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Statement of Guidance

Capital Adequacy of Class B Insurers

1. Statement of Objectives

To provide guidance on how much capital a Class B insurance company should hold.

2. Introduction

2.1. Insurers need capital to provide a buffer against the uncertainty inherent in their activities and their results. Broadly speaking, the greater the uncertainty about the outcome, the more capital that is required. It is recognized that holding higher levels of capital than is necessary for regulatory needs, promotes policyholder confidence.

2.2. Uncertainty commonly arises from three main risk areas:

a) Insurance risk

This includes underwriting risk and claims risk (including the possible adverse development on claims)

b) Investment risk, and

c) Credit risk

This arises particularly in relation to reinsurance arrangements.

2.3. The asset–liability management process is fundamental to the business operation.

2.4. Premium to surplus ratios, although ingrained in much insurance market thinking and regulatory practice, may be easy to calculate but they can be misleading. This is demonstrated by a simple example (and in recent years a common one in the insurance world): an insurer slashes its rates in response



November 2006

to competition. Evidently its underwriting risk is greater as it will now be receiving less premium for the same business. It therefore needs more capital to support this market driven rather than risk based underwriting, not less as reference to a premium to surplus ratio implies. In addition, relating solvency to premiums means credit or investment risks, which can be significant, are not taken into account.

3. Liabilities (Technical Provisions)

- 3.1. Technical provisions of companies have to be adequate, reliable, objective and allow comparison across companies.
- 3.2. There needs to be a justification for anticipated claims, which is related to the actual risks being underwritten. Unsubstantiated assumptions about loss ratios create additional uncertainty.
- 3.3. A significant item on the liabilities side of the balance sheet that the Authority may not take as given is the provision for outstanding claims, particularly the IBNR element. In respect of long tail and long term business, it is expected that the ultimate cost of these liabilities will have been calculated by actuaries or be supported by an equally credible process.
- 3.4. Where the company's reserving policy leads to reserves that are in excess of expected losses as determined actuarially or by management, the excess may be treated as unreleased earnings and therefore as contributing to overall net worth for regulatory purposes. As appropriate, the Authority will call for additional actuarial work to be undertaken to evaluate the implications of certain reserving policies.
- 3.5. Insurance (Underwriting) risk
On the basis that "the law of large numbers" does not work to the advantage of most class B insurers, it is vital that the risks being accepted and the resulting insurance obligations are well understood. Limits of coverage, policy



November 2006

form and premium are key in this respect. In the single parent owned class B structure source of business should not be an issue. In other class B ownership structures however, control of the risks being underwritten may become more remote. In addition, moral hazard can exist where those introducing the business have no vested interest in its quality.

4. Assets

4.1. Assets have to be appropriate, having regard to their safety and return. The assets must be sufficiently spread and should ensure overall liquidity, being convertible to cash within a reasonable time. Assets should also be objectively valued.

4.2. Licensees should avoid assets that have conditions and restrictions attached such as those requiring future commitments of funds to hold or be of value.

4.3. Unrealised investment losses will be discounted to varying degrees, and should allow for the time horizon of the company's claims settlement profile.

4.4. Credit risk

Credit risk arises from the existence of relationships with counter-parties, including insureds, ceding insurers and reinsurers.

4.4.1 Premium income

The credit risk attached to the premium income may be relatively low in the case of Class B insurers, however this should not lead to complacency in the relationship with the insured. Prudent business practice with regard to premium flow and collection is expected.

4.4.2 Ceding insurer

As a ceding arrangement will usually require a commitment of capital from the class B insurer, this represents a credit risk exposure to the insurer in the event of the ceding company becoming insolvent.



November 2006

4.4.3 Reinsurance

The level of reinsurance purchased, will determine how fundamental the reinsurance is to the insurers viability. In order to minimise the potential credit risk inherent in the use of reinsurance, class B insurers should seek to select reinsurers that have a proven track record of being willing and able to meet their obligations as they fall due. To this end class B insurers are advised to adopt risk management strategies to address the credit risk presented.

4.5. Investment risk

A company's investment structure will be a major determinant of its performance and stability. Preserving asset value is fundamental to maintaining adequate reserves for technical liabilities. Likewise, to the extent those reserves are discounted, the discount rate used must broadly reflect actual investment yields. High levels of trading activity portend more volatile results.

4.5.1 Liquidity risk

The mix of investments should take account of the company's cash flow needs and its flexibility to make accelerated claim settlements, as necessary.

4.5.2 Foreign exchange risk

Those companies involved in international business with multi-currency obligations should structure their investments to match these.

4.6. Concentration risk

The degree to which parent company or related party loans are acceptable will be left to the discretion of the Authority, for example repayment terms and the financial strength of the borrower will be taken into account.

5. Funding Levels

Insurance pricing is inherently difficult and it may be many years before a decision can be determined to have been correct. The logic for the premium



November 2006

rates being applied needs to be spelt out. Earned premium, as opposed to written premium, is also important. The Authority expects insurers to aim for at least break-even underwriting results. Operating expenses should be factored in along with an allowance made for policies that provide retrospective premium adjustments.

6. Minimum Capital Requirements

6.1. Absorption of losses

Capital requirements are needed to absorb unforeseen losses.

6.2. Net worth definition

Net worth is the excess of assets over liabilities, other than liabilities to partners or shareholders. This is also termed the solvency margin.

6.3. Statutory capital requirement

Unrestricted Class "B" insurers must maintain at all times net worth as prescribed by the law. This may be described as the **statutory capital** requirement, and it must be held as realisable assets. For restricted class B licensees the minimum amount required will be as agreed with the Authority.

6.4. Regulatory Capital

The Authority may require a further, risk-based level of capital to be maintained, and the aggregate is referred to as **regulatory capital**, the form of which may be negotiable, and includes among other instruments letters of credit. Statutory capital, where applicable, is then a part of the overall regulatory capital where prescribed.

6.5. Capital should be of good quality with the following features:

- a) It is able to absorb losses
- b) It ranks for repayment upon winding up after all other debts and liabilities.
- c) Permanent in nature, and



November 2006

d) Unencumbered.

6.6. In recognising the level of capital and surplus that is deemed to be sufficient for the proposed insurance business of the class B insurer under review, the rationale is not that a company's underwriting creates an exposure that must be filled by capital, but that the blend of risks faced generates a degree of uncertainty that needs to be hedged against.

7. Control Level

7.1. Where regulatory capital has been eroded, a capital injection may be required.

7.2. Management should be monitoring the performance of the company to continually assess whether it has sufficient capital and surplus for the risks it is writing. At the very least, this should mean the regular analysis of management accounts.

8. Operational Risk Management

8.1. Quality of the risks being written, including the standard of risk management: The rationale for most class B insurers is based on the premise that the business performance of the parent company is well above average. This needs to be demonstrated both by the insured's record and the effort being applied to risk control. The positive management of risk should result in a good loss experience.

8.2. Claims management procedures:

Timely and effective management of the claims process after a loss occurrence can have a dramatic effect on reducing the ultimate cost of a claim. The arrangements made to achieve this will be an important ingredient in the success of many class B insurers.



November 2006

9. Run-Off

For companies in run-off i.e. those that are no longer writing business (new or renewed), the level of regulatory capital will be reviewed and may be reduced over time.

10. Segregated Portfolio Companies (“SPCs”)

As a single legal entity, and consequently one licensee, the SPC is required to maintain a minimum net worth as prescribed by the Insurance Law, e.g. US\$120,000 in the case of an Unrestricted Class B Insurer and writing only general business. This will typically be the core capital (general assets) for the purposes of the Companies Law, which provides that this capital is not available to meet the liabilities of a segregated portfolio, except where the assets of the portfolio are exhausted and provided the overall minimum net worth requirement for the SPC continues to be met. Thus, to ensure viability of the SPC, the Authority expects each individual segregated portfolio to be solvent in its own right.