Module D Unit 6B

SOLVENCY

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of the methods by which solvency is tested and the importance of maintaining adequate solvency at all times.

Assumed knowledge

None

Summary of learning outcomes
1. Explain the difference between MCR, PCR and OSCA in relation to the regulatory solvency requirements.
2. Explain how the amount of premium written and claims reserves impact a (re)insurer's solvency.
3. Explain when an ORSA is required.
4. Describe the four stages of the Supervisory Ladder of Intervention.

Module D Unit 6B

SOLVENCY

6.0 THE INSURANCE BUSINESS (SOLVENCY) RULES AND GUIDANCE, 2021

This document takes a two-level approach:

- the Rules set out the standards to be met; and

- guidance notes offer ways of demonstrating compliance with the Rules.

Insurers may adopt alternative measures to those set out in the guidance as long as it is possible to demonstrate that such measures achieve compliance.

6.1 RULES

6.1.1 Part 1 - Introduction

For the purposes of the Rules each insurer falls under one of the following categories –

(a) Category 1 – Commercial Life Insurers – a long-term insurer with any element of unrelated party business;

(b) Category 2 – Commercial Life Reinsurers – a long-term reinsurer with any element of unrelated party business;

(c) Category 3 – Commercial General Insurers – a general insurer with an element of unrelated party business;

(d) Category 4 – Commercial General Reinsurers – a general reinsurer providing reinsurance to a commercial insurer, whether or not part of the same group, and with no direct business;

(e) Category 5 – Captive (Re)insurers – a life or general insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities or associations the purpose of which is to provide insurance or reinsurance cover for risks, other than commercial risks, of the entity or entities to which it belongs, or for entities connected to those entities; and

(f) Category 6 – Special Purpose Entities –

(i) Special Purpose Insurers as defined under the Insurance Business Rules, Part 6; or
(ii) Entities that the Commission agrees, in writing, may fall into this category.

Category 6 is primarily intended for insurers whose underwriting and counterparty Credit risk are effectively eliminated. Examples of these would include transformer cells, fully collateralised catastrophe cells, Insurance Linked Securities cells and fully funded entities.

6.1.2 Part 2 – Capital adequacy

(1) A licensed insurer must at all times hold regulatory capital resources greater than or equal to its Minimum Capital Requirement (“MCR”).

(2) A licensed insurer must at all times hold regulatory capital resources greater than or equal to its Prescribed Capital Requirement (“PCR”).

(3) It is a requirement of section 32 of the Law that:

(a) a licensed insurer which is a company must maintain a paid up share capital of not less than the Capital Floor or an equivalent sum in any currency acceptable to the GFSC; and
(b) a licensed insurer which is a company shall maintain minimum shareholders' funds of at least 75% of the Capital Floor or an equivalent sum in any currency acceptable to the GFSC.

(4) The Capital Floor of a licensed insurer is currently:

(a) £100,000 for a licensed insurer carrying on general business;
(b) £250,000 for a licensed insurer carrying on long term business;
(c) £250,000 for a licensed insurer carrying on both long term business and general business; or
(d) an amount specified in writing by the GFSC.

(5) For PCCs the Capital Floor only applies to the overall PCC. There is no Capital Floor for each cell or the core.

(6) The MCR of a licensed insurer must be no less than the Capital Floor.

An insurer must calculate its PCR and report the results of that calculation to the GFSC at least once a year. A regulatory capital resources calculation must be submitted as part of an insurer's annual return and be calculated and reported, where the Guernsey standard formula is used, using the standard format determined by the GFSC and published on its website.

A licensed insurer must monitor the amount of its regulatory capital resources and its MCR on an ongoing basis.] If the licensed insurer's risk profile deviates significantly from the risk profile detailed in its last reported PCR, the licensed insurer must recalculate its PCR without delay and report it to the GFSC.

6.1.3 Part 3 – MCR

The MCR is intended to be the capital required to ensure that the insurer should be able to meet its obligations over the next twelve months with an 85% probability.

The MCR of an insurer carrying on general business is an amount of not less than the higher of:

(a) 12% of that insurer's gross written premiums during the previous financial year, net of –

(i) the amount of any premium taxes, rebates, refunds, and commissions accrued by the licensed insurer, and
(ii) the gross amount of any reinsurance premiums, after deduction of any rebates or commissions receivable by the insurer, ceded by the insurer in respect of general business during that preceding financial year;

(b) 12% of the value of claims reserves and premium reserves, net of reinsurance and amounts reserved to maximum; and

(c) the Capital Floor.

The MCR of a licensed insurer writing life business is the higher of:

(a) 2.5% of total reserves, net of reinsurance; and
(b) the Capital Floor.

The MCR does not apply to a Category 6 insurer, provided that the entity continues to qualify for inclusion in this category on an ongoing basis.

6.1.4 Part 4 - PCR

1) The PCR of an insurer equals:

(a) an amount determined either –

(i) by applying the 'Guernsey standard formula';
(ii) by applying a 'recognised standard formula';
(iii) by using an internal model developed by the company to reflect the circumstances of its business;
(iv) by using a partial internal model which is a combination of the approaches specified in (i) and (iii) or (ii) and (iii); or (v) by using any one of (i) to (iv) above and modifying it to take account of the Green Discount set out in the Rules, provided the insurer meets all of the requirements set out in Part 8 of these Rules; plus

(b) any regulatory adjustment specified in writing by the Commission.

(2) The PCR is the capital required to ensure that the licensed insurer is able to meet its obligations over the next 12 months with a probability as defined by the following specified confidence levels:

(a) Category 1 - Commercial Life Insurers- the PCR is determined at a 99.5% confidence level;

(b) Category 2 - Commercial Life Reinsurers - the PCR is determined at a 97.5% confidence level;

(c) Category 3 - For Commercial General Insurers - the PCR is determined at a 99.5% confidence level;

(d) Category 4 - Commercial General Reinsurers - the PCR is determined at a 97.5% confidence level;

(e) Category 5 - Captive (Re)insurers - the PCR is determined at a 90% confidence level.

The PCR does not apply to a Category 6 insurer, provided that the entity continues to qualify for inclusion in this category on an ongoing basis.

Regardless of the method used, an insurer's PCR cannot be less than its MCR.

General Business - PCR standard formula

(1) The PCR for general business determined using the standard formula is equal to –

(a) the capital requirement for market risk; plus

(b) the capital requirement for counterparty default risk; plus

(c) the capital requirement for premium risk; plus

(d) the capital requirement for reserve risk; less

(e) a diversification adjustment as determined in accordance with Schedule 8; plus

(f) any regulatory adjustment specified in writing by the Commission.

(2) For each risk and risk component the resulting capital requirement must not be negative.

Life Business – Standard Formula

(1) The PCR for life business determined using the Guernsey standard formula is equal to –

(a) the capital requirement for market risk; plus

(b) the capital requirement for counterparty default risk; plus

(c) the capital requirement for underwriting risk; less

(d) a diversification adjustment as determined in accordance with the Schedule 10; plus

(e) any regulatory adjustment specified in writing by the Commission.

(2) The capital requirement for each risk and each risk component is determined as –

(a) the unstressed value of the assets less the unstressed value of the liabilities; less

(b) the stressed value of the assets less the stressed value of the liabilities,
subject to a minimum of zero.

(3) When determining the capital requirement for each risk, the licensed insurer may make allowances for management actions that it would reasonably expect to take in response to the risk being considered, subject to the management actions being determined:

(a) in an objective and consistent manner

(b) they are realistic and consistent with the licensed insurer's current business plan;

(c) they reflect any legal, regulatory or contractual requirements; and

(d) where there is business with a profits participation clause, they consider policyholder's reasonable expectations.

(4) Licensed insurers may simplify the stresses set out in these Rules to the extent that it is proportionate to the nature, scale and complexity of the risk being considered.

6.1.5 Part 5 – Internal Model

(1) An insurer may use a partial or full internal model to calculate its PCR subject to the prior written approval of the Commission.

(2) An insurer may use a partial model for the calculation of –

(a) one or more risk components of the standard formula.
(b) one or more risk components of a recognised standard formula.

(3) A partial model may be applied to the whole business of the insurer or only to one or more major business units.
(4) An internal model cannot be used to determine an insurer's MCR or determine its regulatory capital resources.

(5) An insurer does not require Commission approval, initial or ongoing, for the use of its internal model in determining its own economic capital needs or management.

6.1.6 Part 6 – Valuation

For the purpose of preparing the Regulatory Balance Sheet the value of the assets and the value of the liabilities must be determined on the basis of the Recognised Accounting Standards used to prepare the financial statements; adjusted for any basis adjustment.

6.1.7 Part 7 – Investment

(1) A licensed insurer, when investing in assets, must consider whether, for the portfolio as a whole:

(a) assets are sufficiently secure;

(b) liquidity, that payments to policyholders or creditors are able to be made as they fall due;

(c) assets are held in the appropriate location for their availability; and

(d) assets are sufficiently diversified subject to the nature, scale and complexity of the business.

(2) A licensed insurer must invest in a manner that is appropriate to the nature of its liabilities.

(3) A licensed insurer must invest only in assets whose risks it can properly assess and manage.

(4) A licensed insurer must establish an investment policy which –

(a) specifies the nature, role and extent of its investment activities;

(b) specifies how it complies with these Rules; and

(c) establishes explicit risk management procedures with regard to more complex and less transparent classes of asset and investment in markets or instruments that are subject to less governance or regulation.

(5) A licensed insurer must not invest in derivative contracts or any asset under lien securing any derivative contract, unless in any particular case the Commission consents in writing to their being regarded as such and on such conditions as it may impose

(6) A licensed insurer may invest in Exchange Traded Derivative Contracts, or schemes resulting in equivalent arrangements, without the prior approval of the Commission only in certain circumstances.

(7) A licensed insurer may invest in forward foreign exchange transactions, conducted with a recognised bank, to the extent that they hedge currency exposures to currencies other than the reporting currency in the statutory accounts.

6.1.8 Part 8 – Risk Management and Own Risk Solvency Assessment

Risk Management

(1) A licensed insurer must establish and maintain a risk management framework that is appropriate to the nature, scale and complexity of the business. The risk management framework is the totality of the systems, structures, policies, processes and people that identify, assess, mitigate and monitor all internal and external sources of risk that could have a material impact on the licensed insurer.

(2) A licensed insurer's risk management framework must –

(a) provide for the identification and quantification of material risks under a sufficiently wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of the risks it bears;

(b) include a risk management policy;

(c) be supported by accurate documentation;

(d) be responsive to changes in its risk profile; and

(e) incorporate a feedback loop, based on appropriate and good quality information, management processes and objective assessment, which enables it to take the necessary action in a timely manner in response to changes in its risk profile.

(3) A licensed insurer is required to establish and maintain a risk tolerance statement. The statement must set out its overall quantitative and qualitative risk tolerance levels and define its risk tolerance limits taking into account all relevant and material categories of risk and the relationships between them.

(4) A licensed insurer's risk management policy must, at a minimum-

(a) describe how all relevant and material categories of risk are managed, both in the licensed insurer's business strategy and its day-to-day operations;

(b) describe the relationship between the licensed insurer's tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk;

(c) include explicit policies in relation to –

(i) underwriting risk;
(ii) investment; and
(iii) asset-liability management.

Own Risk Assessment
(1) The licensed insurer must perform an Own Risk and Solvency Assessment ("ORSA") comprising:

(a) the licensed insurer's own assessment and calculation of its solvency requirements, an Own Solvency Capital Assessment, "OSCA";

(b) the licensed insurer's assessment of risk management; and

(c) the licensed insurer's assessment of the adequacy of capital resources to meet future capital requirements.

(2) Subject to (3), all licensed insurers are required to perform an ORSA.

(3) A licensed insurer meeting at least one of the following criteria is not required to perform an ORSA –

(a) a licensed insurer classified as a Category 6 licensee;

(b) a licensed insurer which is dormant with no outstanding insurance liabilities;

(c) a licensed insurer that would otherwise be required to perform an OSCA only and whose board of directors considers the PCR to be sufficient. In such cases, this should be clearly stated either in the documentation submitted with the annual return or in separate correspondence. Any such statement should be accompanied by the supporting rationale for this decision; and

(d) a licensed insurer notified in writing by the Commission.

(4) Unless otherwise notified in writing by the Commission, a licensed insurer meeting at least one of the following conditions need may limit their assessment to an OSCA only:

(a) a Category 1 licensed insurers writing life business with an MCR below £350,000;

(b) a Category 2 licensed insurer with an MCR below £7,500,000;

(c) a Category 3 licensed insurer with an MCR below £1,500,000;

(d) a Category 4 licensed insurer with an MCR below £7,000,000;

(e) a Category 5 licensed insurer; and

(f) a Protected Cell Company.

(5) An ORSA must be performed at least once a year.

(6) A licensed insurer must recalculate the ORSA if the risk profile of the licensed insurer deviates significantly from the assumptions underlying the last performed assessment.

(7) A licensed insurer must include in its ORSA all reasonably foreseeable and relevant material risks including, as a minimum –

(a) underwriting risk;

(b) credit risk;

(c) market risk;

(d) operational risk;

(e) liquidity risk; and

(f) any additional risks arising due to membership of a group.

6.1.9 Part 9 – Green assets

(1) Green Assets are defined as resources controlled by an insurer, as a result of past events, from which future benefits are expected to flow to the insurer and which meet one of the green criteria set out in Schedule 11. [208]

(2) A Category 1 or Category 2 insurer that makes investments into Green Assets may apply an adjustment, or “Green Discount”, when calculating their PCR using the Guernsey standard formula, a recognised standard formula, of a full or partial internal model.

6.2 GUIDANCE

6.2.1 Guidance Note for Licensed Insurers Own Solvency Assessment

OSCA Methodology

The GFSC does not give prescriptive guidance about the methodology which must be used by insurers to calculate their OSCAs. The following general comments are given to insurers to help them identify the factors which they may wish to consider when making their own calculations and developing their rationale to explain the methodology which has been used.

Where insurers already use their own internal models, for example to calculate their internal economic capital requirements, these models could be recalibrated to calculate the OSCA for regulatory purposes. Where internal models are not available, as would be the case for most captives, licensed insurers may wish to adopt a deterministic approach to calculating the OSCA by identifying and considering a number of different possible scenarios.

When considering possible levels of future claims under a deterministic approach, insurers should consider the potential for future adverse development of claims already notified as well as the uncertainty surrounding provisions for claims incurred but not reported (“IBNR”).
Allowance should also be made for the possibility of future claims occurring during the accounting period at a level that exceeds the premium received in respect of that period. If future claim payments are discounted in calculating provisions, allowance should be made for the possibility of yields on matching investments falling below the discount rate used. If account is taken of actuarial advice in deriving provisions for existing claims not yet settled or in setting IBNR provisions, consideration should be given to the underlying rationale for the range of possible outcomes and the adequacy of the insurer’s capital resources in the event of a “worst-case” scenario occurring.

As well as considering potential levels of future claims, consideration should be given to the performance of non-cash assets under different economic scenarios as well as the potential non-recovery of reinsurance balances and the security of bank deposits. The OSCA should also take account of the expected probability of each scenario occurring and the need to hold further capital to provide enhanced protection to any unrelated party policyholders or third party claimants, for example under liability policies.

An allowance can be made, if appropriate, for diversification of risks using an accepted methodology such as the “square root of the sum of the squares”, provided allowance is also made for correlation between the various risks.

The OSCA should also take account of any other potential risks that might impact the solvency of the company. Apart from the insurance and investment risks mentioned above, these could include operational risk, liquidity risk, concentration risk, catastrophe risk, regulatory risk (particularly in the jurisdiction where the risk is located) or the exposure to related parties.

The guidance includes a list of items that the GFSC expects will be addressed in order for the GFSC to determine that the methodology used is appropriate.

6.2.2 Guidance Note on Supervisory Ladder of Intervention

International Association of Insurance Supervisors (IAIS) ICP 17, Capital Adequacy requires the supervisor to set solvency control levels which trigger different degrees of intervention by the supervisor. The upper control level is a level above which the supervisor does not intervene on capital adequacy grounds. The lower level is the level below which no insurer is regarded as viable to operate effectively and which, if breached, the supervisor would invoke its strongest actions.

The upper control level is required to be defined such that assets will exceed liabilities with a specified level of safety over a defined time horizon. This is referred to as the calibration of the solvency requirement.

The concept of an upper and lower range for the regulatory capital requirements is well established internationally and is used in a number of jurisdictions including the EU, Switzerland, Canada and Australia.

Broadly speaking, the GFSC does not require action to increase capital held or reduce risks undertaken if the insurer’s capital remains over the PCR. However, this does not preclude the GFSC from intervening or requiring action by the insurer for other reasons, such as weakness in the risk management or governance of the insurer. The PCR is set at a level that allows intervention at a sufficiently early stage such that there would be a realistic possibility of rectifying the situation.

The MCR is the intervention point at which the GFSC would invoke the strongest action and represents the level below which no insurer is regarded as being viable to operate effectively.

The PCR and MCR represent two solvency control levels on the GFSC’s ladder of intervention. Solvency control levels are regulatory capital levels at which intervention by the GFSC would be triggered. The strength of such intervention will vary with the point on the ladder at which it occurs.

6.2.3 The Ladder:

Normal operations

- **Circumstances -** Capital resources are greater than 105% of the PCR.
- **GFSC intervention –** None. Standard supervisory measures apply.

Stage 1 – Early warning

- **Circumstances –** Capital resources are between 100% and 105% of the PCR. Identification of deficiencies in policies or procedures or the existence of other circumstances that could lead to the development of problems. The situation is such that it can be remedied, by a collaborative approach between the insurer and the GFSC, before it impacts on the financial viability of the insurer.
- **GFSC intervention –** The GFSC will discuss the concerns with the insurer and request measures to rectify the situation. Remedial actions will be monitored by the GFSC and may involve requests for additional information and/or follow-up examinations.

Stage 2 - Risk to financial viability or solvency

- **Circumstances –** Capital resources are between 50% and 100% of the PCR. Risks are identified which suggest weaknesses in the insurer’s systems and controls which could adversely impact upon its future solvency. The situation can be resolved collaboratively but more formal regulatory action may be required to protect policyholders.

- **GFSC intervention –** The GFSC will intensify risk dialogue with the insurer with the objective of mitigating the increased risk. The insurer is notified of concerns and required to submit and implement a recovery plan appropriate to the nature, scale and complexity of its risks that will return the insurer to Normal Operations within a defined period of the underfunding being detected. The scope of on-site examination and/or frequency of on-site examinations may be enlarged or increased. An external party (inspector) may be required to perform a particular examination relating to the adequacy of the insurer's procedures for the safety of its creditors, shareholders and policyholders, or any other examination that may be required in the public interest, and report thereon to GFSC at the insurer's expense. An independent actuary may be required to perform a review of the appropriateness of the insurer's technical provisions at the insurer's expense. The GFSC may require adjustments to the insurer's actuarial methods and assumptions. Business restrictions appropriate to the nature, scale and complexity of the insurer may be imposed.

Stage 3 - Future financial viability in serious doubt

- **Circumstances –** Capital resources are between the MCR and 50% of the PCR. The risks outlined as per stage 2 suggest significant weaknesses in the insurer's systems and controls which are highly likely to impact upon its future solvency
- **GFSC intervention –** The GFSC may enhance the Stage 2 measures where applicable and/or initiate further actions including:
    - modifying the Licensee's capital requirement
    - thematic on-site examinations focusing on the particular areas of concern. Such examinations may involve the engagement of external specialists or professionals to assess certain areas such as asset values, appropriateness of actuarial reserves, etc. The Licensee will be required to meet the costs of such examinations
    - removal and replacement of Directors, Officers or Controllers

  The GFSC will develop a contingency plan for taking rapid action if necessary due to further changes in circumstances.
  Status of Licensee discussed with other relevant regulatory bodies.

Stage 4 – Insurer not viable/insolvency imminent

- **Circumstances –** Capital resources are less than the MCR. The insurer has failed to identify and rectify risks to solvency at an earlier stage in the ladder resulting in an unacceptable level of risk:

  - that policyholder obligations will not be paid; and/or
  - that the reputation of the Bailiwick will be damaged; and/or
  - that debts cannot be met as they fall due.

- **GFSC intervention – The GFSC** notifies the insurer's management and board of directors of intended regulatory intervention measures that will be taken unless immediate actions to restore solvency are undertaken. It must be apparent to the GFSC within a short period of time whether the actions initiated by the insurer are likely to rapidly restore its financial position. Such immediate actions include:

  - increase of capital resources or reduction of requirement capital
  - voluntary transfer of the entire insurance portfolio
  - partial transfer of the insurance portfolio, resulting in capital resources being above the MCR subsequent to the transaction

  New business restrictions will be imposed or existing restrictions expanded.

The GFSC contingency plan will be implemented. Other relevant regulators are notified of proposed regulatory intervention measures to be applied to the Licensee.

The GFSC may apply to the Court for an order to wind up or place the Licensee into administration if the remedial measures do not lead to success in the short term.

The GFSC will consider the conduct of controllers, directors, auditors and actuaries in the context of Corporate Governance requirements and, if appropriate, will consider regulatory action against the individuals.

Module D Unit 6B

SOLVENCY

Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. What type of business activity is a Category 5 licence permitted to write?
2. What is the Minimum Capital Floor for a Guernsey insurer writing General Insurance only?
3. When should the PCR of an insurer be calculated?
4. What is the purpose of an OSCA?

Summary of learning outcomes
1. Explain the difference between MCR, PCR and OSCA in relation to the regulatory solvency requirements.
2. Explain how the amount of premium written and claims reserves impact a (re)insurer's solvency.
3. Explain when an ORSA is required.
4. Describe the four stages of the Supervisory Ladder of Intervention.