

CAYMAN ISLANDS MONETARY AUTHORITY

PRIVATE SECTOR CONSULTATION



STATEMENT OF GUIDANCE – APPROVAL OF INTERNAL CAPITAL MODELS REGULATORY PROCEDURE - APPROVAL OF INTERNAL CAPITAL MODELS

A. Introduction

1. Section 34(1)(a) of the Monetary Authority Law (2013 Revision) (as amended) ("MAL") states that –

After private sector consultation and consultation with the Financial Secretary, the Authority may –

- (a) *issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;*

2. Requirements specific to the private sector consultation are outlined in section 4(1) of the MAL as follows:

When this Law requires private sector consultation in relation to a proposed measure –

- (a) *the Authority shall give to each private sector association a draft of the proposed measure, together with –*

- i. an explanation of the purpose of the proposed measure;*
- ii. an explanation of the Authority's reasons for believing that the proposed measure is compatible with the Authority's functions and duties under section 6;*
- iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands;*
- iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and*
- v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3));and*

- (b) *before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations,*

and shall give a written response, which shall be copied to all the private sector associations.

3. The Cayman Islands Monetary Authority (“Authority” or “CIMA”) seeks consultation and comment from the private sector associations concerning the following:
 - a. Statement of Guidance - Approval of Internal Capital Models (“SoG”)
 - b. Regulatory Procedure – Approval of Internal Capital Models (“RPR”)
4. The SoG is attached as Appendix 1 and the RPR is attached as Appendix 2.

B. Background

5. An Internal Capital Model (“ICM”) is the collection of processes, systems, and calculations that together quantify and rank the risks faced by a business. ICMs are largely used by insurance and reinsurance companies to better integrate their processes of risk and capital management. An ICM provides greater insight into a company’s risk profile and assists management in strategic decision making. In particular, it is beneficial for monitoring a company’s health and navigating towards more efficient use of company’s capital and enhanced shareholder value.
6. At present, the Insurance (Capital and Solvency) (Classes B, C, and D Insurers) Regulations, 2012 (“Regulations”) allow a Class B(iii) or a Class D insurer to use an ICM to calculate the prescribed capital requirement (“PCR”), subject to the approval of the Authority. It should be noted that when the provisions of the Insurance (Amendment) Law 2013 relating to Class B (iv) licenses come into effect, class B (iv) licensees will also be eligible to choose to use an ICM to calculate the PCR, subject to the approval of the Authority.
7. At present, the Authority’s sole guidance for an ICM review is included under the section ‘Business Plan Changes Requiring Prior Approval’ in the ‘Regulatory Procedure – Approval and Notification of Changes-Class B, C and D Insurers and Portfolio Insurance Companies. A comprehensive review of the Insurance Law (2010) and Regulations made thereunder revealed that the Authority does not have a sufficiently detailed framework to review and approve ICMs. As a result, the Authority took the decision to engage third party consultants to assist the Authority in developing a comprehensive ICM framework.
8. In addition, Insurance Core Principle 17 (“ICP 17”), issued by the International Association of Insurance Supervisors, sets out recommendations for supervisors that allow the use of internal models to determine regulatory capital requirements. The current framework for approving ICMs is not compliant with ICP 17. It is anticipated that the international Monetary Fund (“IMF”) will conduct an assessment of the Cayman Islands financial services regulatory regime against international standards in the near future. As such, raising compliance with ICP 17 is an additional goal of issuing the SoG and RPR.

9. It must be noted that the use of the ICM is facultative and the Regulations do not require any licensee to use an ICM to calculate its PCR. The SoG and RPR only apply to those licensees who choose to use an ICM.

C. Purpose of Proposed Measure and Consistency with the Authority's Functions

10. The Statement of Guidance contains guiding principles and technical criteria with which licensees must comply when seeking approval from the Authority to use an ICM to calculate the PCR. Many of the standards in the SoG apply on an ongoing basis and not solely at the time of the application for approval. Therefore, licensees interested in using an ICM to calculate the PCR must already have frameworks in place that allow them to comply with the SoG. Full compliance with the standards is not expected, however, until the Formal Application stage (as described below). The main sections of the SoG relate to:
 - a. The Use Test
 - b. The Statistical Quality Test
 - c. Calibration
 - d. Stress and Scenario Testing
 - e. Validation
 - f. Documentation
 - g. Model Governance
 - h. Internal Controls
 - i. Risk Assessment
11. The purpose of the Regulatory Procedure is to set out the process that a Licensee should undertake when seeking approval from the Authority to use its ICM to calculate the PCR. The process of applying for approval of an ICM will consist of three steps:
 - a. Initial Review
 - b. Formal Application
 - c. Post-Approval Monitoring
12. Section 6(1) of the MAL provides that the principal responsibilities of the Authority include its regulatory functions, *inter alia*, "to regulate and supervise financial services business carried on in or from within the Islands." The proposed SoG and RPR will assist the Authority in fulfilling its regulatory function. In addition, the SoG and RPR are compatible with the requirements listed in section 6(3) of the MAL, in particular the considerations in paragraphs 6(3)(a), (c) and (e)

Section 6(3) of the MAL provides that in performing its regulatory functions, the Authority shall, inter alia,

(a) endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre;

...

(c) recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, vis a vis both consumers and suppliers of financial services, while conforming to

internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands;

(...)

(e) *recognise the desirability of facilitating innovation in financial services business.*

D. Implementation in Other Jurisdictions

13. The approval of ICMs to determine regulatory capital is still a relatively new concept internationally. The number of regulatory approvals of ICMs to date is not commonly published. The Authority gained some insight to the current status in various jurisdictions as follows:

- a. The Bermuda Monetary Authority has undertaken and is in the process of several ICM reviews to date with only two reviews near completion / approval;
- b. Multiple supervisory authorities in Europe have also undertaken and are in the process of many ICM reviews, ahead of the Solvency II implementation date of 1st January 2016. The Prudential Regulatory Authority in the United Kingdom has approximately 20-30 ongoing ICM reviews; and
- c. The Australian Prudential Regulation Authority has approved one ICM to date and is in the process of reviewing other ICMs.

14. A key area in designing the ICM framework whereby the Authority considered a jurisdictional comparison was necessary was for determining a calibration measure. Calibration is a method by which a risk metric is selected as a benchmark from which to calculate the capital charge for all risks captured within an ICM. Calibration involves a test to demonstrate that the regulatory capital requirement determined by a licensee's ICM satisfies the specified modelling criteria. The Authority determined that the ICM should be calibrated such that the PCR is determined using the Value at Risk ("VaR") metric subject to a confidence level of 99.5% with one year of new business over a one year time horizon. Table 1 compares the proposed calibration measure with the measures in other jurisdictions.

Table 1 – Calibration in Other Jurisdictions

	European Union	Bermuda	Switzerland	Singapore
Capital Level Calibration	VaR 99.5% over 1 year	TVaR ¹ 99% over 1 year	TVaR 99% over 1 year	VaR 99.5% over 1 year

15. Another area where a jurisdictional comparison was needed related to fees charged by regulators for reviewing and approving an ICM. A comparison of fees is found in table 2.

16. The review fees in the various jurisdictions reflect the complexity of an ICM review by a regulator as well as the length of time required for review

¹ Tail Value at Risk ("TVaR")

(approximately two years). In the case of the Cayman Islands, these fees do not include any fees payable by the licensee to third party service providers to assist the Authority in reviewing the ICM. The fee payable to the Authority was calculated on a cost recovery basis based on the number of man hours required to complete the each phase of the approval process.

Table 2 – ICM Approval Fees in Other Jurisdictions (USD unless otherwise stated)

Stage	Australia	Bermuda	Cayman Islands (proposed)
Initial Review	\$220,000	\$41,200	KYD\$101,000
Formal Application	None	\$160,000	KYD\$15,150
Annual Monitoring	Depends on insurers' assets but additional fee assessed for insurers that use ICM	\$15,450	50% surcharge in annual license fee
Change Fee	N/A	\$15,450	\$20,200

E. Significant Costs and Benefits

17. The table below provides an overview of the costs and benefits for the Authority, the Cayman Islands and for licensees in respect of the proposed measures.

Table 3 – Costs and Benefits of Proposed Measures

	Costs	Benefits
Authority	<p>Cost of hiring third party consultant to assist the Authority in building the ICM review framework</p> <p>Gazette and publication of new measure</p> <p>Amend supervisory manuals</p> <p>Training of Insurance Division staff</p> <p>Possibility of need to hire new staff with relevant expertise to allocate to ICM reviews.</p>	<p>Provide a comprehensive CIMA framework for the ICM review and approval process.</p> <p>Increases compliance with IAIS insurance core principles and benefits IMF review.</p> <p>Right step towards obtaining NAIC accreditation.</p> <p>Provides an opportunity to improve the quality of the information received by the Authority (e.g. stress and scenario testing)</p> <p>PCR according to an ICM will be more aligned with the risks of a licensee than the current capital and solvency calculation, thereby reducing the probability of failure</p>

		Improve risk management in licensees, thereby reducing probability of failure
Cayman	None	<p>Creates a more competitive market for attracting international reinsurers.</p> <p>Enhancement of the reputation of the Cayman Islands as a leading financial services centre with prudent and progressive regulation.</p>
Licensees	<p>Implementation of the required frameworks, policies and procedures to support the ICM process.</p> <p>Initial Review and Formal Application payable to the Authority for the Authority.</p> <p>Review fees payable to a third party service provider. These fees are estimated to be significant and range upwards of six figures.</p> <p>The use of an ICM will likely result in a higher capital requirement than the current regime.</p> <p>Preparation of additional annual filing requirements to the Authority.</p> <p>Due to the review of these additional filings, the Authority is also expecting that annual license fees for licensees that use an ICM will be increased by 50%.</p>	<p>Provides direction on how to prepare for and submit an application to the Authority when seeking ICM approval.</p> <p>Assists licensees in developing thorough risk management policies and procedures as sound risk management is a key necessity for ICM approval.</p> <p>An ICM approved for regulatory use is a positive selling point for reinsurers to use when marketing to insurance companies.</p>

F. Comments and Consultation

18. The Authority seeks consultation through written comments and representations from the private sector associations concerning

- *Statement of Guidance – Approval of Internal Capital Models*
- *Regulatory Procedure – Approval of Internal Capital Models*

19. The Authority must receive representations by 1700hrs on Monday, February 1, 2016.

20. Comments and representations must be addressed to
The Managing Director
Cayman Islands Monetary Authority
P.O. Box 10052
80e Shedden Road
Elizabethan Square
Grand Cayman KY1-1001
Cayman Islands
Tel: 345-949-7089
Fax: 345-946-5611
Email:
Consultation@cimoney.com.ky
and copied to s.sadlier@cimoney.com.ky

21. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority's position on this feedback. This response shall be copied to all relevant private sector associations only.
