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January 15, 2021

Mr. Steven Seitz
Director
Federal Insurance Office
U.S. Department of Treasury
1500 Pennsylvania Avenue NW
Attn: Krishna Kundu, Room 1410 MT
Washington, DC 20220

Re: *Federal Insurance Office Study on the Insurance Capital Standard (FIO ICS Study)*

Dear Director Seitz,

On behalf of the Solvency Committee of the American Academy of Actuaries,[1] thank you for the opportunity to provide comments on the *Federal Insurance Office (FIO) Study on the Insurance Capital Standard (ICS)*. Below are the committee's comments, organized by question:

1. If the ICS were adopted in the United States, how would this affect the insurance market in the United States, including consumers and insurers? How would the adoption of the ICS affect the competitiveness of U.S.-domiciled IAIGs, foreign insurance groups with significant operations in the United States, and U.S. insurers that have current or planned operations abroad?

The International Capital Standard 2.0 (ICS) developed by the International Association of Insurance Supervisors (IAIS) is currently undergoing observation and data collection during its five-year monitoring period. However, as it is currently constructed the ICS could have a detrimental impact on the provision of long-duration life insurance products. This is primarily due to the additional reporting volatility and capital requirements flowing from the ICS market-adjusted valuation approach.

In addition, the ICS, which is being developed for Internationally Active Insurance Groups (IAIGs), could, in practice, apply only to IAIGs. Thus, if the ICS were implemented within the U.S., U.S. insurance groups with international operations could be subject to at least two and possibly three different capital regimes: IAIS ICS, U.S. group capital calculation (GCC),

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

and National Association of Insurance Commissioners (NAIC) legal entity risk-based capital (RBC). Note that it is still an open question whether some version of the NAIC GCC would be deemed comparable to the IAIS ICS. Implementation of the ICS in the U.S. would lead to different incentives/concerns for U.S. domestic-only companies versus U.S.-based companies with international operations.

While there could be some benefit to U.S. insurers operating abroad if a comparable approach to group capital determination is adopted across the globe, competitive impacts will only be fully understood when each jurisdiction decides how any group standard would be implemented and to whom it applies.

2. **Please provide information on whether the ICS could create regulatory capital arbitrage opportunities or have procyclical effects, leading to increased volatility in U.S. insurance markets.**

   Implementation of the ICS could reduce capital arbitrage opportunities to the extent that it is implemented consistently across and within jurisdictions

   Procyclicality is a concern as there is a potential for overreaction to short-term market impacts, such as capital infusions, or de-risking. This could be offset by the fact that a market-based regime such as the ICS requires the realities of the market, e.g., low interest rates, to be addressed.

3. **How should the FIO Study consider the potential effects of implementing the AM in U.S. insurance markets as compared to implementing the ICS? In addition, should the FIO Study consider the potential impact upon U.S. insurance markets if credit rating agencies were to accept the ICS as a global standard?**

   It should be acknowledged that both the Aggregation Method (AM) and ICS are still evolving. For example, the ICS is being considered on two different accounting bases during the monitoring period in progress: Market-Adjusted Valuation and GAAP Plus. An internal model basis for determining capital requirements is under consideration, as is the comparability of the alternative AM. And, as of this commentary, the relationship between the NAIC GCC and AM is not entirely clear to us.

   Fundamentally, however, the AM would build upon the existing U.S. regulatory solvency framework whereas the ICS will introduce a global consolidated group capital standard independent of any local jurisdictional historical/current regulatory practices. The AM would also automatically adjust to changes in views of risks and products within various jurisdictions, while the process for updating the ICS in the future is not clear (and hence might be less responsive to changes). We are unaware of analysis as yet of potential responsiveness to future changes.

   The FIO study would benefit from a consideration of relative operational, solvency regulation, risk management, and product consequences. For example, are there startup and ongoing operational costs that could be avoided or reduced by implementing the AM? Would implementation of the ICS yield incrementally better solvency outcomes that would warrant the additional market volatility? Are there impacts on companies' risk management? Would accessibility of products for consumers be impacted by either price increases or lack of availability?

Credit rating agencies have their own models. While it may be in a company's best interest to evaluate internal capital in light of credit rating agency models, there are no requirements to do so. Unless there is evidence to the contrary, we believe it would not be advisable for study to consider credit rating issues.

4. **What information should be considered in evaluating the impact of ICS implementation on the various business lines and the cost and availability of different product types in the U.S. insurance market?**

   The impact is of course unknown, but the study would best focus on identifying incentives and disincentives. Actuaries would be critical in comparing valuation and capital requirements on specific products under various regimes for purposes of identifying such incentives. It is recommended that results be reviewed over time to assess volatility. Incentives for hedging of economic risk is also a concern to be considered.

5. **If the ICS were implemented in foreign jurisdictions where U.S. insurers operate, what effects could the ICS have on the ability of U.S. insurers to compete with local insurers and other international insurers in these overseas markets? How should FIO evaluate issues related to global competitiveness of U.S. insurers and potential adoption of the ICS by foreign jurisdictions?**

   We have no comments on this question.

6. **Please provide your views on the following issues, as relevant to the FIO Study.**

   a. ***Data for FIO Study:*** **The ICS has been developed with data provided by volunteer insurance groups. To what extent should FIO use data provided to FIO by individual insurers to conduct the FIO Study? In addition to data from specific insurers, are there any other relevant data sources that should be used to evaluate the ICS? If so, what other sources of quantitative and qualitative data would be available, including any data that could be representative of U.S. insurance practices and product types.**

      A suggested approach would be to calculate regulatory provisions (valuation and capital) for representative product lines and investment strategies utilizing U.S. and ICS alternatives to identify the incentives and disincentives that would be created.

      Any data would need to be of a credible volume for an evaluation of required capital. Such data may be available for U.S. capital requirements using the NAIC database (especially for P&C insurers, and possibly for life insurers if data from the confidential RBC filings were made available), and for investment risks from publicly available data, but the number of IAIGs will not be sufficient for the creation of a credible volume of data.

b. ***Market Effects from MAV:*** **The reference ICS is based on a market-adjusted valuation methodology. What information should be considered in assessing MAV versus other valuation approaches and their potential effects on the insurance market in the United States, including consumers and insurers? In particular, how should the FIO Study consider how MAV affects the following areas?**

i. Changes to U.S. insurer investment behavior and ability to match asset-liability cash flows;

For life and annuity products because reported volatility is negative for insurers, market-adjusted valuation (MAV) will create an incentive to align asset mix with the hypothetical discounting reference portfolio, potentially leading to herding behavior. On the other hand, a valuation approach based on own assets may create perverse incentives to increase asset risk to lower liabilities and improve an insurer’s solvency position.

For P&C products, the concept of asset-liability “matching” is a misnomer due to the uncertainty as to the amount and timing of the liability flows and the need for liquidity to address uncertain cash outflows. Regardless, the interest rate risk charges are generally of secondary importance when compared to the insurance risk charges (based on premiums, claim liabilities, and catastrophe exposure), so the use of MAV may not have a material impact on P&C investment strategy for most P&C products.

ii. Implications for product offerings and shifts in product mix for both life insurers and property & casualty insurers; and

This can be assessed by comparing the level and volatility of required provisions for various product lines. While the regulatory capital levels may be different for the ICS vs. AM vs. RBC, in practice, the influence of regulators and rating agencies results in a much higher level of capital being held.

iii. Potential effects on insurers’ role as a significant source of long-term investment and liquidity in the economy.

This can be assessed by comparing the level and volatility of required provisions for long-term investments as well as the level and volatility of provisions for long-term products such investments would support.

c. ***Capital Requirement:*** **The ICS capital requirement is based on a standardized framework, whereby the calculation of ICS required capital, including the risks and stresses, is defined. How should the FIO Study consider the following?**

i. **The extent to which jurisdiction specific risks should be taken into account; and**

The issues should be thought of in the context of incentives and disincentives. If the ICS "undercharges" a risk, it will create an incentive for insurers to take on "too much" of that type of risk; if the ICS "overcharges," the opposite incentive is created.

For P&C, the risk factors in the ICS already vary by jurisdiction and follow the jurisdiction-specific line structures. As such, those jurisdiction specific risks are generally already considered. What could be more important is the ability of the ICS to adapt to changes in the risks in a jurisdiction. For example, as cyber insurance evolves, how well will the ICS be able to adapt to these new products/risks compared to the AM method

ii. **The use of internal ratings for assessing credit risk exposures.**

The ICS tends to apply blunt yet prudent approaches for difficult-to-measure types of risk (i.e., those for which internal ratings might be used). Some of those could be more prevalent in the U.S. than elsewhere. Therefore, the study might appropriately consider whether the inherent bluntness of the ICS creates disincentives for insurers to assume certain types of risk that are common in the U.S.

d. ***Available Capital:*** **The reference ICS measures available capital according to IAIS-established criteria and composition limits. The IAIS is also considering transitional arrangements during the monitoring period in order to ensure a smooth transition of the ICS as a PCR. How should the FIO Study consider the following?**

i. **Application of transitional arrangements during the monitoring period; and**

Transitional arrangements are inherently a jurisdiction-specific implementation issue and are tailored to local needs. There seems to be little purpose in having the IAIS develop these. Moreover, because the U.S. does not plan to adopt the ICS, there would seem to be little point in considering such arrangements in the FIO study.

ii. **Implications for the fungibility of capital under the ICS.**

The implications regarding fungibility of capital is tied to the purpose of a group capital metric. Group capital metrics are a broad indicator of the financial strength of the insurance group. They are generally not an accurate measure of the dividend capacity of the group. The ability to move capital between entities or out of the group will be a function of a variety of capital metrics applicable to entities within the group, including local regulatory standards, rating agency standards, and internal requirements. A consolidated group capital standard generally views the group as a single economic unit and therefore does not inherently reflect fungibility.

Note that fungibility is only part of the issue with regard to the ability to move capital. Any such analysis must also consider frictional costs, such as income tax liabilities that may be triggered by such movements.

e. *Jurisdictional Flexibility:* The reference ICS recognizes a limited number of areas for national discretion, such as senior debt as qualifying capital. Should the FIO Study evaluate any further application of jurisdictional flexibility for ICS implementation?

Jurisdictional flexibility seems to be intended to address targeted areas where a jurisdiction's implementation of the ICS differs from the baseline ICS. Because the U.S. does not plan to implement the ICS, there would seem to be little point in assessing the application of jurisdictional flexibility.

7. Please provide any views regarding the following additional issues, as they relate to the FIO Study.

a. What data and input from market participants should be taken into consideration?

A useful study would compare required regulatory provisions under various regimes at different points in time using model portfolios of products and assets. The building of those models can use industry data for calibration. Such a study would be dependent on the existence of such industry data, implying that it may be possible for some but not all jurisdictions.

b. Describe any data or data services that independent third parties could provide for purposes of the FIO Study.

No comments.

c. For the purposes of the FIO Study, would a ''point in time'' analysis be appropriate or would another time frame be more relevant for determining the implications?

Using different points in time—or at least sensitivities—would be useful in assessing volatility.

8. How should the FIO Study inform FIO's engagement on the IAIS economic impact assessment of the ICS?

It is advisable that the study inform FIO's views on how the impact assessment might be conducted. Because this ICS is not actually implemented anywhere, much of the analysis will, of necessity, be hypothetical in nature. In addition, the impacts may vary by jurisdiction. At the same time, it may be possible to assess how ICS-like regimes have, in practice, impacted different non-U.S. jurisdictions.

9. How has the COVD-19 pandemic informed your views on the issues discussed in this Notice?

The pandemic has not had a significant impact on our views regarding the issues in this Notice.

10. Please provide any other comments on the issues discussed in this Notice.

Consumer protection is another important component to consider addressing in the study: Market-adjusted valuation creates an incentive to close asset-liability mismatches and to address low interest rates. This would have consumer protection benefits that should be acknowledged.

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Thank you for the opportunity to provide comments on the *Federal Insurance Office Study on International Capital Standards*. If you have any questions or would like to discuss these comments in more detail, please contact Shera Niemirowski, the Academy's risk management and financial reporting analyst, at niemirowski@actuary.org.

Sincerely,

Jeff Johnson, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries