



**IAIS**

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INTERNATIONAL ASSOCIATION OF  
INSURANCE SUPERVISORS

**Basic Capital Requirements for Global Systemically  
Important Insurers (G-SIIs):  
Proposal**

**16 December 2013**

**Public Consultation Document  
Comments due by 3 February 2014**

## About the IAIS

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets. In addition to active participation of its Members, the IAIS benefits from input in select IAIS activities from Observers representing international institutions, professional associations and insurance and reinsurance companies, as well as consultants and other professionals.

The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), founding member and co-parent of the Joint Forum, along with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), member of the Standards Advisory Council of the International Accounting Standards Board (IASB), and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector.

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## 1 Overview and process for responding

### 1.1 Purpose

- 1 The purpose of this Consultation Document is to solicit feedback regarding proposed options for the development of global Basic Capital Requirements (BCR)<sup>1</sup> for Global Systemically Important Insurers (G-SIIs). These requirements are expected to apply to G-SIIs from 2015 or shortly thereafter.
- 2 The development of the BCR is the first step of an International Association of Insurance Supervisors' (IAIS) project to develop group-wide global capital standards. The second step is the development of Higher Loss Absorbency (HLA) requirements to apply to G-SIIs, due to be completed by the end of 2015. The HLA will build on the BCR and address additional capital requirements for G-SIIs reflecting their systemic importance in the international financial system. The third step is the development of a risk-based group-wide global insurance capital standard (ICS), due to be completed by the end of 2016, and to be applied to IAIGs (as defined using the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) criteria) from 2019 after refinement and final calibration in 2017 and 2018. The development of the ICS will be informed by the work on the BCR.
- 3 Feedback on this Consultation Document will inform the field testing process the IAIS will conduct in the second quarter of 2014 and the subsequent analysis which will support the design and development of the BCR.
- 4 The IAIS is aware that data collected during field testing may be confidential and commercially sensitive. The IAIS is committed to execute appropriate confidentiality agreements and protocols to protect the commercial interests of field testing participants.
- 5 The views expressed in this Consultation Document are preliminary and may not be reflected in future IAIS standards.

### 1.2 Providing feedback

- 6 Comments on this Consultation Document are invited by 3 February 2014. The IAIS has committed to deliver a BCR proposal for the G20 summit in November 2014 and that deadline should be taken into account when comments are provided. Comments are invited on any aspect of this paper. Responses are most helpful if they:
  - Are clear as to the issue being addressed,
  - Provide a clear rationale and basis for comments made, and
  - Describe alternatives proposed for consideration.
- 7 Comments must be sent electronically via the "Consultations" page on the IAIS website <http://iaisweb.org>. All comments will be published on the IAIS website unless a specific request is made for comments to remain confidential.

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<sup>1</sup> The abbreviation BCR refers to both "backstop capital requirements" and "basic capital requirements" as there has been an evolution in the development of the BCR from a backstop role to a basic role. See section 3.5.

## 2 Executive summary

### 2.1 Overview

- 8 On 18 July 2013, the IAIS and the Financial Stability Board (FSB) made the following joint commitment:  
*As a foundation for HLA requirements for G-SIIs, the IAIS will as a first step develop straightforward, backstop capital requirements to apply to all group activities, including non-insurance subsidiaries, to be finalised by the end of 2014.*
- 9 The IAIS considers it appropriate to use the term “Basic Capital Requirements” (BCR) instead of “backstop capital requirements.” In banking, the Basel III Framework provides a global risk-based capital standard and so it is relevant to apply a backstop to that accord. In the insurance context there is not yet a global risk-based regime against which a backstop could apply.
- 10 The lack of comparability of insurance liabilities between different jurisdictions is a major issue, as is the need for the BCR to include some risk sensitivity. The development of the BCR that provides, albeit at a “basic” level, globally comparable outcomes is a necessary first step to the development of the Higher Loss Absorbency (HLA) for Global Systemically Important Insurers (G-SIIs). The BCR thus plays a different role and has different characteristics compared to the Basel III Leverage Ratio.<sup>2</sup>
- 11 The IAIS has committed to develop group-wide global capital standards:
- The first step is to develop the BCR by the end of 2014.
  - The second step is to develop HLA requirements for G-SIIs by the end of 2015. The primary role of the BCR will be to serve as the foundation for HLA.
  - The third step is to develop a risk-based group-wide global insurance capital standard (ICS) by the end of 2016. The ICS is to apply to Internationally Active Insurance Groups (IAIGs)<sup>3</sup> from 2019.
- 12 The development and field testing of the BCR will inform development of the ICS. When the ICS is developed the role of the BCR will be reassessed. That is, once a front-stop has been developed, it becomes feasible to develop a backstop that is logically aligned with that front-stop. Also, when the ICS is developed, it is intended that the HLA will be determined using the ICS as a foundation.

### 2.2 Approach

- 13 A “factor-based” approach will be adopted to develop the BCR that multiplies factors and proxy measures of major risk exposures and then sums the results to obtain the required capital. This approach reflects a combination of proposals received from IAIS Members,

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<sup>2</sup> As noted in the Basel Committee on Banking Supervision (BCBS), Consultation Paper discussing its backstop Leverage Ratio, see <http://www.bis.org/publ/bcbs251.pdf>, is asset focussed and is not risk sensitive. The behaviour of asset risks is generally not a good proxy for the behaviour of insurance liability risks.

<sup>3</sup> As defined using the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) criteria from 2019 after refinement and final calibration in 2017 and 2018. All G-SIIs are also subject to ComFrame.

extracts the best features from them, and satisfies an agreed set of guiding principles. Other options were considered, but they were not considered appropriate for the purpose of the BCR given its scope and development timeframe.

- 14 The IAIS has developed and endorsed six principles to guide the development of the BCR and to provide a high-level framework against which the final design will be considered. The three substantive principles are: (1) that major risk categories should be considered, (2) there is comparability of outcomes across jurisdictions and (3) the BCR has resilience to stress. These are complemented by three constructive principles.<sup>4</sup>
- 15 Within this core structure, proxy measures of risks need to be selected and their factors calibrated. It is intended the BCR will have a relatively small number of risk measures and factors. This supports a simple structure in the sense of having few factors while retaining transparency.
- 16 There is a natural tension between the objectives of simplicity, comparability and risk-sensitivity in the development of regulatory capital frameworks. An over emphasis on any one of these objectives may compromise the others. Finding an appropriate trade-off between granularity and risk sensitivity will be investigated through a field testing process, which will be carried out in the second quarter of 2014.
- 17 Current estimates<sup>5</sup> are the proposed proxy measure for insurance liabilities (excluding any prudential margins). For asset valuations, it is proposed to use generally accepted accounting principles in each relevant jurisdiction, with various adjustments (for example, for invested assets use fair value measurement as a basis for valuation). Field testing will inform the appropriate level of granularity required and will provide an understanding of the impact of stresses on that balance sheet. Non-traditional and non-insurance (NTNI) risks also need to be addressed to ensure that risks from all group activities are considered.
- 18 The potential integration of other risk areas, such as operational and liquidity risk, will require future consideration, but that work is beyond the scope of the BCR.
- 19 For determining the BCR, the starting point is the consolidated group balance sheet. Where there are non-financial activities, non-material activities should be excluded where appropriate. Off-balance-sheet exposures also need to be considered.
- 20 A sole focus on capital requirements does not provide a full picture when assessing the financial condition of G-SIIs. While important, they are one of many elements of a full supervisory assessment, which requires a total balance sheet approach taking into account all risks relating to assets and liabilities, both on- and off-balance-sheet, an evaluation of qualifying capital resources with proper adjustments reflecting specific

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<sup>4</sup> See section 3.4.

<sup>5</sup> ICP 14.8, states: “The current estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling insurance obligations, using unbiased, current assumptions.” In other contexts a “current estimate” may be called a “best estimate.” A “best estimate” of a quantity is, in principle, an estimate of the quantity that is neither deliberately overstated nor deliberately understated. The determination of a best estimate needs to be made within the context of its use. That is, the purpose for which it will be used needs to be clear and properly reflected.

characteristics of insurance liabilities, as well as other quantitative and qualitative elements.

### 2.3 Generic example

- 21 As a generic example, the application of a factor-based approach might proceed as follows. The key focus is on whether the Qualifying Capital Resources exceed the Required Capital or not. This can be expressed in terms of a ratio, which provides a metric that is comparable between G-SIIs.

$$\text{BCR Adequacy Ratio} = \text{Qualifying Capital Resources} / \text{Required Capital}$$

If the BCR Adequacy Ratio exceeds 100%<sup>6</sup> then the BCR is met, otherwise it is not.

- 22 The Required Capital reflects each of the major categories of risk:

$$\begin{aligned} \text{Required Capital} &= \text{Sum of (Liability factors multiplied by Liability measures)} \\ &+ \text{(Sum of Asset factors multiplied by Asset measures)} \\ &+ \text{(Sum of NTNI factors multiplied by NTNI measures)} \\ &+ \text{(Sum of Other factors multiplied by Other measures)} \end{aligned}$$

The degree of risk sensitivity could be increased by using additional factors (as discussed below).

- 23 The second component of the BCR Adequacy Ratio is:

$$\begin{aligned} \text{Qualifying Capital Resources} &= \text{Capital resources} \\ &+/- \text{(plus or minus) Adjustments (to obtain qualifying capital resources for} \\ &\text{BCR purposes)} \end{aligned}$$

### 2.4 Key risks addressed

- 24 The primary risks faced by G-SIIs in their insurance business are those arising from insurance liabilities. They also face asset and NTNI risks. Each of these major categories of risk includes diverse elements and, potentially, interactions between those elements when risk events occur. To satisfy the principle that major risk categories are considered these three major risk categories need to be considered.
- 25 Insurance liability risks:
- The most basic proposal would only discern between life insurance and non-life insurance. More detailed and risk responsive proposals would include more business segments, such as: life insurance with minimum guarantees; life insurance without guarantees; non-life short tail insurance; non-life long tail insurance; and non-proportional reinsurance.
  - The primary risk measures that should be used for insurance risks are the current estimates of insurance liabilities. Differentiation arises with respect to the number of business segments reflected.

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<sup>6</sup> The benchmark need not be set at 100% but could be set at a different level, if so desired.

- As a contingency with respect to the allotted timeframe and possibly to reflect other aspects of some insurance risks, proxies for current estimate calculations (for example, premiums and/or claims for non-life insurance and sums at risk for life insurance) may be considered.

26 Asset risks may be assessed in several ways:

- Differentiation by category of assets (bond and loans, other assets, reinsurance assets).
- Differentiation between assets covering insurance liabilities (with and without duration matching) and other assets.
- Differentiation between investment grade and non-investment grade assets.

27 NTNI risks:

- NTNI risks are partially addressed above. Some NT risks will be addressed, for example, by having a specific factor for life/unit linked with guarantees, as this takes account of variable annuities.
- NI risks will be addressed by taking the respective sectoral capital requirement for non-insurance subsidiaries, for example, Basel III for banking subsidiaries, requirements for securities subsidiaries and Basel III equivalent for the rest.
- More detailed reflection of NTNI risks could include additional NTNI factors akin to the G-SII assessment methodology (for example, credit/financial guarantee insurance, short and long term liabilities, off-balance-sheet items, assets under management, and variable interest entities).

28 Asset Liability Matching (ALM) is a major risk category, particularly for life insurance, and so it is desirable that ALM risks be included. However, practical difficulties within the given timeframe for the development of the BCR may pose a particular challenge for addressing this risk category.

## 2.5 Other Considerations

29 In implementing a factor-based approach, there is a continuum of possibilities to investigate. Given the need to reflect the major categories of risk identified above and the need to align incentives to G-SIIs to be consistent with their risk management activities and decisions, the IAIS considers that a simplistic one-factor approach is not appropriate. In particular, the IAIS believes that the use of the Basel III Leverage Ratio for G-SIIs is not appropriate.

30 It is considered unlikely that fewer than five measures and factors will be used, if major risk categories are to be reflected. It is considered desirable to have 10 or less factors used to support the retention of the impression of a simple structure. The trade-off between this simplicity and risk responsiveness will be investigated through the field testing process.

31 The potential to directly apply pre-calibrated factors from other already established solvency and capital frameworks, such as Solvency I and Basel III, will also be considered. This may provide a means to accelerate the upcoming calibration effort. However, use of any existing pre-calibrated factors would need to be done on a coherent basis to ensure consistency.



- 32 There is a clear need for the field testing referred to above. To support informed decision making in matters such as considering the robustness and availability of data for effective calibration of factors and assessment of the importance of various risk measures, it is necessary to collect current data from industry, particularly G-SIIs. The field testing required to support the development of the BCR is being integrated into the broader field testing work already in progress for ComFrame. The IAIS is confident that the BCR field testing and analysis can be completed in a timely manner to provide a firm basis for the delivery of a specific and credible BCR proposal within the available timeframe.
- 33 A further issue that will be considered during field testing and analysis work is that of discouraging unintended consequences, or “gaming,” of the BCR process. That is, the BCR should not discourage sound risk management and not provide encouragement for inappropriate risk taking behaviours.
- 34 Limitations, such as a limitation of the number of factors that may be considered, should not be imposed on the development of the BCR prior to the opportunity to obtain data and undertake proper analysis. To support informed decision making, it is likely that data of higher granularity than that expected to be ultimately used will be sought to provide an objective basis from which a decision to use fewer factors may be taken.

## **2.6 Conclusion and next steps**

- 35 The IAIS is confident that a viable BCR can be developed within the timeline required and that constraints due to the limited timeframe for developing the BCR can be appropriately addressed.
- 36 A factor-based approach will be adopted to develop the BCR. The implementation of this approach requires field testing to obtain reliable data and to assess trade-offs between simplicity, risk sensitivity and comparability. Since the BCR mandate references all these criteria, their balance in the development of the BCR is important.
- 37 The timeline for the development of the BCR is:
- December 2013 – Consultation Document published
  - 16 December 2013 to 3 February 2014 – public consultation period
  - March to May 2014 – field testing
  - April to July 2014 – selected expert input sought as and when deemed appropriate by the IAIS
  - June to August 2014 – analyse results from field testing and reflect this and other feedback in BCR proposal and development of factors
  - July/August 2014 – second public consultation period (specific dates to be determined)
  - September 2014 – IAIS to approve BCR proposal
  - October to November 2014 – FSB to review BCR proposal
  - November 2014 – G20 to endorse BCR proposal

- 38 In the longer term, the proposed development of a set of global insurance capital standards can be summarised as follows:
- Develop BCR as the foundation for HLA by the end of 2014
  - Decide in 2014 whether the BCR will also apply to IAIGs and, if so, when
  - Develop the HLA for G-SIIs by the end of 2015 (to apply from 2019)
  - Develop the ICS for IAIGs (which include all G-SIIs) by the end of 2016 (to apply from 2019)
  - When the ICS is developed, consider the need for backstop measures for all IAIGs and review the construction of the HLA in light of the development of the ICS
  - A backstop measure for all IAIGs might include some, all or none of the elements of BCR as initially developed for G-SIIs

### 3 Context

#### 3.1 Background

- 39 The global financial crisis underscored the interconnected nature of major financial firms and the widespread financial and economic costs that could be caused by their severe distress or failure as well as the need for public sector interventions to mitigate those costs.
- 40 The G20 Leaders and the FSB have agreed to identify financial firms that are systemically important and to take measures to lessen the impact and reduce the moral hazard associated with public sector interventions to mitigate the distress or failure of such financial firms.
- 41 In July 2013, the IAIS published an assessment methodology, *Global Systemically Important Insurers: Initial Assessment Methodology*,<sup>7</sup> that supports the FSB designation of any insurers whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity. The IAIS also published a framework of policy measures, *Global Systemically Important Insurers: Policy Measures*<sup>8</sup> that should be applied to insurers that are determined to be G-SIIs.
- 42 On 18 July 2013, the FSB and national authorities, in consultation with the IAIS, identified an initial list of nine G-SIIs<sup>9</sup> to which the IAIS policy measures will apply. These G-SIIs were identified using the IAIS assessment methodology. Going forward, the list of G-SIIs is intended to be updated each year in November, starting in 2014. Consideration of reinsurers for designation as G-SIIs was deferred until 2014.
- 43 At the same time as the initial list of G-SIIs was announced, it was announced by the IAIS and the FSB that, as part of the development of HLA capacity for G-SIIs, the BCR would be developed.

#### 3.2 The BCR mandate

- 44 The IAIS<sup>10</sup> and FSB<sup>11</sup> announced on 18 July 2013 that:  
*As a foundation for HLA requirements for G-SIIs, the IAIS will as a first step develop straightforward, backstop capital requirements to apply to all group activities, including non-insurance subsidiaries, to be finalised by the end of 2014.*

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<sup>7</sup> See [http://www.iaisweb.org/view/element\\_href.cfm?src=1/19151.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf), 18 July 2013.

<sup>8</sup> See [http://www.iaisweb.org/view/element\\_href.cfm?src=1/19150.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf), 18 July 2013.

<sup>9</sup> See [http://www.financialstabilityboard.org/publications/r\\_130718.pdf](http://www.financialstabilityboard.org/publications/r_130718.pdf), 18 July 2013.

<sup>10</sup> See <http://iaisweb.org/db/content/1/19152.pdf>, 18 July 2013.

<sup>11</sup> See footnote 9.

- 45 The BCR is expected to reflect the risks and required capital associated with different business segments or activities and so may be expected to reflect a range of factors. The BCR is intended to provide a more comparable foundation for the HLA than local capital requirements, which often differ considerably across jurisdictions.
- 46 The breadth of applicability of the BCR is also noted from the announcement's words "apply to all group activities, including non-insurance subsidiaries." This wording emphasises the cross-sectoral nature of the rationale for the BCR and the need to consider, and where considered appropriate reflect, developments in other parts of the financial sector, such as the Joint Forum's *Principles for the Supervision of Conglomerates*<sup>12</sup> and *Review of the Differentiated Nature and Scope of Financial Regulation*.<sup>13</sup>
- 47 The BCR will be developed with the goal that G-SIIs continue as "going concerns."

### 3.3 Scope of application

- 48 For the purposes of determining the BCR, the starting point is the consolidated group balance sheet. Where that group conducts non-financial activities, non-material activities should be excluded where appropriate. Off-balance-sheet exposures also need to be considered.
- 49 The BCR needs to capture NTNI risks. The BCR should only reflect the aspects of NTNI risks that impact on the group's insurance operations, with the systemic risk aspects of those risks being addressed by the HLA.

### 3.4 Principles

- 50 The IAIS has developed six principles to guide development of the BCR. These principles provide a high level framework against which approaches and proposals may be reviewed. The principles are:

Substantive principles:

- **BCR Principle 1 - Major risk categories should be reflected.** The BCR must reflect major insurance risks including risks from both assets and liabilities, and non-insurance risks.
- **BCR Principle 2 - Comparability of outcomes across jurisdictions.** Outcomes should be comparable across jurisdictions. This implies the need to minimise distortions, including those arising from differing levels of conservatism included in valuation processes. The level of discretions that may be applied or introduced should be minimised across jurisdictions and over time.
- **BCR Principle 3 - Resilience to stress.** The BCR should be able to function in a wide variety of circumstances (including a stressed macro environment) and remain valid. Approaches adopted should be testable against historic data and

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<sup>12</sup> See <http://www.bis.org/publ/joint29.pdf>, 2012.

<sup>13</sup> See <http://www.bis.org/publ/joint24.pdf>, 2010.

circumstances to reflect the impact of major drivers of experience that are appropriate for a basic capital requirement.

Construction principles:

- **BCR Principle 4 - Simple design and presentation.** The design of the BCR needs to be pragmatic and practical. The form of presentation of the BCR, focusing on meaningful communication to external parties, should be “simple” and “intuitive” at a high level, yet sufficiently granular for the results to be fit for purpose. The BCR should utilise the minimum number of parameter and data requirements while attaining valid and robust outcomes with a focus on material issues.
- **BCR Principle 5 - Internal consistency.** The structure of the BCR needs to be consistent and should be applicable over the range of insurance and non-insurance entities it will need to cover and over time.
- **BCR Principle 6 - Optimise transparency and use of public data.** The level of transparency, particularly with regard to the final results provided, and the use of public data should be optimised.

51 BCR Principle 4 specifically points to the need to be pragmatic and practical. Meeting this need is emphasised by the short time frame in which the BCR is to be developed. A consequence of meeting this need is the recognition that focus must be placed on material issues, that is, issues that materially impact BCR outcomes.

52 This, coupled with the use of the word “straightforward” in the BCR mandate, also implies there will almost certainly be the need to use approximations in BCR. This may also lead to the outcome that some risks may be addressed implicitly, as it is judged that the behaviour of other risks, addressed directly, is sufficiently similar or representative that the approximation of reflecting the risk addressed implicitly versus the risk addressed explicitly is adequate for the purposes of the BCR.

53 In financial services, a regulatory objective is the prevention or discouragement of “regulatory arbitrage” of capital requirements across sectors and jurisdictions. That is the situation where a financial services product may be provided under multiple regulatory regimes but its provision under one regime requires less capital than under a different regulatory regime. There is a need to ensure, in the development of capital requirements and measures for G-SIIs, that opportunities for regulatory arbitrage between the banking and insurance sectors are not increased. In the design of capital requirements for G-SIIs, this requires the recognition and understanding of the design and intended impacts of banking capital requirements.

### 3.5 Role of a “basic” BCR

54 The primary purpose of the BCR is to provide a foundation for the application of the HLA. The BCR should thus be regarded as basic capital requirements and the work being undertaken for its development should be regarded as a stepping stone towards the ICS. To reflect this view, the BCR is being renamed **basic** capital requirements rather than backstop capital requirements. A basic capital requirement is a logical first step at the global level until a global front-stop (i.e. the ICS) has been developed. Once a front-stop has been designed it is much more feasible to develop a genuine backstop that would have logical alignment with the front-stop.

- 55 The BCR will serve as the foundation for HLA requirements for G-SIIs. It is anticipated that its development and testing will also inform development of the ICS. This foundation role is taken to be primarily in terms of calculation of the quantum of HLA using the BCR as the base level of capital requirement. When the ICS<sup>14</sup> is developed, it is possible that the HLA will then be determined (and so revised) using the ICS as a foundation. In addition, once the ICS is in place, the role and specific form of the BCR should be reconsidered.
- 56 The BCR is not expected to be breached as a matter of course under normal business conditions but, in some circumstances, for some G-SIIs, it may be breached. It is noted that if the BCR for a G-SII is breached then this implies that the HLA has already been breached. For G-SIIs which are facing a short supply of appropriate capital resources and may be under some stress, the possibility and consequences of breaching the BCR could be material.
- 57 As there is no global risk-based insurance capital standard, the BCR should provide a more comparable base than local capital requirements upon which to apply the HLA uplift. Longer term, the role of the BCR could change as the ICS evolves into a global standard. Until the ICS is developed, the BCR will serve as the basic capital requirements although it may also share some of the goals of a backstop measure.
- 58 Some of the considerations that need to be balanced in both the short and longer term in the development of both basic and backstop capital requirements include:
- There is a natural tension between the objectives of simplicity, comparability and risk-sensitivity in the development of regulatory capital frameworks. An overemphasis on any one of these objectives may compromise the others.
  - The pursuit of increased risk sensitivity, including internal models, can considerably increase the complexity of capital adequacy frameworks and makes the effective supervision of large complex financial institutions more difficult.
  - There is benefit in having “simpler,” more “straightforward,” backstop capital measures to supplement a core risk sensitive “front-stop” capital framework. Provided this backstop is not just a summarised version of the core measure (that is, it has an alternative development) it can provide a floor and/or a “sensiblyness” check of the results from the “core” measure. It thus provides some protection against arbitrage or bias in application.
  - Another implication of the more straightforward nature of a backstop is that it becomes inherently less reflective of risk profile differences between G-SIIs. Provided it is used and interpreted understanding this, and in a broader context, and given that the G-SII population is not as diverse as the whole insurance sector, it is not anticipated this will be an issue.
  - A backstop is not intended to replace a front-stop global standard, but to supplement it. Being more straightforward than a front-stop, the backstop could provide some early warnings of impending issues through being more quickly available. This may be particularly pertinent in the case of more sophisticated front-stop requirements, for instance when (internal) models are allowed, and/or in unusual circumstances.

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<sup>14</sup> See Annex A – Relationship with other IAIS initiatives.

- Due to its different nature, a backstop potentially improves comparability of outcomes between entities and so may provide regulators and other counterparties with an alternative tool. Such improved comparability needs to be balanced by an understanding that a backstop is inherently less precise and less risk sensitive than a more sophisticated front-stop capital standard.

59 The IAIS is aware that different circumstances, including economic circumstances, may apply in different jurisdictions or economic regions at any point in time. Hence, comparability needs to take into account economic differences, such as differences in risk free discount rates, and other relevant factors.<sup>15</sup>

60 The IAIS is aware that some concerns have been voiced that there may be changes in how G-SIIs are managed in order to reduce the risk that the BCR and HLA may be breached. This is an expected implication of introducing the BCR and HLA and needs to be considered during the calibration process of the BCR (and consequently when the HLA is developed).

61 There will be a need to consider how the BCR may evolve after 2014 in light of the development of the ICS, and also to consider whether and when it may apply beyond G-SIIs. These considerations will be commenced after the field tests are conducted in 2014.

### 3.6 Qualifying capital resources

62 The quality of capital resources supporting the BCR should be considered. Guidance on these matters is available from the ICPs (ICP 17<sup>16</sup> in particular). Further guidance in the context of IAIGs is contained in the current (October 2013) draft of ComFrame,<sup>17</sup> in particular in its Module 2 (ComFrame Standards M2E5-3 through M2E5-9).

63 ComFrame specifies two categories of capital resource, core and additional:<sup>18</sup>

*The IAIG's core capital is comprised of qualifying financial instruments and capital elements other than financial instruments that contribute to financial strength, absorb losses during going-concern and winding-up and otherwise contribute to survival through periods when the IAIG is under stress.*

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<sup>15</sup> For example, if identical portfolios of insurance business, managed identically and with identical experience, are held in two jurisdictions or economic regions and the only difference between the jurisdictions or economic regions is that in one the risk free interest rate is 5% and in the other the risk free of 10% then an insurance liability valuation process which depends on the risk free rate for determining a discount rate for determining the present value of the portfolio liabilities will generate different results in the different jurisdictions. or economic regions. In the context of each jurisdiction or economic region the results may be intended to be at the same level of confidence. However using the result from one jurisdiction in the other will lead to different level of confidence than that sought being met. Comparability comes from the comparability of methodology and objective of the calculation, not the specific numerical outcomes.

<sup>16</sup> See [www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795](http://www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795), paragraph 17.11.34.

<sup>17</sup> See [http://www.iaisweb.org/view/element\\_href.cfm?src=1/20149.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/20149.pdf). It is noted that this ComFrame document is a Consultation Paper and so may be subject to change in the future.

<sup>18</sup> See footnote 17, ComFrame Standard M2E5-4.

*In order to qualify as core capital, financial instruments are permanent, available, subordinated and free of both encumbrances and mandatory distributions that reduce shareholders' equity or members' surplus.*

*The IAIG's additional capital is comprised of qualifying financial instruments and capital elements other than financial instruments that protect policyholders, Non-Regulatory-Capital Creditors (NRC Creditors) and some other creditors from loss, mostly during winding-up.*

*key characteristics of capital instruments that qualify as additional capital are subordination and availability.*

*Additional capital also includes qualifying financial instruments and capital elements other than financial instruments that make a contribution to financial strength through their ability to absorb limited losses during periods when the IAIG is under stress but do not qualify for inclusion in core capital.*

Capital resources supporting the BCR may be made up of both core and additional capital.

- 64 The guidance in ComFrame (Module 2, element 5.9) and ICP 17<sup>19</sup> also addresses the issues of transferability and fungibility of capital. How these requirements are satisfied is a matter for the supervisors of each G-SII to address.

### 3.7 Non-insurance activities

- 65 The IAIS framework for G-SII policy measures<sup>20</sup> indicates the BCR will be calculated as follows:
- Insurance entities: the BCR.
  - Non-insurance **financial entities**
    - for which Basel III rules apply: the BCR is that required capital under Basel III rules. Given the mandate and principles (described above) guiding the development of the BCR, the IAIS believes that the relevant Basel III rules to be applied are those being developed under the Basel III leverage ratio framework.<sup>21</sup> This also applies in jurisdictions where Basel III has not been implemented.
    - for which Basel III rules do not apply: the BCR.
  - Non-insurance **non-financial entities**: the BCR mandate includes non-insurance subsidiaries. Where there are non-financial activities, non-material activities should be excluded from the BCR where appropriate

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<sup>19</sup> See [www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795](http://www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795), paragraphs 17.11.19 et seq. and 17.11.50 et seq.

<sup>20</sup> See paragraph 57 in the G-SII policy measures [http://www.iaisweb.org/view/element\\_href.cfm?src=1/19150.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf).

<sup>21</sup> See <http://www.bis.org/publ/bcbs251.pdf> for a reference to the most recent BCBS Consultative Document on this matter.



## 4 Comparability of valuations

- 66 A precondition for comparability of the BCR is that the calculation basis is comparable. Different jurisdictions have different approaches and introduce different levels of conservatism into their regulatory requirements. In particular, there is currently no global insurance liability valuation standard. Also, there are different approaches to valuation of significant asset classes for insurance groups, especially for financial instruments and reinsurance recoverable assets.<sup>22</sup> These differences affect both the issue of measuring qualifying capital resources and the capital required.
- 67 The valuation basis proposed for BCR purposes is the underlying balance sheets, subject to various adjustments. Hence, field testing in 2014 will be used to identify the most appropriate valuation approach for the BCR. Once this approach is identified it will be the foundation for the BCR. Current G-SIIs will be included in field testing along with a sample of volunteer IAIGs.
- 68 Field testing will gather data on valuation approaches in two key alternative ways:
- Balance sheets prepared using generally accepted accounting principles for financial reporting purposes (GAAP reporting) along with additional components of the balance sheets prepared on an adjusted basis and submitted separately.
  - Valuation bases used in the G-SII and volunteer IAIG's own economic capital models on a consolidated group-wide basis.
- 69 It is expected that the first approach will demonstrate a difference in results arising from the use of GAAP reporting in different jurisdictions. The adjusted basis of valuation for certain components of the balance sheet will be an attempt to create greater comparability and will be a market-based valuation. The technical specifications setting out which components of the balance sheet will be subject to this adjusted basis of valuation and how it is to be prepared will be included in field testing. These technical specifications will be developed in cooperation with field testing volunteer IAIGs and G-SIIs. Broadly, the items for which an adjusted basis of valuation will be required are:
- Technical provisions
  - Financial instrument assets
  - Reinsurance recoverable assets
- 70 The second approach is not proposed as a basis for the BCR. However, obtaining such quantitative and qualitative data will be useful and it should not be burdensome for the G-SIIs and volunteer IAIGs to provide. The data will be gathered as a point of comparison and reference in field testing and for the development of the proposed valuation principles.
- 71 Technical provisions are a key aspect of the adjustments and the main source of the lack of comparability of balance sheets among insurance groups. The adjusted basis of valuation for technical provisions will be a current estimate (that is, excluding any prudential margins).

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<sup>22</sup> ICP 14 addresses valuation but is not sufficiently granular to create comparability across jurisdictions. It is meant to set out the issues to be addressed by each individual jurisdiction and its development did not include the goal of comparability among across jurisdictions.

#### 4.1 Valuation of liabilities – current estimates

- 72 The intended approach is to develop principles for current estimates of liabilities, including limited flexibility for implementation of principles within jurisdictions. The IAIS encourages the industry to contribute to a consistent valuation of current estimates of liabilities. The IAIS intends to engage with other standard setters (including the International Accounting Standards Board (IASB), U.S. Financial Accounting Standards Board (FASB), and the International Actuarial Association (IAA)) to encourage development of complementary financial reporting and actuarial standards, over time, noting that this is more likely to support the ICS than the BCR, due to the timeframe necessary for such standards to be developed, adopted and implemented. It is expected that comparability of valuation results should improve over time and hence the IAIS encourages a dynamic process to occur, including feedback from supervisory peer review processes and market disclosure and analysis.
- 73 The key adjustment that will be requested as part of the insurance liability valuation approach for the BCR will be to put technical provisions on a current estimate basis as per the definition in ICP standard 14.8: *“The current estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling insurance obligations, using unbiased, current assumptions.”*
- 74 In other contexts this current estimate may be called a best estimate<sup>23</sup> or the statistical mean (commonly referred to as the “average”) of a range of possible values. The term “current estimate” will be used going forward as that is consistent with existing IAIS terminology.
- 75 The concept of a current estimate is widely endorsed and promulgated outside the IAIS, for example, by the IAA<sup>24</sup> and in Solvency II.<sup>25</sup> Usually, margins to add a degree of prudence are included in technical provisions but differences in how these margins are calculated are a key reason for the lack of comparability in the valuation of technical provisions. The IAIS proposes that where margins are calculated, whether explicitly or implicitly in technical provisions currently, these margins could be removed from technical provisions and treated as a component of capital resources for BCR purposes. If the current estimate proves to be a useful basis of comparability in field testing, the technical provisions could then be presented on a less prudent basis than they currently are in most jurisdictions and the calibration of BCR parameters would take that into account. This proposal would be specifically considered during field testing to examine its implications.

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<sup>23</sup> A “best estimate” of a quantity is, in principle, an estimate of the quantity that is neither deliberately overstated nor deliberately understated. The determination of a best estimate needs to be made within the context of its use. That is, the purpose for which it will be used needs to be clear and properly reflected.

<sup>24</sup> See [http://www.actuaries.org/LIBRARY/Papers/Global\\_Framework\\_Insurer\\_Solvency\\_Assessment-members.pdf](http://www.actuaries.org/LIBRARY/Papers/Global_Framework_Insurer_Solvency_Assessment-members.pdf), *A Global Framework for Insurer Solvency Assessment*, International Actuarial Association, 2004. See section 6, paragraph 6.14 in particular. This work was undertaken by the IAA with the support of the IAIS, and its objective was to develop a global framework for insurer capital requirements.

<sup>25</sup> The concept of Best Estimate is introduced in Article 77 of the Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009).

76 The IAIS recognises that there may be some practical considerations to be addressed in reliably obtaining current estimates either directly or approximating them indirectly. It is the understanding of the IAIS that for most G-SIIs the computation of current estimate liability valuations, for a variety of purposes, is common practice.

#### 4.2 Valuation of assets

77 There is currently no agreed global accounting standard for the valuation of significant asset classes for insurance groups. This raises questions of consistency of asset valuations that may be used, or may be required to be used, in different jurisdictions. Inconsistency in asset valuations may reduce comparability of BCR outcomes.

78 Variations in the valuation of financial instruments and reinsurance recoverables may also reduce the comparability of BCR.

79 For the purpose of developing the BCR, the IAIS proposes to use asset valuations based on generally accepted accounting principles in each relevant jurisdiction, subject to various adjustments that will be determined via the field testing process.<sup>26</sup> The appropriateness of this proposal will be investigated further through field testing to be carried out by the IAIS in 2014. This testing will focus on the total balance sheet approach and on understanding the impact of stresses on that balance sheet.

80 The adoption of the total balance sheet approach by the IAIS should lead to the interactions, between assets and liabilities as circumstances change, being reflected in both capital resources and capital required for BCR purposes.

81 Once asset valuations have been established, there are further adjustments with regard to certain assets that may be excluded by reducing qualifying capital resources or applying a full capital charge. ComFrame, in its Module 2, Element 5-3 proposes an approach for determining, from the total of potential capital resources, the amount that qualifies as capital adequacy resources. The IAIS intends to follow this approach in the design of BCR.

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<sup>26</sup> Preliminary principles for valuation adjustments include:

- Total balance sheet approach
- Where assets and liabilities are matched, market volatility should have no impact on the net assets of the G-SII
- For invested assets use fair value measurement as a basis for valuation
- All values to be based on either observed market values or an estimate of the future cash flows related to the invested asset and insurance liabilities
- ICP 14 standards to apply – but the margin on current estimate (MOCE) to be separately identified and counted as a component of the capital resources of the G-SII
- No recognition of changes in own credit standing as per ICP 14.

## 5 Factor-based approach

### 5.1 Context

- 82 A “factor-based” approach will be adopted to develop the BCR. This multiplies factors and proxy measures of major risk exposures and then sums the results to obtain the required capital. This approach reflects an amalgam of a number of proposals received from IAIS Members, extracts the best features from them, and satisfies an agreed set of guiding principles. Other options were considered, but they were not considered appropriate for the purpose of the BCR given its scope and development timeframe.
- 83 During the preparation of this Consultation Document, a group of industry participants presented two initial proposals for consideration by the IAIS. One, entitled the “Simple factor-based approach” has similarities to the factor-based approach. The other, entitled the “Aggregate activities based approach,” is based upon the scaling of existing local capital requirements across jurisdictions. The IAIS has considered this proposal and has concluded that it would not be feasible to assess the robustness over time of the proposed scaling techniques within the time available for development of the BCR and there is little scope for this proposal to inform the development of the ICS. Accordingly, that proposal is not pursued further in this Consultation Document.
- 84 The remainder of this section summaries requirements and choices made regarding the BCR prior to discussing its calculation.
- 85 There is a need to recognise major categories of risks, both direct and indirect, impacting the businesses of G-SIIs. There is also a need to not be overly granular. The data required will be relatively high level in order to facilitate applicability for all G-SIIs.
- 86 The BCR needs to account for on- and off-balance-sheet traditional and non-traditional insurance business as well as non-insurance business including banking and other non-financial business.
- 87 Both liability and asset risks should be considered. The distinctions between long and short term liabilities should be recognised. The focus of the design and development of the BCR will be on the risks directly associated with the contingencies insured and other sources of risk for the G-SIIs. While necessary in a comprehensive framework, some business risks are not proposed to be explicitly considered at this stage.
- 88 The need for simplicity and comparability means that internal models will not be used for BCR purposes.
- 89 While it is important for the BCR to be risk sensitive, but not overly so, it is more important that the BCR changes in the same direction as the overall risk profile of the firm (increasing if the profile becomes riskier, and decreasing if the profile becomes less risky) than the quantum of the change in the risk profile be accurately reflected in the BCR. See also paragraph 107.
- 90 This is considered important both to align incentives to G-SIIs consistent with their risk management activities and decisions, and also to support the discouragement of, and unintended consequences of, potential “gaming” of the process.

- 91 It is not intended to explicitly allow for potential diversification benefits between different risk factors incorporated in the BCR. Implicit allowance could be made through the calibration process used in the development of the BCR.
- 92 The Basel Committee on Banking Supervision (BCBS), in a recent Consultation Paper,<sup>27</sup> has defined a “Leverage Ratio” as the ratio of a capital measure divided by an exposure measure. The capital measure is defined as the Tier 1 capital of the risk-based capital framework as defined in the Basel III standards (taking into account transitional arrangements). The exposure measure is the sum of a bank’s on-balance-sheet exposure, derivative exposure, securities financing transaction exposures and other off-balance-sheet exposures. The BCBS Consultation Paper provides guidance on how these exposures are to be determined and disclosed. Any final adjustments to the definition and calibration of the Leverage Ratio will be made in 2017 with the intention of it becoming part of Pillar 1 of the Basel III Framework on 1 January 2018.
- 93 The IAIS has considered using a ratio as defined in the BCBS Consultation Paper summarised in the previous paragraph. It has concluded that seeking to apply this leverage ratio to G-SIIs, in particular to their insurance businesses, is not appropriate. The function and context of this leverage ratio, which is to complement the risk-based capital framework, is different from the function and context of the BCR, which is to provide a base capital requirement to give a consistent global base level for the application of the HLA.
- 94 The Basel III leverage ratio focuses on the risks of the asset side of the balance sheet. It is also not intended to be risk sensitive. This, coupled with the different levels and types of insurance risks undertaken (and so the liabilities held for them) by different G-SIIs leads to serious concerns that results obtained using this ratio would not only not be informative but may well provide results which are inconsistent with the current best practices of insurance risk management. That is, this leverage ratio may well generate misinformation regarding the risks of insurance activities.
- 95 A sole focus on capital requirements does not provide a full picture when assessing the financial condition of G-SIIs. While important, they are one of many elements of a full supervisory assessment, which requires a total balance sheet approach taking into account all risks relating to assets and liabilities, both on- and off-balance-sheet, an evaluation of qualifying capital resources with proper adjustments reflecting specific characteristics of insurance liabilities, as well as other quantitative and qualitative elements.

## 5.2 Major risks

- 96 Capital should be held in proportion to risk assumed. Therefore, a fundamental requirement for establishing capital amounts is to articulate what risks are assumed and/or reflected and to what extent. The BCR mandate states that the BCR is “*to apply to all group activities, including non-insurance subsidiaries.*” This means that all major risks affecting a G-SII need to be considered.

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<sup>27</sup> See <http://www.bis.org/publ/bcbs251.pdf> for the reference to the relevant BCBS Consultation Paper.

- 97 To facilitate this, a listing of major risks is needed. The starting point for determining which risks will be addressed will be taken from ComFrame.<sup>28</sup> See in particular Module 2, Element 5 (specifically Standard M2E5-11 and its parameters and guidelines). This list of risks is then augmented by the set of risks included in the IAIS assessment methodology for G-SIIs.<sup>29</sup>
- 98 The fact that there is a list of major risks to start should not be taken to imply that all need to be addressed explicitly, or even implicitly, in all cases, by the BCR. The BCR has constraints imposed on its risk sensitivity from a number of directions and a pragmatic trade-off between risk sensitivity and other factors, as guided by the principles (see section 3.3) is needed.
- 99 The primary risks faced by G-SIIs in their insurance business are those arising from insurance liabilities. They also face asset and NTNI risks. Each of these major categories of risk includes diverse elements and, potentially, interactions between those elements when risk events occur. To satisfy the principle that major risk categories are considered these three major risk categories need to be considered.
- 100 Insurance liability risks:
- The most basic proposal would only discern between life insurance and non-life insurance. More detailed and risk responsive proposals would include more business segments, such as: life insurance with minimum guarantees; life insurance without guarantees; non-life short tail insurance; non-life long tail insurance; and non-proportional reinsurance.
  - The primary risk measures that should be used for insurance risks are the current estimates of insurance liabilities. Differentiation arises with respect to the number of business segments reflected.
  - As a contingency with respect to the allotted timeframe and possibly to reflect other aspects of some insurance risks, proxies for current estimate calculations (for example, premiums and/or claims for non-life insurance and sums at risk for life insurance) may be considered.
- 101 Asset risks may be assessed in several ways:
- Differentiation by category of assets (bond and loans, other assets, reinsurance assets).
  - Differentiation between assets covering insurance liabilities (with and without exact duration matching) and other assets.
  - Differentiation between investment grade and non-investment grade assets.
- 102 NTNI risks:
- NTNI risks are partially addressed above. Some NT risks will be addressed, for example, by having a specific factor for life/unit linked with guarantees, as this takes account of variable annuities.

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<sup>28</sup> See [http://www.iaisweb.org/view/element\\_href.cfm?src=1/20149.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/20149.pdf).

<sup>29</sup> See footnote 7

- NI risks will be addressed by taking the respective sectoral capital requirement for non-insurance subsidiaries, for example, Basel III for banking subsidiaries, requirements for securities subsidiaries and Basel III equivalent for the rest.
- More detailed reflection of NTNI risks could include additional NTNI factors akin to the G-SII assessment methodology (credit/financial guarantee insurance, short and long term liabilities, off-balance-sheet items, assets under management, variable interest entities, etc.).
- NTNI risks may also be addressed through either the Risk Weighted Assets or the total exposure of the leverage ratio of the Basel III framework.

103 Asset Liability Matching (ALM) is a major risk category, particularly for life insurance and so it is desirable that it be included. However, practical difficulties within the given timeframe for the development of the BCR may pose a particular challenge for addressing this risk category. Two methods to address ALM risks are under consideration, one focusing on whether assets are matched to insurance liabilities (so actual durations are not required), and the other on directly requesting durations for insurance liabilities and their backing assets. The practicality of these methods will be investigated through field testing, in particular with regard to data availability.

### 5.3 Factor-based approach calculation

104 A “factor-based” approach depends on the application of factors to proxy measures of exposure, multiplying the measure by the factor, and then summing the results. The measures are proxies for the risk exposures that they represent.

105 At a high level the basic approach is:

- Determine a set of risks to be addressed.
- For each of those risks specify a measure (or measures) typically expressed in currency units.
- For each measure specify a factor which will be applied to it.
- Sum the product of the measure and the factors to produce a capital requirement in currency units.
- This provides the “Required Capital.”<sup>30</sup> This amount is specific to the entity under consideration since the values of the measures are specific to the entity. Note the factors are not proposed to be entity specific.
- The Qualifying Capital Resources<sup>31</sup> is obtained by starting with the allowable capital resources and adjusting this to reflect the use of current estimates instead of technical provisions. Adjustments for any inadmissible items will also be made. The Qualifying Capital Resources are the amount of capital the entity under consideration has available to meet the BCR. This amount is specific to the entity under consideration.

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<sup>30</sup> This is the amount of capital the entity under consideration requires in order to meet the BCR. This amount is specific to the entity under consideration.

<sup>31</sup> This is the amount of qualifying capital resources the entity under consideration has available for BCR purposes. This amount is specific to the entity under consideration.

- The BCR Adequacy Ratio is the ratio of Qualifying Capital Resources divided by the Required Capital. If the BCR Adequacy Ratio exceeds 100%<sup>32</sup> then the BCR is met, otherwise it is not. This ratio provides a metric that is comparable between entities.

106 Within this structure there is scope for selection of proxy measures and calibration of factors. This will be explored through the field testing process, which will be carried out in the second quarter of 2014. There are different levels of granularity that may be applied and alternative perspectives which may lead to similar looking formulas with different emphases.

- 107 Some design features of the factor approach include:
- The factor-based approach can be assessed against the BCR Principles, from the perspective of intent and potential. Subject to the level of granularity sought and the use of current estimates, it can substantially or fully meet all the BCR Principles.
  - Risks may be included in the design of the BCR even if they ultimately do not contribute to the capital requirement (via a factor of zero) for reasons such as the lack of availability of sufficiently robust and reliable data.
  - Not all risks need be explicitly included if it is considered that they are implicitly included via the assessment of another risk or a combination of other risks.
  - There is no inherent requirement to have a single measure for each risk and it may be that using more than one factor is valuable to reflect different aspects of the risk, particularly when situations of stress are being investigated or guarded against. For example, Solvency I, which is not generally regarded as being particularly risk sensitive, makes use of multiple measures for both life and non-life insurance capital requirements.
  - If multiple risks are addressed using a single measure, then the appropriateness of such an aggregation should be considered during the design of the BCR. The apparent simplification obtained by using fewer risk measures should be compared to the increased complexity of the set of risks being measured. That is, the implication that fewer measures and factors provide a simpler model may not be helpful as there is a decline in transparency and risk sensitivity.

#### 5.4 Level of granularity

108 In developing the basic approach of a factor-based approach there is a continuum of possibilities to address, which vary in complexity both in terms of the number of factors (and so risk measures) used and the level of complexity embedded into each factor (and risk measure) employed. Given the need to reflect the major categories of risk identified above and the need to align incentives to G-SIIs to be consistent with their risk management activities and decisions, the IAIS considers that a simplistic one-factor approach is not appropriate.

109 Balancing the guidance from the BCR Principles, the place in the continuum of factor-based approaches that will ultimately be the most appropriate will depend on field testing so it is not appropriate to seek to make specific judgements at this point in time.

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<sup>32</sup> The benchmark need not be set at 100% but could be set at a different level, if so desired.



- 110 It is intended the BCR will have a relatively small number of risk measures and factors. This supports a simple structure<sup>33</sup> in the sense of having few factors while retaining transparency.

It is considered unlikely that fewer than five measures and factors will be used, if major risk categories are to be reflected. See section 5.1. It is considered desirable to have 10 or less factors used to support the retention of the impression of a simple structure. The trade-off between this simplicity and risk responsiveness will be investigated through the field testing process.

- 111 The preferred proxy for insurance liabilities is their current estimates. If necessary, the possibility of deriving current estimates of the insurance liabilities indirectly instead of obtaining them directly has also been flagged so that the principle of utilising current estimates of insurance liabilities is retained.

## 5.5 Generic example

- 112 As a generic example, the application of a factor-based approach might proceed as follows. The key focus is on whether or not the Qualifying Capital Resources exceed the Required Capital. This can be expressed in terms of a ratio, which provides a metric that is comparable between G-SIIs.

$\text{BCR Adequacy Ratio} = \text{Qualifying Capital Resources} / \text{Required Capital}$
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If the BCR Adequacy Ratio exceeds 100%<sup>34</sup> then the BCR is met, otherwise it is not.

- 113 The Required Capital reflects each of the major categories of risk:

$\begin{aligned} \text{Required Capital} &= \text{Sum of (Liability factors multiplied by Liability measures)} \\ &+ \text{Sum of (Asset factors multiplied by Asset measures)} \\ &+ \text{Sum of (NTNI factors multiplied by NTNI measures)} \\ &+ \text{Sum of (Other factors multiplied by Other measures)} \end{aligned}$
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The degree of risk sensitivity could be increased by using additional factors.

Each factor will be a numerical factor, calibrated during the field testing process. It is not intended that the factors be reviewed regularly, however they may be reviewed under certain circumstances, such as significant additional information and analysis becoming available, or the role and purpose of the BCR being reviewed.

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<sup>33</sup> However care is required as the appearance of simplicity through a reduced number of factors may well obscure the complexity hidden within each of those factors. For example, the Basel III Leverage Ratio (see Footnote 1) appears “simple” in form but contains a range of factors hidden within the construction of this form.

<sup>34</sup> The benchmark need not be set at 100% but could be set at a different level, if so desired.

114 The second component of the BCR Adequacy Ratio is:

Qualifying Capital Resources = Capital resources  
+/- Adjustments (to obtain qualifying capital resources for BCR purposes)

115 There is a natural tension between the objectives of simplicity, comparability and risk-sensitivity in the development of regulatory capital frameworks. An over emphasis on any one of these objectives may compromise the others. Finding an appropriate trade-off between granularity and risk sensitivity will be investigated through the field testing process.

## 5.6 Field testing process

116 The calibration and choices of risk measures used will be informed by a field testing process. This process is important for a number of reasons including:

- It is necessary to identify data items which are available and their quality, reliability and robustness.
- It is necessary to collect current data from industry, particularly G-SIIs.
- It is necessary to examine which measures of risk are appropriate as there may be the need to make trade-offs between desired measures and the availability and reliability of data regarding them. Such decisions cannot be made prior to field testing.
- The field testing process will provide detailed technical specifications to its participants which will expand on and clarify issues identified at a higher level in this paper.

117 There is also the need to consider the stability over time of both methodology and data (inputs, parameters and results), that is the robustness of both data and process. Unnecessary volatility in results risks misinterpretation and misleading users. It may also risk creating an unreasonable and unwarranted expectation of accuracy which may not be present.

118 To support informed decision making, it may be that the data requested in the field testing will be more than is required directly for the given options. There are two primary reasons for this. First, as a consequence of the analysis, some modification of options may be needed. Second, if multiple risks are addressed using a single measure, then the appropriateness of such an aggregation should be reviewed, if possible. That is, the apparent simplification obtained by using fewer risk measures should be considered in light of the increased complexity of the set of risks being measured.

119 There are two strands involved in the field testing process with G-SIIs and volunteer IAIGs:

- G-SIIs and volunteer IAIGs who provide data, and
- Supervisors, primarily the home supervisors of G-SIIs and volunteer IAIGs who will provide the conduit through which data may be securely provided.

120 Appropriate confidentiality agreements and protocols will be put in place to protect the confidentiality and commercial interests of G-SIIs and volunteer IAIGs who participate in the field testing.

- 121 The field testing required to support the development of the BCR is being integrated into the broader field testing work already in progress for ComFrame. While critical to the success and credibility of the BCR initiative, it is not envisaged that the effort required of data providers or those analysing it for the BCR will be a major exercise compared to more traditional quantitative impact studies.
- 122 A further issue that will be considered during field testing and analysis work is that of discouraging unintended consequences, or “gaming,” of the BCR process. That is, the BCR should not discourage sound risk management and not provide encouragement for inappropriate risk taking behaviours.
- 123 There is also the possibility, subject to resource constraints (including IAIS and volunteer resources, both human resources and IT resources) and appropriate confidentiality processes being in place, for the IAIS to seek additional insight and information from supervisors regarding industry and historic trends and experience.

## **5.7 Next steps**

- 124 The IAIS is confident that a viable BCR can be developed within the timeline required and that constraints due to the limited timeframe for developing the BCR can be appropriately addressed.
- 125 The timeline for the development of the BCR is:
- December 2013 – Consultation Document published
  - 16 December 2013 to 3 February 2014 – public consultation period
  - March to May 2014 – field testing
  - April to July 2014 – selected expert input sought as and when deemed appropriate by the IAIS
  - June to August 2014 – analyse results from field testing and reflect this and other feedback in BCR proposal and development of factors
  - July/August 2014 – second public consultation period (specific dates to be determined)
  - September 2014 – IAIS to approve BCR proposal
  - October to November 2014 – FSB to review BCR proposal
  - November 2014 – G20 to endorse BCR proposal.
- 126 In the longer term, the proposed development of a set of global insurance capital standards can be summarised as follows:
- Develop BCR as the foundation for HLA by the end of 2014
  - Decide whether the BCR will also apply to IAIGs in 2014 and, if so, when
  - Develop the HLA for G-SIIs by the end of 2015 (to apply from 2019)
  - Develop the ICS for IAIGs (which include all G-SIIs) by end of 2016 (to apply from 2019)
  - When the ICS is developed, consider the need for backstop measures for all IAIGs and review the construction of the HLA in light of the development of the ICS
  - A backstop measure for all IAIGs might include some, all or none of the elements of BCR as initially developed for G-SIIs

## Annex A – Relationship with other IAIS initiatives

- 1 The IAIS has developed a framework of policy measures for G-SIIs based on the general framework published by the FSB with adjustments that reflect the factors that make insurers different from other financial institutions. This framework includes three main types of measures:
- **Enhanced Supervision.** These measures build on the IAIS Insurance Core Principles<sup>35</sup> (ICPs) and the FSB's Supervisory Intensity and Effectiveness recommendations and include the development of a Systemic Risk Management Plan (SRMP) and enhanced liquidity planning and management. They also require the group-wide supervisor to have direct powers over holding companies to ensure that a direct approach to consolidated and group-wide supervision can be applied.
  - **Effective Resolution.** Based on the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions, these measures include the establishment of Crisis Management Groups, the elaboration of recovery and resolution plans, the conduct of resolvability assessments, and the adoption of institution-specific cross-border cooperation agreements. The IAIS proposals take account of the specificities of insurance through the inclusion of plans for separating non-traditional non-insurance (NTNI) activities from traditional insurance activities, the potential use of portfolio transfers and run-off arrangements, and the recognition of existing policyholder protection and guarantee schemes.
  - **Higher Loss Absorption (HLA) Capacity.** The IAIS has proposed that "*HLA uplift may be calculated according to the base capital requirements of NTNI activities in the combined insurance entities and the interconnectedness score.*"<sup>36</sup>

Further discussion of these measures is provided in the IAIS' *Global Systemically Important Insurers: Policy Measures*.<sup>37</sup>

- 2 As a foundation for HLA requirements for G-SIIs, the IAIS has committed to the development of the BCR. The IAIS has also committed to develop the implementation details for HLA by the end of 2015. It is intended that HLA requirements will apply to G-SIIs, as designated in 2017, from the beginning of 2019.
- 3 The BCR is mandated to apply to all group activities, including non-insurance subsidiaries. In particular, this implies that it should reflect the risks, both direct and indirect (or immediate and consequential), involved with NTNI activities.
- 4 Details of the HLA proposals will be consulted by the end of 2014. The starting point of the HLA design will be the proposals contained in *Global Systemically Important*

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<sup>35</sup> See [www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795](http://www.iaisweb.org/Supervisory-Material/Insurance-Core-Principles-795).

<sup>36</sup> See [http://www.iaisweb.org/view/element\\_href.cfm?src=1/19150.pdf](http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf) paragraph 52.

<sup>37</sup> See footnote 8.

*Insurers: Policy Measures*, including particular focus on the NTNI and interconnectedness components of the G-SII assessment methodology. However, the HLA design will need to be aligned with the BCR design and hence the actual design of the HLA policy measure will become clearer after field testing commences and after the BCR design is settled.

- 5 ComFrame is a comprehensive group-wide supervisory framework for IAIGs, and builds on the ICPs which apply to all insurers. ComFrame, amongst other key matters, refers to capital, both from the perspective of availability and quality, and from the perspective of requirements. The ComFrame Consultation Paper of October 2013,<sup>38</sup> discusses capital adequacy assessment in its Module 2, Element 5. In its Standard M2E5-9 group wide issues are discussed.
- 6 It is expected that supervisors would take an increased interest in the G-SII if its HLA is breached and, possibly, then its BCR is also breached. This may include a requirement for prompt corrective actions to restore compliance including, for example, the raising of additional capital or some form of de-risking. The specifics of how such breaches may be addressed are the responsibility of the supervisors (home and host) involved and will depend on the specific circumstances of the breach and on how the BCR interacts with existing capital requirements in the ICPs. Further consideration of the management of breaches of the BCR is thus beyond the scope of this paper.<sup>39</sup>

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<sup>38</sup> See <http://www.iaisweb.org/index.cfm?pageID=1128>, *Common Framework for the Supervision of Internationally Active Insurance Groups For Consultation*, October 2013.

<sup>39</sup> An example of how a backstop could be used by supervisors is the annual Comprehensive Capital Analysis and Review (CCAR) performed by the US Federal Reserve Board (FRB) on large bank holding companies and on all non-bank financial institutions designated by the US Financial Stability Oversight Council (FSOC) as being systemically important. The FRB reviews several forecast capital ratios, including a backstop leverage ratio, prior to approving capital management plans which incorporate proposed payment of dividends. This process is expected to be applied to all G-SIIs which have a US home supervisor.

## Annex B – Glossary of abbreviations

Abbreviation	Meaning
ALM	Asset Liability Matching
BCBS	Basel Committee on Banking Supervision (also Basel Committee)
BIS	Bank for International Settlements
BCR	Basic (or Backstop) Capital Requirements
BCR Adequacy Ratio	This is the ratio of Qualifying Capital Resources divided by the Required Capital. If the BCR Adequacy Ratio exceeds 100% then the BCR is met, otherwise it is not. As it is a ratio, this provides a metric that permits comparison between entities.
ComFrame	Common Framework for the Supervision of Internationally Active Insurance Groups
FASB	US Financial Accounting Standards Board
FSB	Financial Stability Board
G-SIIs	Global Systemically Important Insurers
G20	Group of Twenty Countries
HLA	Higher Loss Absorbency
IAA	International Actuarial Association
IAIGs	Internationally Active Insurance Groups
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICPs	IAIS Insurance Core Principles
ICS	Risk-based global Insurance Capital Standard
NTNI	Non-traditional Insurance and Non-insurance (activities)
Qualifying Capital Resources	This is the amount of qualifying capital resources available for BCR purposes.
Required Capital	This is the amount of capital required to satisfy the BCR.