makes clear, the risks insurers assume arise out of geographic or demographic characteristics that create unique societal needs. Accordingly, insurance operations and the regulation of these operations are largely local and tailored to local requirements. Many global insurers, including MetLife, are concerned that the ICS is not sufficiently developed and won't allow us to meet the varying local needs for insurance products.

"The study should assess if the ICS will create artificial volatility or reduce...protections."

- JOSEPH L. ENGELHARD

While there is a need for a common language to facilitate understanding among supervisors of large, global groups, an insistence on a goal of a single framework focused on near-term market movements threatens the diversity of product offerings, social support and positive impact on economic growth that insurance traditionally provides. This result runs counter to G20 calls for a virtuous cycle of growth where all may realize their full potential.

To avoid these negative outcomes, we believe it is necessary to address the remaining ICS design issues during the five-year monitoring period, which the IAIS admits should be a period of continued development of the ICS. We also believe it is critically important for the FSB and IAIS to do an impact study. The study should assess if the ICS will create artificial volatility or reduce policyholder protections. This requires studying not just how the ICS would impact insurers during a financial crisis but, more importantly, how insurers might adjust their product offerings to the detriment of the public policy goals of protecting consumers in the long-term and making long-term investments in capital markets and infrastructure. ●

Tobias Bücheler

Head of Regulatory Strategy,
Allianz SE

Navigating treacherous waters – the ICS 2.0 and the monitoring period

After substantial development efforts since 2013, the International Association of Insurance Supervisors (IAIS) intends to finalize the global Insurance Capital Standard version 2.0 in November 2019. This will be followed by a 5 year monitoring phase in which the ICS shall be discussed in supervisory colleges of Internationally Active Insurance Groups (IAIG) prior to its adoption in 2025.

While Allianz has been supportive of the development of a truly global insurance capital standard since its inception, we are concerned about current proceeding due to design but also implementation challenges and related implications.

From a design perspective, major elements of the ICS, such as the final discount methodology, the risk margin approach and the deferred tax concept remain yet to be defined. As a result, the final ICS 2.0 will be subject to last minute changes resulting in a framework that has not been thoroughly tested. This does not bode well as a basis for the monitoring period in which only limited adjustments were initially envisioned.

Against this background we believe that it is important to allow for a comprehensive quantitative impact study (QIS) to test the ICS under different economic scenarios but also to address remaining concerns by stakeholders regarding potential pro-cyclical investment incentives, impact on long-term life insurance products and financing of the real economy. The ICS 2.0 should then be evaluated based on the QIS results and further developed as relevant. This is also important to avoid a premature relevance of the ICS for capital markets which would inevitably result when markets perceive the ICS as completed.

These challenges are further aggravated by the fact that the ultimate target picture for the ICS remains somewhat elusive. The IAIS' Kuala Lumpur agreement calls for a standard ICS to be implemented by relevant jurisdictions, possibly complemented by „outcome equivalent" regimes. The local adoption of any future ICS standard however seems unclear especially considering ongoing developments of local regimes in major markets like USA, Europe and Japan.

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- TOBIAS BÜCHELER

Against this background it might be worth considering whether a global equivalence framework based on an ICS benchmark could be a more viable alternative. Such a framework would allow jurisdictions to assess foreign regimes for recognition as equivalent under local rules and could provide a pathway towards a joint global language for supervision while addressing level playing field concerns and respecting relevant jurisdictional specificities. ●

Martin Merlin

Director, Bank and Insurance, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Ramping up insurers' contribution to European long-term and sustainable growth

The European economy needs more stable capital in order to finance tangible assets (including energy infrastructure, industrial facilities, climate change and eco-innovation technologies) as well as intangible assets (such as education and research and development) that boost growth, innovation and competitiveness.

With trillions of assets under management, the insurance sector remains a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurance groups can greatly contribute to the sustainable and long-term financing of the economy. They have therefore a pivotal role to play in the context of both the Capital Markets Union (CMU) and the Commission's Sustainable Finance Action Plan. By being able to invest counter-cyclically, they can also temper down excessive price movements in financial markets, thereby contributing to financial stability.

> *"It is now up to insurers to help finance the shift to a low-carbon economy and a sustainable growth."*
>
> \- MARTIN MERLIN

In the current low-yield environment, investments in equity and green infrastructure should attract insurance groups, as they provide regular income and some inflation hedge with low correlation to the returns of other investments. However, in practice, insurers have been retrenching from long-term assets and the actual share of their investments in the real economy and in green infrastructure remains limited. Further, some studies challenge the counter-cyclical nature of insurers' investment behaviours.

As part of the CMU Action Plan, the Commission is committed to identifying the barriers that are keeping insurers' allocations to long-term investments low, and to determining which policy levers can help overcome these barriers. In this regard, some stakeholders claim that the prudential framework, relying on market value and capital requirements calculated over a 1-year time horizon, have fostered insurers' short-termism in investment decisions. On the other hand, the downward trend of investments in long-term assets dates back to the late 1990s, and therefore cannot be only driven by prudential rules.

In fact, the prudential regulation should neither unduly favour nor hinder long-term investment but provide the right incentives for robust risk-management while avoiding excessive risk-taking both from a micro- and macro-prudential perspective. The European Commission has recently amended Solvency II to lower capital requirement for long-term investments in equity, including in small and medium sized enterprises, provided that insurers have implemented appropriate asset-liability management.

In the context of the forthcoming broad review of the Solvency II Directive in 2020, the Commission will further explore whether the prudential framework appropriately reflects the long-term nature of the insurance business and the ability of insurers to invest counter-cyclically, as well as the impact of Solvency II on insurers' sustainable investments.

As regards the Sustainable Finance Action Plan, building on the future EU taxonomy, the integration of sustainability considerations in financial advice or the current discussions on an EU Green Bond standard can ramp up the contribution of the insurance sector to the greening of the economy and to our climate objectives.

It is now up to insurers to help finance the shift to a low-carbon economy and a sustainable growth. ●