



AMERICAN ACADEMY of ACTUARIES

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August 6, 2015

Mr. Yoshihiro Kawai  
Secretary General  
International Association of Insurance Supervisors  
c/o Bank for International Settlements  
CH-4002 Basel  
Switzerland

RE: *Higher Loss Absorbency Capacity for Global Systemically Important Insurers (G-SIIs)*  
Public Consultation Document (June 25, 2015)

Dear Secretary General Kawai,

On behalf the American Academy of Actuaries'<sup>1</sup> Solvency Committee, I appreciate the opportunity to provide comments on the International Association of Insurance Supervisors' (IAIS) Higher Loss Absorbency Capacity for Global Systemically Important Insurers (G-SIIs) public consultation document. While there are several elements of the higher loss absorbency (HLA) design we support, particularly those related to the weighting of non-traditional (NT) and non-insurance (NI)<sup>2</sup> products and activities, we have concerns about the inclusion of an "uplift" above the basic capital requirement (BCR) prior to the application of HLA and the use of a "bucketing" approach.

Please find our responses below, organized by section and question number.

## **HLA Consultation Questions**

### **Section 2.1 Executive Summary Overview**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The concept of the "BCR uplift" concerns us, as it appears to effectively recalibrate the BCR at a significantly higher level. Given the deliberately simplistic construct of the BCR and the limited field testing performed on this metric to date, recalibrating the BCR as a higher prudential

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<sup>1</sup> The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists 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.

<sup>2</sup> The IAIS refers to the combination of the two as "NTNI" in the consultation document.

standard may result in misleading conclusions that do not accurately reflect a G-SII's risks. A simple factor approach, such as that used in the BCR, cannot be a precise measure of solvency. As a result, an uplifted BCR that is calibrated to a more stringent capital standard may generate a high level of false positives, in which capital appears deficient in contrast with a more risk-focused approach. As such, the use of an uplift is inconsistent with the design and intention of the BCR.

We recognize that the intent of the uplift is to anticipate the expected calibration of the insurance capital standard (ICS). While we understand that achieving rough comparability between the calibration of the BCR and the ICS would be advantageous, as discussed above, the BCR is designed in such a way that it is unlikely to function effectively as a temporary prudential capital standard. In contrast, although it is still under development, we expect that the ICS will be far more granular and responsive to risk, as well as subject to more robust and extensive field testing. For these reasons, it would be better to design and calibrate the initial HLA with a focus on NTNI risks to augment the existing BCR. Once the ICS is implemented, the HLA can then be recalibrated as necessary to appropriately reflect the calibration of the ICS.

If the concept of the BCR uplift is retained in the initial HLA, it should be eliminated once the ICS is in place. As such, this document should explicitly label the BCR uplift as temporary to avoid confusion.

## **Section 2.2 Key HLA consultation points—General Comments**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

We consider these points in our comments below.

## **Section 3.1 Context Overview**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

We have no comments on this section.

### **Section 3.2 The purposes of HLA at July 2013**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The purpose of the HLA, as laid out in the consultation document, is clear.

### **Section 3.3 IAIS position on systemic risk**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

We support the IAIS position on systemic risk and agree that traditional insurance does not create systemic risk. For additional details, please see our response to Section 3.4.

### **Section 3.4 Relatively small size reported of BCR NT insurance and BCR NI required capital amounts**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The result reported in Section 3.4 is not surprising, particularly because there generally is not much systemic risk for traditional insurance products and activities. It is possible, however, that additional work on the ICS may conclude that either the definition of NTNI activities and products or the factors applied to NTNI activities and products may need adjustment. For example, the factors applied to NT claim liabilities for non-life insurance are lower than the factors applied to traditional claim liabilities and may need to be reviewed in relation to factors for traditional insurance. While we are not commenting further on this issue for the purposes of HLA, we may do so in our responses to future ICS consultations.

### **Section 3.5 HLA relationship with ICS**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

We agree that when the ICS is completed the HLA will need revision, particularly with respect to the factors used.

### **Section 3.6 Principles for development of HLA**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

With respect to Annex C, Principle 1, we request clarification of the meaning of “comparable” in the document. Does this refer to entities having the same HLA regardless of the jurisdiction in which they provide insurance? The last sentence of this principle states that results should be similar and comparable over jurisdictions. What results should be comparable? Is it the numerical result or the regulatory action, HLA and BCR or each piece separately? The IAIS should provide clarification.

While we understand Principle 3 of Annex C, we believe there is little advantage for a company that is labeled a G-SII.

We are pleased to see that the goal of Principle 5 is a “going concern.” This is the correct target for the HLA.

Finally, in Principle 6, we request clarification on the statement that the HLA requirement must be met by the “highest quality capital.” In section 6.1 paragraph 99, the consultation document indicates that the “highest quality capital” is limited to core capital. Both core and additional capital should be considered the “highest quality capital.” If the goal of the HLA is to have an ongoing entity, it is not necessary to have assets that are immediately realizable for cash.

### **Section 3.7 HLA time frame**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The time frame is ambitious.

### **Section 4.1 BCR Calibration**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

As noted above, the uplift is inconsistent with the design and intention of the BCR. We suggest designing and calibrating the initial HLA with a focus on NTNI risks to augment the existing BCR.

## **Section 4.2 Components of total BCR + HLA**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

We have no comments on this section.

## **Section 4.3 Uplifting the BCR**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

As noted above, the uplift is inconsistent with the design and intention of the BCR. We suggest designing and calibrating the initial HLA with a focus on NTNI risks to augment the existing BCR. Further, we suggest that the IAIS clarify whether the uplift will be removed when the ICS replaces the BCR. If so, we recommend explicitly labeling the uplift as temporary in the HLA consultation document.

## **Section 4.4 Transition period for Uplifts**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

As noted above, the uplift is inconsistent with the design and intention of the BCR. We suggest designing and calibrating the initial HLA with a focus on NTNI risks to augment the existing BCR. If an uplift is used, the transition is unlikely to achieve any major purpose. Measuring the results would be just as easy using the full uplift amount. As long as the uplift is shown explicitly, any necessary adjustment could be made.

## **Section 5.1 Overall Approach (Possible HLA required capital formulas)**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The formula chosen is very simple. Risk sensitivity is focused in the BCR calculation with a secondary effect from the choice of gamma ( $\gamma$ ). The formula may be more risk-sensitive once ICS is implemented.

## **Section 5.2 Bucketing**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The presence of cliffs in regulatory formulas—such as the one being proposed in HLA—can result in unintended behavior by regulated entities. In particular, if an entity finds itself close to the cliff, it may alter its behavior to avoid going over, even if the step does not reduce risk in a significant manner, or at all. For example, a company could make a minor change to a liability estimate, even if there is no, or marginal, justification for the action.

The Solvency Committee would strongly urge the IAIS to consider a continuous approach instead. For example, rather than assigning a different value to  $\beta$  based on the entity's bucket,  $\beta$  could be a continuous function of an entity's score in the G-SII Assessment Methodology.

## **Section 5.3 Proposed HLA Insurance formulas**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

Please see our responses to previous questions regarding the use of a BCR uplift and the cliff in the bucketing proposal. We also have addressed our concerns about the choice of  $\gamma$  in our response to Section 5.7.

## **Section 5.4 Calibration of HLA**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The reasonableness of using 20 percent of the uplifted BCR (or ICS when it is implemented) will depend on a number of factors, including: the risk sensitivity of the BCR itself, the risk factors applied to HLA, and the revised definitions and risk charges of NTNI. It is difficult to make a determination of the usefulness of the calibration without this information.

## **Section 5.5 HLA Non-Insurance required capital formulas**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

Capping the NI HLA at the level for regulated banking may not be reasonable. If the IAIS believes regulated banking activities pose systemic risk and that systemically important firms should be required to hold additional capital, then it may be reasonable to require G-SIIs to hold more capital for their banking operations than the Basel requirements require.

## **Section 5.6 Outcomes for a range of Combined HLA required capital formulas**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

Given the assumed factors, we understand the potential outcomes.

## **Section 5.7 Managing the tension between risk sensitivity, complexity and volatility**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

*Question 1: The IAIS is currently considering putting G-SIIs into one or two populated buckets when determining the HLA required capital. How many buckets should the IAIS consider selecting to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

As discussed above, we suggest the IAIS adopt a continuous approach to determining HLA rather than a bucketing approach. Use of a cliff may lead to insurers taking action to avoid the cliff, which runs contrary to the IAIS's intended goals.

*Question 2: Should the IAIS consider selecting the size of gamma to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

Because the IAIS has stated that systemic risk in insurers arises from NTNI activities, the amount of the HLA should be based primarily on a G-SII's level of NTNI activity. Therefore, we recommend that  $\gamma$  be set close to 1.0 in order to reflect the systemic risk of each entity.

*Question 3: Should the IAIS consider selecting the calibration levels of the factors to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

Due to the simplicity of the BCR, the uplift/recalibration could result in a high level of false positives. The calibration level may need to be set lower for non-complex approaches or those in which the resulting capital charge is more volatile. For complex approaches, the calibration levels are unlikely to significantly impact the risk sensitivity, complexity, or volatility of the formula as proposed.

*Question 4: Should the IAIS consider introducing ceilings and/or floors on results for G-SIIs to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

A clear floor of approximately 10 percent might be reasonable. Without such a floor, it is questionable whether an entity should be considered a G-SII.

*Question 5: Should the IAIS consider using a combination of the above approaches to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

We strongly urge the IAIS to adopt the recommendations in our comments. Adopting these suggestions will help produce a HLA formula that is simple, risk-sensitive, and responsible to market volatility.

*Question 6: Should the IAIS consider using other approaches to manage the tension between risk sensitivity, complexity and volatility when calibrating the HLA required capital? Please provide a rationale for your response and suggest how this may be done if you consider it should be done.*

Please see our previous responses.

## **Section 5.8 Coverage ratios using various calibration reference points**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The ratios shown are useful for interpreting the results. However, after experience is gathered and the formula is better understood and calibrated, only a few of these will be needed.

## **Section 6.1 BCR and HLA capital resources**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

As noted above, the consultation document states that the HLA requirement must be met by the “highest quality capital,” later restated as core capital, whereas the uplifted BCR may be met by a combination of core capital and additional capital. Both core and additional capital should be considered the “highest quality capital” for purposes of the HLA. At the very least, the HLA should be met by a combination of core capital and additional capital, similar to the BCR.

## **Section 7.1 HLA interaction with G-SII designation process**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

If, after incorporating our recommended changes, an entity demonstrates a low HLA requirement relative to other insurers, an insurer’s designation as a G-SII may need to be re-examined. We would urge the IAIS to provide the results of the HLA calculations to those reviewing the G-SII Assessment Methodology.

## **Section 7.2 Field Testing 2015**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

Using both the 2014 and 2015 field testing results may enhance the selection of factors.

## **Section 7.3 HLA reporting process**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The reporting process should be confidential. Given the simple design of the BCR, the results could mislead users concerning the relative strength of the G-SIIs.

## **Section 7.4 BCR and HLA review process**

*Please provide your views on the assessments made and conclusions arrived at in this subsection. If you agree, then please indicate this. If you disagree then please explain the rationale for your disagreement. If you consider there are additional issues that should be considered, then please outline them and how they may impact the conclusions reached.*

The HLA factors do not need to be reviewed annually once the ICS is implemented. Prior to that, however, the factors would benefit from being reviewed annually, as the BCR is a very simplified measurement of required capital.

### **General**

*Are there any further comments you would like to make regarding this Consultation which have not been included in your responses under specific sections above?*

We have no further comments at this time.

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Thank you for this opportunity to provide feedback to the IAIS on its HLA consultation document. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202-223-8196 or [sarper@actuary.org](mailto:sarper@actuary.org).

Sincerely,

Elizabeth K. Brill, MAAA, FSA  
Chairperson, Solvency Committee  
Risk Management and Financial Reporting Council  
American Academy of Actuaries

cc: Michael McRaith, Director, Federal Insurance Office, U.S. Department of Treasury  
Tom Sullivan, Senior Adviser for Insurance, Federal Reserve Board  
Commissioner Kevin McCarty, Chair, ComFrame Development and Analysis Working  
Group, National Association of Insurance Commissioners  
David Sandberg, Chair, Insurance Regulation Committee, International Actuarial Association  
Jeff Schlinsog, Chairperson, Financial Regulatory Task Force, Risk Management and  
Financial Reporting Council, American Academy of Actuaries