August 14, 2017

IAIS—Global Insurance Capital Standard ICS 1.0

IAIS Releases Insurance Capital Standard ICS 1.0 for Extended Field Testing

SUMMARY

On July 21, 2017, the International Association of Insurance Supervisors (the "*IAIS*") released the Risk-based Global Insurance Capital Standard (the "*ICS*") ICS 1.0 for Extended Field Testing ("*ICS 1.0*").[1] The ICS is a group-wide, consolidated insurance capital standard being developed by the IAIS for application to Internationally Active Insurance Groups ("*IAIGs*")[2] and Global Systemically Important Insurers ("*G-SIIs*").[3] Once finalized, the ICS will constitute a minimum standard for a consolidated capital requirement to be achieved by IAIGs and G-SIIs. Supervisory authorities of IAIS member jurisdictions will be expected to implement, or propose to implement, the finalized ICS taking into account specific market circumstances in their respective jurisdictions. The IAIS has indicated that, as a group-wide, consolidated insurance capital standard, the ICS is not intended to serve as a legal entity capital standard or to replace existing capital standards for insurer legal entity supervision in any jurisdiction. The IAIS is developing the ICS as part of the Common Framework for the Supervision of Internationally Active Insurance Groups ("*ComFrame*").[4]

ICS 1.0 will be subject to extended field testing by a volunteer group of insurance companies, who will receive a field testing package, including technical specifications, templates, questionnaires and yield curve spreadsheets. ICS 1.0 follows two public Consultation Documents ("*CDs*") on the ICS, the first issued on December 17, 2014 (the "*2014 ICS CD*")[5] and the second on July 19, 2016 (the "*2016 ICS CD*").[6] The IAIS currently plans to issue a public consultation document on ICS Version 2.0 ("*ICS 2.0*") in mid-2018, and to adopt ComFrame and the final ICS Version 2.0 at the IAIS 2019 General Meeting. ICS

1.0 and the related field testing packages contain extended data requests and technical and policy issues that the IAIS is seeking to resolve for purposes of ICS 2.0.

ICS 1.0 describes the background and rationale for different components of extended field testing, which is intended to be conducted for all potential IAIGs and other interested volunteer groups. Through the extended field testing process, it is expected that volunteer insurance groups will be able to assess the impact of different ICS design options by their effects on the ICS ratios. ICS 1.0 covers the following four aspects of the ICS construction:

- *Valuation*: the valuation basis of assets and liabilities is a primary component of the ICS. ICS 1.0 includes two valuation approaches: the Market-Adjusted Valuation approach ("*MAV*") and the GAAP with Adjustments (GAAP Plus) approach ("*GAAP Plus*").
- *Capital resources*: ICS 1.0 provides for a two-tier system for capital resources where (1) Tier 1 capital resources comprise qualifying financial instruments, and capital elements other than financial instruments, that absorb losses on a going-concern basis and in a winding-up, and (2) Tier 2 capital resources comprise qualifying financial instruments and other capital elements that absorb losses only in a winding-up.
- *Capital requirement*: ICS 1.0 develops a standard method for calculating the ICS capital requirement (alternative methods, including the use of internal or external methods, for calculating the ICS capital requirement will be addressed in ICS 2.0). The standard method specifies the appropriate treatment of specified categories of risk, and addresses the treatment of risk mitigation techniques and aggregation/diversification.
- *Scope of application*: With respect to the scope of the ICS application and perimeter of the ICS calculation, there is no change from what was set out in the 2016 ICS CD. ICS 1.0 sets forth a set of principles for determining the scope of the group that falls within the ICS, and addresses how capital requirements for non-insurance activities will be handled under the ICS.
- *Tax*: ICS 1.0 includes some preliminary considerations for a holistic approach to tax within the ICS.

BACKGROUND

The IAIS

The IAIS, established in 1994, is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. U.S. members of the IAIS include the Federal Insurance Office (FIO), the National Association of Insurance Commissioners (NAIC), state insurance regulators and the Board of Governors of the Federal Reserve System. Although the policy measures and financial reforms promulgated by the IAIS have no legal force unless enacted at the relevant jurisdictional level, IAIS members have committed to implement policy measures promulgated by the IAIS, taking into account specific market circumstances, and to undergo periodic self-assessments and peer reviews with respect to their implementation.

The IAIS has developed three tiers of supervisory requirements and actions applicable to the insurance industry:

- Insurance Core Principles ("*ICPs*") that are intended to apply to the supervision of all insurers and insurance groups, regardless of size, complexity or systemic importance;
- ComFrame, which contains the ICS and is intended to apply to the cross-border supervision of IAIGs; and
- G-SII Policy Measures, which are intended to apply only to those insurance groups designated as G-SIIs.

ComFrame and IAIGs

ComFrame is a framework for the supervision of IAIGs and consists of both quantitative and qualitative supervisory requirements tailored to the complexity and international scope of IAIGs. ICS is only one component of ComFrame. As part of the integration of ICS into the comprehensive ComFrame framework, IAIS will consider how the ICS should be addressed in other parts of ComFrame, particularly those relating to Enterprise Risk Management (ERM), the supervisory process and reporting.

Development of the ICS

The IAIS announced its plan to develop the ICS in October 2013 in response to a request by the Financial Stability Board ("*FSB*") that the IAIS produce a work plan to create "a comprehensive group-wide supervisory and regulatory framework for Internationally Active Insurance Groups." The first consultation document, the 2014 ICS CD, was published by the IAIS in December 2014, and the second, the 2016 ICS CD, in July 2016. The IAIS received multiple comments on both CDs from IAIS members and stakeholders.

In addition to solicitation of responses through consultation documents and stakeholder meetings, the IAIS has undertaken quantitative field testing processes ("*Field Testing*") with volunteer insurance groups beginning in 2015. The analysis by the IAIS of the submitted data as well as additional feedback and comments provided by field testing volunteers informed the development of the subsequent field testing exercises in 2016 and 2017, and will continue through to 2019. Currently, the IAIS is conducting its third quantitative Field Testing exercise, with data to be submitted in September 2017. Each year, the IAIS will assess the results of Field Testing and determine any evidence-based changes necessary to the ICS prior to the scheduled 2019 adoption of the ICS. There will be a third CD for ICS 2.0 published prior to the 2019 adoption.

Once finalized, the ICS is intended to be a minimum standard for a group prescribed capital requirement to be achieved by IAIGs and all GSIIs.[7] Because the ICS is a group-wide, consolidated insurance capital standard, however, it is not intended to be a legal entity requirement or to affect or replace existing capital standards for legal entity supervision in any jurisdiction. Supervisors will, however, be free to adopt additional arrangements that establish more stringent standards or higher levels of minimum capital in their jurisdiction.

It is not clear what effect the development of U.S. insurance group capital standards[8] will have on the ICS process, or how the continuing development and refinement of the ICS may impact insurance group (and

potentially insurance legal entity) capital requirements in the United States or other jurisdictions. It also remains to be seen how any final ICS standards and requirements would be implemented in the event they are inconsistent with insurance group capital standards already developed and enacted at the domestic level.

PROCESS

The IAIS expects to launch the 2018 field testing process by mid-2018, collect comments on the ICS 2.0 and ComFrame consultation by late 2018, launch the 2019 field testing process by mid-2019, and adopt ComFrame, including ICS 2.0, at the IAIS 2019 General Meeting in late 2019.

The goals of ICS 2.0 are: (1) to achieve an improved level of comparability of outcomes across jurisdictions over ICS 1.0 (but possibly less comparability than as envisaged by the ultimate goal discussed below); (2) to continue using, but reduce the differences between, the two valuation methods; and (3) to allow the use of both a standard method and other methods of calculating the ICS capital requirement, including the use of internal models (partial or full), external models and variations of the standard method. In the period between the completion of ICS 1.0 and ICS 2.0, the IAIS will also consider transitional arrangements to help ensure a smooth implementation of the ICS.

The IAIS's ultimate goal, by a date not yet determined, is a single ICS that includes a common methodology that achieves the desired level of comparability, i.e., substantially the same outcomes across all jurisdictions. This is in line with one of the stated principles of the ICS, that "the amount of capital required to be held and the definition of capital resources are based on the characteristics of risks held by the IAIG irrespective of the location of its headquarters."

SCOPE OF APPLICATION: PERIMETER OF ICS CALCULATION

ICS capital resources and the ICS capital requirement are calculated on a consolidated group-wide basis; "Scope of Application" refers to entities within a group that are included in the calculation of ICS capital resources and the ICS capital requirement.

The Scope of Application for purposes of the ICS is intended to include all entities within a group that may be a potential source of risk to the group's insurance operations. For ICS purposes, non-insurance entities are included in the consolidated balance sheet when calculating ICS capital resources, with capital requirements for non-insurance financial entities calculated according to the specific sectoral requirements of such entities.[9] As a result, the overall ICS capital requirement will reflect the addition of insurance and non-insurance components.

Financial entities may be excluded from the Scope of Application only if the entities are immaterial from a risk perspective. In addition, non-financial entities may be excluded from the ICS consolidation if they are completely separate from the financial business of the group (e.g., no guarantees from, or shared

treasury or IT operations with, the financial businesses). The IAIS is in the process of considering providing either a specific definition or principles for determining the materiality of entities to include or exclude from the Scope of Application.

VALUATION

The valuation basis of the ICS is intended to be comparable across jurisdictions, and to be based on a total balance sheet approach which recognizes the interdependence between all assets, all liabilities, all regulatory capital requirements and all capital resources. Informed by 2014 Field Testing results, the IAIS initially determined that the MAV approach would be used as the initial basis to develop an example of a standard method in the ICS, and that participating IAIGs would supply data for the GAAP Plus approach and perform a reconciliation between the two approaches. In 2015 Field Testing, the IAIS tested the full example of a standard method on a MAV basis but tested the GAAP Plus approach on only a subset of risks. Field Testing in 2017 and 2018 will include the calculation of all risk charges on both a MAV basis and GAAP Plus basis.

The MAV approach

The MAV approach requires various IAIS-prescribed adjustments to significant components within jurisdictional GAAP accounting valuations, including the requirement to use current estimates (as determined under MAV) for insurance liabilities; the use of an IAIS-prescribed yield curve to project and discount insurance liability cash flows; and the use of fair value for financial instruments. The adjustments are limited to material assets and liabilities, including insurance liabilities and financial instruments. The valuation of assets and liabilities other than insurance liabilities and financial instruments would generally be based on IFRS or GAAP (or statutory accounting for U.S. mutual IAIGs), as applicable. In connection with developing ICS 2.0, the IAIS plans to continue to refine the MAV approach through field testing and public consultation, improving the technical specifications as necessary.

Note that by limiting MAV to the current estimates of insurance liabilities, margins that insurers typically establish on top of current estimates are eliminated; those margins are effectively added back through a margin over current estimates ("*MOCE*") (discussed below), to form, along with current estimates, the total insurance liabilities. Thus, insurance liabilities and reinsurance balances are adjusted to a current estimate, to which a MOCE is then added. Financial instruments, both assets and liabilities, including derivatives and mortgage and loan assets, are adjusted to fair value using the fair value method determined under the IAIG's applicable IFRS or GAAP standards. Non-insurance liabilities, including debt instruments issued by the IAIG, are adjusted to a value that does not take into account changes in the IAIG's credit standing.

Current Estimate

"Current estimate" for the ICS is defined in conformity with 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." The current estimate is intended to correspond to the probability-weighted average of the present values of the future cash flows associated with insurance liabilities using IAIS-specified yield curves. The ICS applies the same concept to the calculation of reinsurance recoverables, such that they are calculated consistently with the current estimates of insurance liabilities, using the same assumptions and inputs.

Discounting

The approach taken in ICS 1.0 for discounting is to prescribe yield curves for the 35 most traded currencies and provide the methodology for determining those yield curves for volunteer insurance groups that operate in other markets that are not covered by the prescribed yield curves.

In addition, ICS 1.0 provides three discounting methodology options; volunteer groups are expected to report the impact of each of these options under normal market conditions (at the reference date of the exercise) and under stressed credit spread conditions (under a synthetic scenario of widening of spreads developed by the IAIS for 2017 Field Testing, which does not aim to replicate any specific historical market event).

GAAP Plus

The GAAP Plus approach aims to lessen the operational and audit challenges posed by MAV's departures from GAAP that have been identified by several stakeholders. According to the IAIS, views of stakeholders have been split between using a more market-based approach for valuation (i.e., an approach similar to MAV) and using an approach more closely aligned with "book value" accounting rules followed in certain jurisdictions (e.g., the United States).

The starting point for GAAP Plus is the IAIG's audited, consolidated balance sheet, whether that be on a U.S. or Japanese GAAP, IFRS, or U.S. statutory (for U.S. mutual IAIGs) basis, as appropriate. The IAIS has proposed a set of general principles for the application of GAAP Plus and examples of GAAP Plus for several jurisdictions.[10]

A key principle of GAAP Plus is that it should be based, to the extent possible, on amounts, processes and systems that are subject to audit. As a result of recent accounting rule changes under IFRS and anticipated changes under U.S. GAAP that will significantly impact valuations of invested assets and insurance contracts, the IAIS anticipates that it will be necessary to reevaluate the current design of GAAP Plus for jurisdictions that report under IFRS or U.S. GAAP for purposes of 2018 and subsequent Field Testing.

An important aspect of the technical design of GAAP Plus relates to how Accumulated Other Comprehensive Income ("*AOCI*") is handled for valuation purposes. Under U.S. GAAP, long-term insurance liabilities are valued using an average investment portfolio earned rate that is adjusted gradually based on emerging long-term trends. However, under U.S. GAAP the majority of assets

backing long-term liabilities are measured at fair value each reporting period with the resulting gain or loss flowing through AOCI, a component of equity. Without adjustments, this asymmetric treatment of assets and liabilities would produce artificial and undue volatility under the GAAP Plus approach. In 2015, the IAIS proposed as an adjustment to identify the portion of AOCI comprised of unrealized gains and losses related to debt securities backing long-term liabilities, and exclude that portion from ICS capital resources. ICS 1.0 uses an AOCI adjustment that is consistent with the 2016 Field Testing technical specifications with the addition of some minor technical updates.

Margin Over Current Estimates

Margins over current estimates are included in the valuation of insurance liabilities in many jurisdictions. The IAIS considers the differences in how margins are calculated across regions to be a key reason for the lack of comparability in the valuation of insurance liabilities. The IAIS has therefore been developing and testing a "consistent and comparable MOCE" ("*CC MOCE*") for purposes of the ICS, which could be incorporated under both MAV and GAAP Plus approaches.[11]

The IAIS has been considering two approaches for the determination of CC MOCE: the Cost of Capital MOCE, i.e., a margin to recognise transfer value specified as a cost of capital approach, and the Prudence MOCE, i.e., a margin for prudence. The IAIS intends to continue to test and refine both the C-MOCE and the P-MOCE, and how the different MOCE approaches could interact with and impact the ICS capital requirement and capital resources.

CAPITAL RESOURCES

ICS 1.0, as with prior CDs, sets forth a two-tier system of capital resources. The IAIS is considering allocating financial instruments into two categories with differing qualifying criteria within each tier. The classification of financial instruments into tiers is based on quality and suitability, taking into consideration a number of criteria focused on five key principles: loss absorbing capacity (on a going-concern basis and in winding-up); subordination; availability to absorb losses; permanence; and absence of both encumbrances and mandatory servicing costs. Within each tier, financial instruments may be allocated into two categories with differing qualifying criteria:

- Tier 1:
  - Tier 1 financial instruments for which there is no limit (Tier 1 Unlimited)
  - Tier 1 financial instruments for which there is a limit (Tier 1 Limited)
- Tier 2:
  - Paid-Up Tier 2 financial instruments (Tier 2 Paid-Up)
  - Non-Paid-Up Tier 2 financial instruments (Tier 2 Non-Paid-Up)

ICS 1.0 presents a table, set forth below, providing a high-level overview of the differences between the tiers (other than Tier 2 Non-Paid-Up items).[12]

Key Principles	Tier 1 Unlimited	Tier 1 Limited	Tier 2 Paid-Up
Loss absorbing capacity	Absorbs losses on both a going-concern basis and in winding-up	Absorbs losses on both a going-concern basis and in winding-up	Absorbs losses in winding-up
Level of subordination	Most subordinated (i.e., the first to absorb losses); subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 capital instruments	Subordinated to policyholders, other non-subordinated creditors and holders of Tier 2 capital instruments	Subordinated to policyholders and other non-subordinated creditors
Availability to absorb losses	Fully paid-up	Fully paid-up	Fully paid-up
Permanence	Perpetual	Perpetual – no incentives to redeem; Issuer may redeem after a minimum period of 5 years after issuance or repurchase at any time, subject to prior supervisory approval	Initial maturity of 5 years – may have incentives to redeem but first occurrence deemed to be "effective maturity date"
Absence of encumbrances and mandatory servicing costs	IAIG has full discretion to cancel distributions (i.e., distributions are non-cumulative); The instrument is neither undermined nor rendered ineffective by encumbrances	IAIG has full discretion to cancel distributions (i.e., distributions are non-cumulative); The instrument is neither undermined nor rendered ineffective by encumbrances	The instrument is neither undermined nor rendered ineffective by encumbrances

ICS 1.0 presents results from 2016 Field Testing with respect to capital resources. Volunteer groups for 2016 Field Testing reported 769 financial instruments with a total face amount of approximately $404 billion. Of the reported financial instruments, approximately $140 billion qualified for Tier 1, $114 billion qualified for Tier 2, and $150 billion was non-qualifying. Capital resources (before deductions) were comprised of approximately 14% financial instruments and 86% capital elements other than financial instruments (such as AOCI, contributed surplus and retained earnings).

ICS 1.0 summarizes key themes and issues with respect to capital resources that have been raised during the Field Testing process and in comments and responses to the 2016 ICS CD, and indicates how these issues will be addressed going forward:

- *Structural vs. contractual subordination (treatment of senior debt)*: Some stakeholders have argued that structural subordination is sufficient to guarantee that policyholders will be paid first in a winding-up because capital cannot generally be removed from an insurance company to repay debt holders without regulatory approval. The IAIS is collecting additional data for 2017 Field Testing on how financial instruments in different jurisdictions are subordinated to policyholders through contractual or structural subordination. The IAIS is considering whether to recognize structurally subordinated debt, i.e., debt issued by a holding company and down-streamed into insurance subsidiaries, within ICS capital resources. The IAIS is considering certain conditions for recognizing such structural subordination, including that the instrument be issued by a "clean" holding company (i.e., a holding company without operational liabilities on its balance sheet), that regulatory capital be subordinated to operating liabilities, or that the proceeds from the instrument be down-

streamed into an insurance subsidiary located in a jurisdiction where there exists a "sufficiently high level of regulatory controls" over insurance company distributions.

- *Financial instruments issued by mutual IAIGs*: Some IAIS members and stakeholders have advocated the recognition of certain financial instruments issued by mutual IAIGs within Tier 1 capital resources. This continues to be considered by the IAIS, with possible options including a carve-out within Tier 1 capital resources for certain financial instruments issued by mutual IAIGs.
- *Non-paid-up capital resources*: The recognition of non-paid-up capital resources within ICS capital resources remains under consideration. The IAIS is considering whether recognition of non-paid up capital resources should be limited to mutual IAIGs.
- *Treatment of items deducted from Tier 1 (deferred tax assets (DTAs), computer software intangibles and net defined benefit pension fund surplus)*: Under ICS 1.0, these items will receive some limited recognition in Tier 2 capital resources through the development of a Tier 2 basket, with the sum of the basket items capped at a predefined level.
- *Financial instruments issued by consolidated subsidiaries of the IAIG and held by third parties*: The IAIS is currently considering an approach to limit the inclusion in qualifying capital resources of financial instruments issued by a consolidated subsidiary and held by third-party investors, as well as other capital elements derived from the subsidiary and attributable to third parties (e.g., capital elements included in a non-controlling interest).
- *Prior supervisory approval for redemption at maturity and consideration of lock-in features*: Under ICS 1.0, the Tier 2 criterion requiring prior supervisory approval for redemption of debt instruments will not apply at contractual maturity. For 2017 Field Testing, the IAIS is collecting additional information about lock-in clauses and supervisory approval, and the IAIS will be considering whether to treat lock-in clauses as equivalent to prior supervisory approval, and what criteria or conditions should apply if so.
- *Principal loss absorbency mechanism ("PLAM")*: Stakeholders based in Europe have supported the adoption of a PLAM requirement (e.g., the automatic write-down of principal and interest or the conversion to ordinary shares in the event of defined financial stress), as this is a feature used in Solvency II. Whether to apply a PLAM requirement is not a focus of ICS 1.0 and will be considered in the development of ICS 2.0.
- *Encumbered assets*: For ICS 1.0, the deduction for encumbered assets has been simplified by applying a proxy for the calculation of the incremental capital requirement. In addition, the amount deducted from Tier 1 will be recognized in Tier 2, subject to the limits on Tier 2 capital resources.
- *Capital composition limits*: ICS 1.0 does not include explicit capital composition limits. The IAIS has previously identified three capital composition limits to apply to capital resources: a limit on Tier 1 Limited capital; a limit on total Tier 2 capital; and a limit on Tier 2 Non-Paid Up capital. According to the IAIS, capital composition limits can only be set once the capital resources framework is finalized.
- *Treatment of components of AOCI*: ICS 1.0 indicates that almost all stakeholders agree that certain AOCI elements provide loss absorbing capacity on a going-concern basis. Specific AOCI elements identified include unrealized gains and losses, translation of foreign subsidiaries, cash-flow hedges, derivatives that qualify for hedge accounting under U.S. GAAP, and revaluation surplus. The treatment of AOCI elements is not a focus of ICS 1.0 and will be considered in the development of ICS 2.0.
- *Treatment of insurance liability/reinsurance adjustment offset*: The revaluation of the balance sheet under both the MAV and GAAP Plus approaches results in a balancing amount that has been termed "insurance liability/reinsurance adjustment offset." This amount represents the sum of adjustments for insurance liabilities, reinsurance assets, deferred expense assets and

deferred tax amounts. This issue is deferred for purposes of ICS 1.0 and will be considered in the development of ICS 2.0.

The IAIS intends to finalize all such issues for ICS 2.0, as well as issues around the fungibility of capital within the ICS.

ICS CAPITAL REQUIREMENT: THE STANDARD METHOD

The three key aspects of the ICS capital requirement are risk measure, time horizon, and confidence level. The ICS capital requirement, calculated using a risk-based method, is the amount of capital resources needed to cover losses at the specified criterion, i.e., VaR with a 99.5% confidence level over a one-year period. The ICS Ratio (the measure of capital adequacy) is determined by comparing the amount of qualifying capital resources to the ICS capital requirement using the following ratio:

ICS Ratio = qualifying capital resources / ICS capital requirement

The key categories of risk included in the standard method are: insurance risk, market risk, credit risk and operational risk. Various specific risks are grouped within each of the categories, as indicated in the table below. Each risk is measured individually using either a stress approach or a factor-based approach, although a stochastic modeling approach is used under the standard method for catastrophe risk. In a stress approach, the calculation of the capital requirement follows a dynamic approach where the capital requirement for each individual risk equals the decrease between the amount of capital resources on the pre-stress balance sheet and the amount of capital resources on the post-stress balance sheet. Under the factor-based approach, the calculation of the ICS capital requirement for a particular risk is determined by applying factors to specific exposure measures.

Risk / Sub-risk	**Scope***	**Factor-based**	**Stress**
Insurance Risks			
• Mortality risk	Unexpected changes in the level, trend or volatility of mortality rates		X
• Longevity risk	Unexpected changes in the level, trend or volatility of mortality rates		X
• Morbidity/Disability risk	Unexpected changes in the level, trend or volatility of disability, sickness and morbidity rates		X
• Lapse risk	Unexpected changes in the level or volatility of policy lapses, terminations, renewals and surrenders		X
• Expense risk	Unexpected changes in liability cash flows due to the incidence of expenses incurred		X
• Premium risk (non-life)	Unexpected changes in the level, trend or volatility of mortality rates	X	
• Claims reserve risk (non-life)	Unexpected changes in expected future payments for claims (to the extent not already captured in Morbidity/Disability risk)	X	

Risk / Sub-risk	Scope*	Factor-based	Stress
• Catastrophe risk**	Unexpected changes in the occurrence of low frequency and high severity events		
Market Risks			
• Interest rate risk	Unexpected changes in the level or volatility of interest rates		X
• Equity risk	Unexpected changes in the level or volatility of market prices of equities		X
• Real estate risk	Unexpected changes in the level or volatility of market prices of real estate or from the amount and timing of cash flows from investments in real estate		X
• Currency risk	Unexpected changes in the level or volatility of currency exchange rates		X
• Asset concentration risk	The lack of diversification in the asset portfolio	X	
Credit Risk	Unexpected changes in the actual default as well as in the deterioration of an obligor's creditworthiness short of default, including migration and spread risks	X	
Operational Risk	Operational events including inadequate or failed internal processes, people and systems, or from external events; includes legal risk, but excludes strategic and reputational risk	X	

*Risk of adverse change in the value of capital resources due to:
**Uses stochastic modeling approach

ICS 1.0 recognizes that there are other risks that IAIGs are exposed to other than the risks identified in the table above, such as group risk and liquidity risk. The IAIS considers that these other risks, for the time being, should not be quantified in the ICS capital requirement and should be addressed elsewhere in ComFrame.

Principles for the recognition of risk mitigation

The ICS takes account of the effect of recognized risk mitigation techniques, such as reinsurance, hedging of currency risk or dynamic hedging programs, provided certain conditions are met. Many respondents to the prior CDs have objected that the proposed ICS limits and conditions respecting short-duration risk mitigation techniques did not reflect the true value of the techniques and overstated the risks of not being able to renew in a stress scenario. The approach chosen for ICS 1.0 allows for the recognition of the expected renewal of short-duration risk mitigation techniques by increasing the proportion of such techniques that is recognised. This increase is subject to the renewal meeting specified conditions, and ICS 1.0 also applies a cap to the total proportion that can be recognized. For example, the recognition of the renewal of risk mitigation arrangements for market risks are subject to specified conditions that have been chosen "to limit recognition to circumstances where there is an established process for renewal as well as strong governance and a history of effective renewal." Where these conditions are met, the recognition of the renewal of the risk mitigation arrangement will be limited such that the value attributed to the renewal, net of all potential costs that may be incurred from the

implementation of the risk mitigation strategy, will not be more than 80% of "the difference between applying a proportional recognition and a full recognition of the arrangement after allowing for the costs already captured."

With respect to dynamic hedging arrangements, these are not recognized as a risk mitigation technique under ICS 1.0, except for the proportional recognition of what is in-force as of the balance sheet date. The treatment of dynamic hedging programs will be reconsidered in the development of ICS 2.0.

Look-through

The ICS uses a look-through approach for situations where the assets held by an IAIG "repackage" market, credit or underwriting risks (e.g., investment funds and catastrophe or longevity bonds). The IAIS has determined to go forward with one of the two options presented in the 2014 ICS CD, with certain adjustments. Under this option, the look-through approach should apply whenever and to the extent possible on the basis of the underlying currency exposures at a point in time inherent in the indirect investment or insurance arrangement. This approach allows for partial look-through when full look-through is not possible; when no look-through is possible, the full investment should be treated as unlisted equity.

Management actions

The general approach to management actions in prior Field Testing will be maintained for ICS 1.0, with one refinement compared to 2016 Field Testing, i.e., that management actions no longer include limited premium increases for health business. ICS 1.0 requires that management actions be substantiated in order to be taken into account, which may include documentation in a formal plan with an approval process at the right level of authority, or support through an objective review over prior periods.

Aggregation/Diversification

Because diversification of a portfolio reduces the overall levels of risk and volatility of the portfolio, the IAIS seeks a method of aggregating risks that will capture this diversification effect. In the 2014 ICS CD, the IAIS proposed a variance-covariance matrix approach to aggregate individual risk charges in order to reflect the diversification of risks in the calculation of the standard method for the ICS capital requirement. ICS 1.0 follows this same approach, with adaptations to reflect changes in the design of the ICS capital requirement.

HOLISTIC APPROACH TO TAX WITHIN THE ICS

The 2016 ICS CD sought input on the effects of taking taxes into account in each of the key components of the ICS (valuation, capital resources, and capital requirements), including developing approaches for reflecting, and evaluating the realizability of, deferred tax assets (DTAs) in the MAV and GAAP Plus valuation balance sheets and other ICS components. ICS 1.0 indicates that there has been no resolution

of tax issues and that the IAIS is still considering the way forward for ICS 2.0. The IAIS intends to organize a round-table discussion of tax experts to determine the way forward.

NEXT STEPS

The broad timetable for current expectations on the development of the ICS is set forth below.

Date	Milestone
September 2017	Data due for 2017 field testing process; discussion of ICS Version 2.0 begins
2nd Quarter 2018	Launch of 2018 field testing process
Mid-2018	Publication of comprehensive ComFrame consultation, including ICS Version 2.0
3rd Quarter 2018	Data due for 2018 field testing process
Late 2018	Comments due on ICS Version 2.0 and ComFrame consultation
Late 1st / early 2nd Quarter 2019	Launch of 2019 field testing process
Early 3rd Quarter 2019	Data due for 2019 field testing process
IAIS 2019 General Meeting (4th Quarter 2019)	Adoption of ComFrame, including ICS Version 2.0

* * *

ENDNOTES

[1] IAIS, Risk-based Global Insurance Capital Standard ICS 1.0 for Extended Field Testing (July 21, 2017), available at https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard//file/67651/ics-version-10-for-extended-field-testing. See also IAIS, Frequently Asked Questions for the global risk-based Insurance Capital Standard (updated July 21, 2017), available at https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard//file/67671/ics-frequently-asked-questions-21-july-2017.

[2] An IAIG is a large, internationally active group that includes at least one sizeable insurance entity. The IAIS does not intend to publish a definitive list of IAIGs, but will provide criteria for supervisors to assess, on a regular basis, whether ComFrame should be applied to a particular insurance group. The IAIS expects that in excess of 50 IAIGs will be identified by supervisors. ComFrame allows, however, a degree of supervisory discretion as to whether a particular group (whether or not meeting the proposed IAIG criteria) should be considered an IAIG.

[3] G-SIIs are defined by the Financial Stability Board and the IAIS as 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 FSB, in consultation with the IAIS and national authorities, designates G-SIIs on an annual basis each November based on an assessment methodology developed by the IAIS, which is subject to review and revision every three years. See our memorandum to clients entitled *IAIS Issues Updated G-SII Assessment Methodology* (June 28, 2016), available at https://sullcrom.com/iais-issues-updated-g-sii-assessment-methodology-iais-updates-assessment-methodology.

[4] IAIS, Common Framework for the Supervision of Internationally Active Insurance Groups (September 2014), available at http://www.iaisweb.org/page/supervisory-material/common-framework.

[5] IAIS, Risk-based Global Insurance Capital Standard Consultation Document (December 17, 2014), available at http://www.iaisweb.org/page/consultations/closed-consultations/risk-based-global-insurance-capital-standard//file/41483/risk-based-global-insurance-capital-standard-consultation-document.

[6] IAIS, Risk-based Global Insurance Capital Standard ICS 1.0 Public Consultation Document (July 19, 2016), available at http://www.iaisweb.org/page/consultations/current-consultations/risk-based-global-insurance-capital-standard--second-consultation//file/61557/2016-risk-based-global-insurance-capital-standard-ics-consultation-document. Prior ICS Consultation documents and Field Testing specifications, including the May 2017 Field Testing technical specifications and related materials, are available at https://www.iaisweb.org/page/supervisory-material/insurance-capital-standard//file/67655/public-2017-field-testing-technical-specifications. See our memorandum to clients entitled *IAIS: Global Insurance Capital Standard* (August 5, 2016), available at https://sullcrom.com/siteFiles/Publications/SC_Publication_IAIS_Global_Insurance_Capital_Standard.pdf.

[7] In addition to its ongoing development of the ICS, the IAIS has developed enhanced group insurance capital standards to be applied solely to G-SIIs, including "basic capital requirements" ("*BCR*"), which are applicable to all group activities and, for certain businesses and activities, "higher loss absorption capacity requirements" ("*HLA*"). The IAIS issued, and the FSB endorsed, a final version of the BCR in the fall of 2014, and a final version of the HLA in the fall of 2015. Although the BCR and HLA are more developed than the ICS at present, the IAIS has stated that it intends to revisit both standards following development and refinement of the ICS, and that the BCR will eventually be replaced by the ICS, at which point the ICS will become the basis for additional HLA capital requirements.

ENDNOTES (CONTINUED)

[8] See our memorandum to clients entitled *Federal Reserve Proposes Regulatory Capital Frameworks for Supervised Insurers and Enhanced Prudential Standards for Insurers Designated as Systemically Important* (June 7, 2016), available at https://www.sullcrom.com/federal-reserve-proposes-regulatory-capital-frameworks-06-07-2016.

[9] The capital requirement for regulated banking entities would be the maximum of the Basel III capital ratio requirements of 8% of risk-weighted assets or the 3% leverage ratio. For non-regulated banking business, the capital requirement would be based on the Basel III capital ratio applying a 4% leverage ratio. For assets under management, ICS 1.0 would apply the standard indicator method for addressing the operational risk of asset management activities in Basel II, but with an uplift so that the calculation is 16% of gross income (averaged over 3 years).

[10] The IAIS has proposed examples of GAAP Plus for the following accounting regimes: U.S. GAAP; U.S. SAP (statutory accounting principles for use by U.S. mutual IAIGs that do not prepare or file GAAP financial statements); Solvency II reporting used by EU groups; Canadian GAAP; and Japanese GAAP (J-GAAP).

[11] Feedback from the CDs has revealed that the introduction of a CC MOCE into the ICS has been generally negatively received by stakeholders. The two main reasons for this reaction, according to the CDs, are the lack of clarity on the purpose of the MOCE and the potential for the MOCE to be a source of greater complexity within the ICS framework. Some stakeholders have commented that the purpose of the MOCE overlaps with that of the capital requirement, while others consider it to be loss absorbing and therefore should be counted as part of capital resources.

[12] The IAIS did not include Tier 2 Non-Paid-Up items in its overview because those items do not possess the features presented in the table, although such items would, in their paid-up form, give rise to financial instruments or other capital elements possessing such features.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Michael B. Soleta (+1-212-558-3974; soletam@sullcrom.com) in our New York office.

CONTACTS

New York		
Robert G. DeLaMater	+1-212-558-4788	delamaterr@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Roderick M. Gilman Jr.	+1-212-558-3277	gilmanr@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Washington, D.C.		
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
London		
Ben Perry	+44-20-7959-8477	perryb@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
Garth W. Bray	+852-2826-8691	brayg@sullcrom.com