Labuan Financial Services Authority

CONSULTATION PAPER ON CAPITAL ADEQUACY REQUIREMENT FOR LABUAN CAPTIVE INSURANCE BUSINESS

Issuance Date: 14 December 2018

(*Response to be made by 31 January 2019*)

Labuan FSA
Financial Services Authority

1.0 Purpose and Outline

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Purpose

To seek industry feedback on the proposed solvency requirements for captive insurance business in Labuan IBFC

Outline

I. Background

II. Key Consideration

III. Benchmarking

IV. Proposed Options

V. Action Plan

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1.1 In view of the need to subscribe to the international standard and best practices as well as to ensure that the captive insurance business in Labuan International Business and Financial Centre (IBFC) remains resilient, Labuan Financial Services Authority (FSA) has embarked into reviewing the capital adequacy requirement for captive insurance business.

1.2 The Consultation Paper encapsulates the broad consideration, benchmarking, analysis, proposals and the implementation plan for captive solvency requirements.

1.3 To this end, Labuan FSA would like to seek feedbacks from the industry particularly the captive insurers and captive professionals including insurance intermediaries on the proposed solvency requirements to be adopted by Labuan captives.

2.0 Background

Background

- Part of the plan to ensure captive solvency regime meets the international standard and best practices as well as further promote growth of captives business in Labuan IBFC
- The key principles adopted:
  - ✓ **Simplicity** - less complex as compared to commercial (re)insurance requirements
  - ✓ **Market practice** – comparable to practices adopted by other captive jurisdictions
  - ✓ **Fit for Purpose** – consider the risk exposure and technical capability to manage captive business effectively
- With the development of ICAF which is applicable to the commercial insurance sector, the next sequence of action plan is to refine the capital regulation for captives.

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2.1 The plan to review the solvency requirements for Labuan captive business was mooted and mentioned in the Consultation Paper on Insurance Capital Adequacy Framework (ICAF) issued on 19 December 2013. This is in tandem with the ongoing development of the Insurance Capital Adequacy Framework (ICAF) for the commercial insurance sector.

2.2 The captive solvency review hinges on three key principles as follows:

(i) **Simplicity**

The requirements shall be less complex than ICAF which is applicable to commercial insurance sector. Notwithstanding this, it should meet the base line requirement of the international standards.

(ii) **Market practice**

The review takes into account the practices adopted in other prominent captive centres in the region as well as globally.

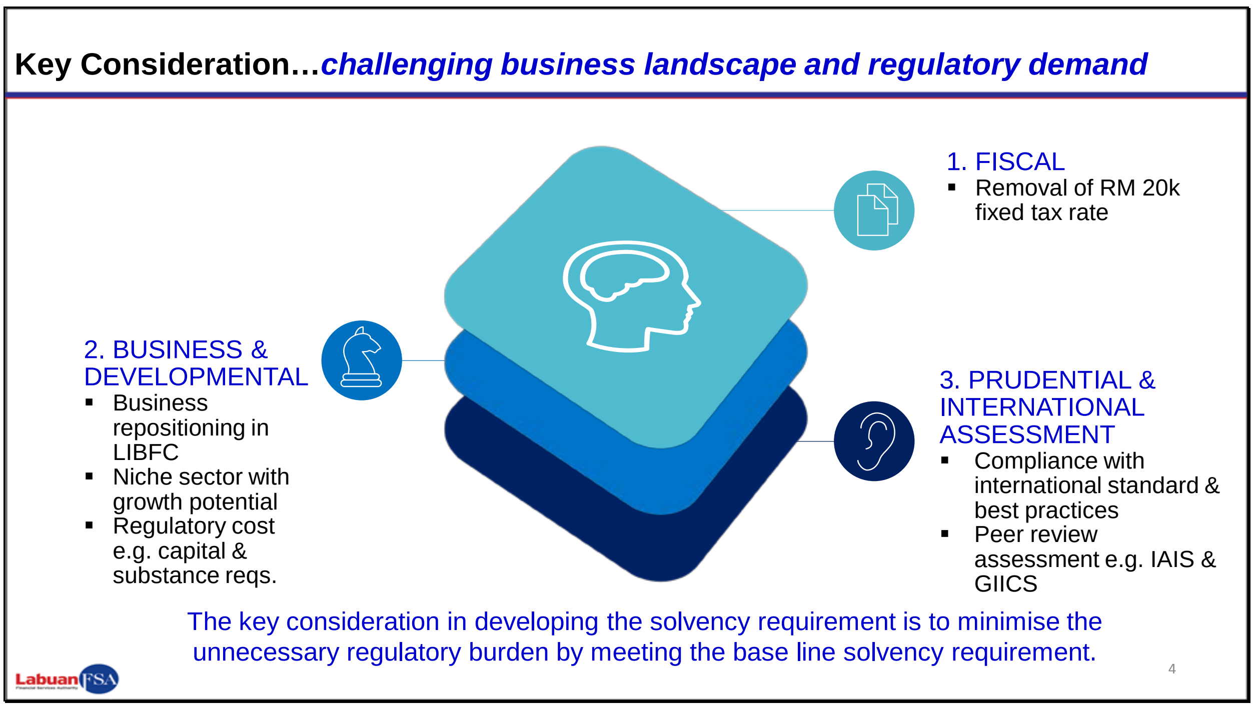
(iii) **Fit for purpose**

It must be practical for implementation in view of low regulatory risk of captive business as there are no unrelated party policyholders or potential third party beneficiaries.

3.0 Applicability

3.1 The proposed capital adequacy requirement shall be applicable to Labuan captive (re)insurers and Labuan captive (re)takaful operators.

4.0 Key Consideration

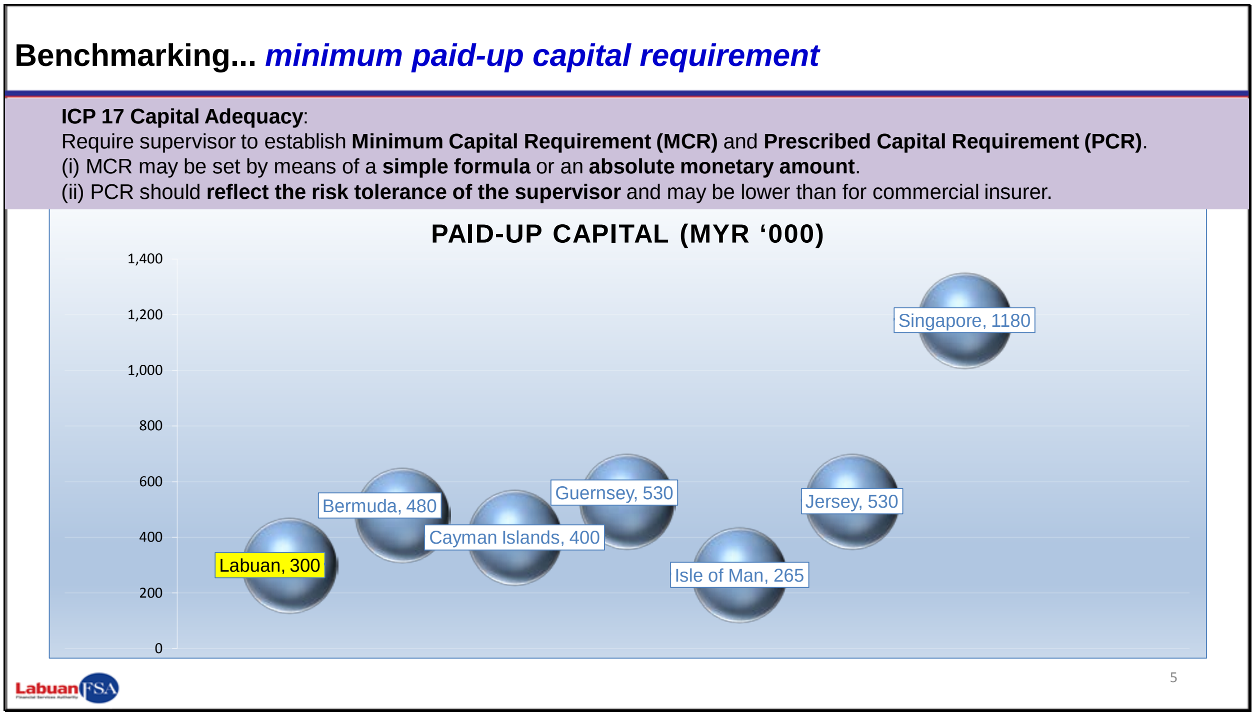


4.1 In developing the proposals for Labuan captive's solvency requirement, Labuan FSA takes into account the challenging business landscape as well as the regulatory demand surrounding the captive insurance business. This includes the rationalisation of fiscal policy, developmental agenda for captive business as well as the demanding need for international compliance.

4.2 In a nutshell, the key consideration in developing the captive solvency requirement would be, where possible, to minimise the unnecessary regulatory burden but at the same time meet the base line solvency requirement.

5.0 Benchmarking Analysis

Minimum Paid-up Capital Requirement



5.1 The International Association of Insurance Supervisors (IAIS)' Insurance Core Principle (ICP) 17: Capital Adequacy requires two solvency level as follows:

(i) **Minimum Capital Requirement (MCR)**, which may be a simple formula or an absolute monetary amount, and

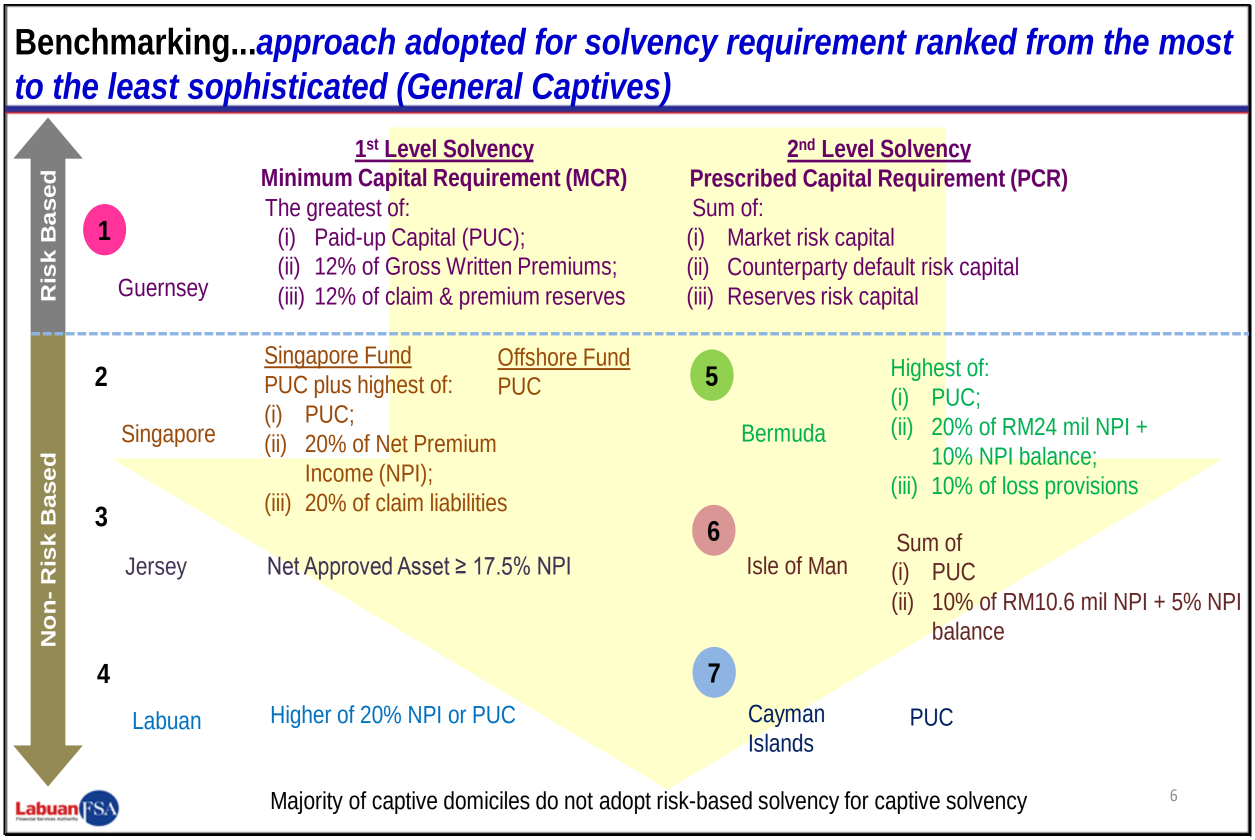
(ii) **Prescribed Capital Requirement (PCR)**, which should reflect the risk tolerance of the supervisor.

5.2 Labuan FSA has benchmarked the current minimum capital requirement against other prominent captive jurisdictions.

5.3 Labuan IBFC's minimum capital requirement for captive business stands amongst the most lenient in comparison with other jurisdictions.

> **Question 1:**
> Are you comfortable with the current minimum capital requirement for captive business in Labuan IBFC? Please provide justification for any of your suggestion.

Solvency Requirement for General Captives



5.4 In terms of solvency requirement for general captives, majority of captive jurisdictions applied a simple margin of solvency akin to Solvency I requirements based on the following criteria:

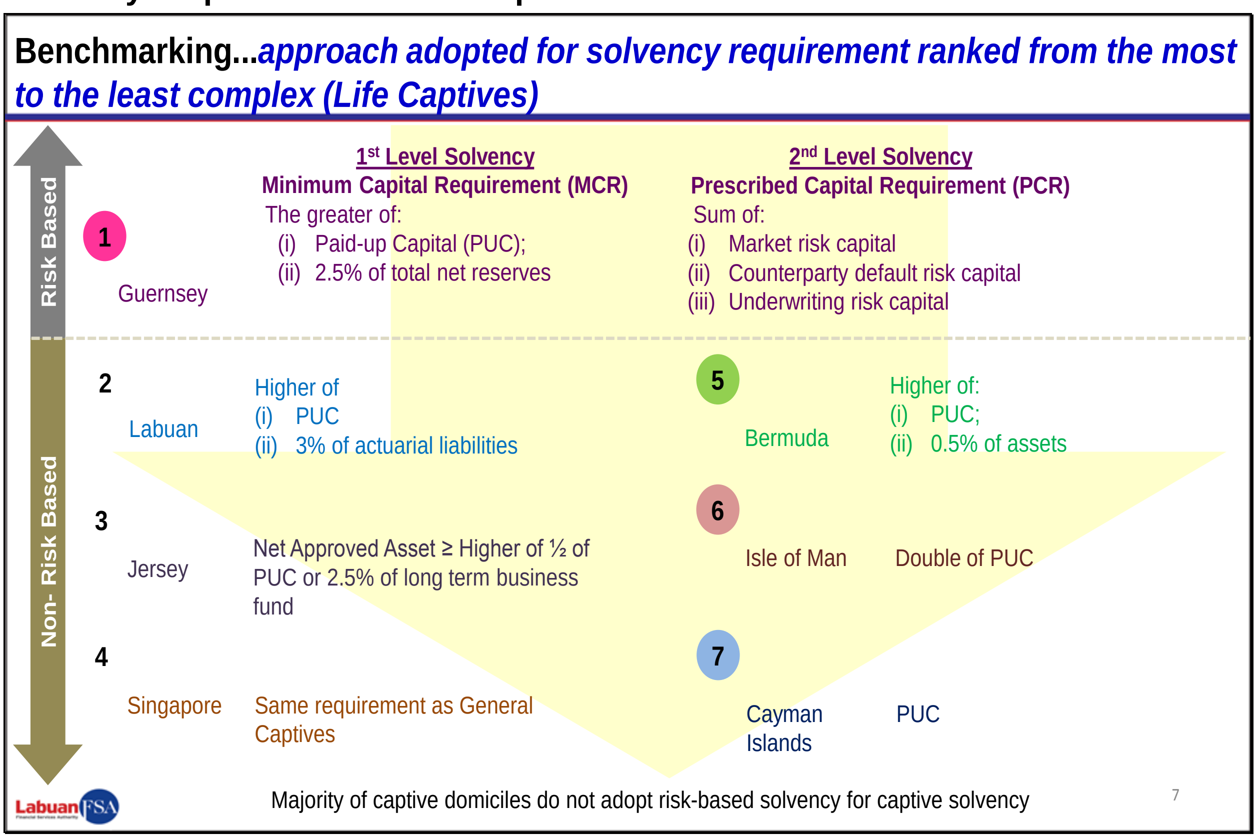
(i) Paid-up capital;
(ii) % of net premium income;
(iii) % of claim liabilities/loss provision;
(iv) Approved assets.

> **Question 2:**
> Are there any other factors that can be considered for general captive solvency computation? Please provide justification for any of your suggestion.

5.5 Guernsey seems to be the only jurisdiction adopting risk based capital at the second level of solvency (PCR) for general captives. Notwithstanding this, its first level of solvency (MCR) is comparable to non-risk based solvency practised by other jurisdictions including Labuan IBFC.

> **Question 3:**
> Labuan FSA plans to modify the capital regulation for Labuan general captives by introducing an additional factor i.e. 20% of the provision for outstanding claims as part of the solvency requirement. This is to ensure a more sensible approach which caters for the various types and size of captive business in Labuan IBFC.
>
> Labuan FSA seeks feedbacks on the plan mentioned above.

Solvency Requirement for Life Captives



5.6 There are various approaches adopted by captive jurisdictions for life captive solvency requirement. This includes the multiplication of PUC amount, proportion of actuarial liabilities, business fund and assets.

Question 4:
Are you aware of any other approaches that can be considered for life captive solvency requirement? Please provide justification for any of your recommendation.

5.7 Based on the benchmarking analysis, it can be concluded that most of the captive domiciles do not adopt risk based solvency for both life and general captives.

Question 5:
In view of more flexible approaches observed in other jurisdictions, Labuan FSA plans to simplify and replace the existing solvency requirement of 3% of actuarial liabilities for Labuan life captives with a percentage of total assets e.g. 0.5%.

Labuan FSA would like to seek views on the appropriateness of the proposed requirement.

Approved Assets Concept

Benchmarking…*jurisdictions adopting approved assets concept for solvency purposes*

<table>
<tr><th></th><th>Jersey</th><th>Bahamas</th><th>Isle of Man</th></tr>
<tr><td rowspan="2">Approved/Admissible</td><td colspan="2">(i) Cash
(ii) Bonds, debentures, fixed deposits, and equities listed on a recognised stock exchange
(iii) Net accrued investment income
(iv) Premiums receivable; reinsurance balance receivable; Accounts receivable, net of provisions for bad debts
(v) Irrevocable letters of credit drawn or confirmed by a licensed bank</td><td rowspan="2">Similar to Jersey & Bahamas with additional requirements as follows:
(i) Unpaid share capital fully supported by a letter of credit from an acceptable bank – max of 3 times the paid up share capital
(ii) Investments, land and buildings, tangible fixed assets- between 10% & 25% of aggregated/ shareholders' funds</td></tr>
<tr><td>▪ General business: ≥75%
▪ Long term business: ≥25%</td><td>(vi) Mortgage loans on real estate
(vii) Funds held by ceding reinsurers</td></tr>
<tr><td>Non-Admissible</td><td>An amount receivable/balance due from associate</td><td>Accounts receivable from associate without Commission's approval.</td><td>(i) Loan amounts owing from an associate without Supervisor's approval in excess of 25% of shareholders funds.
(ii) Intangible fixed assets and outstanding debts for > 12 months</td></tr>
</table>

Singapore, Bermuda, Cayman Islands, Guernsey do not adopt approved assets concept.

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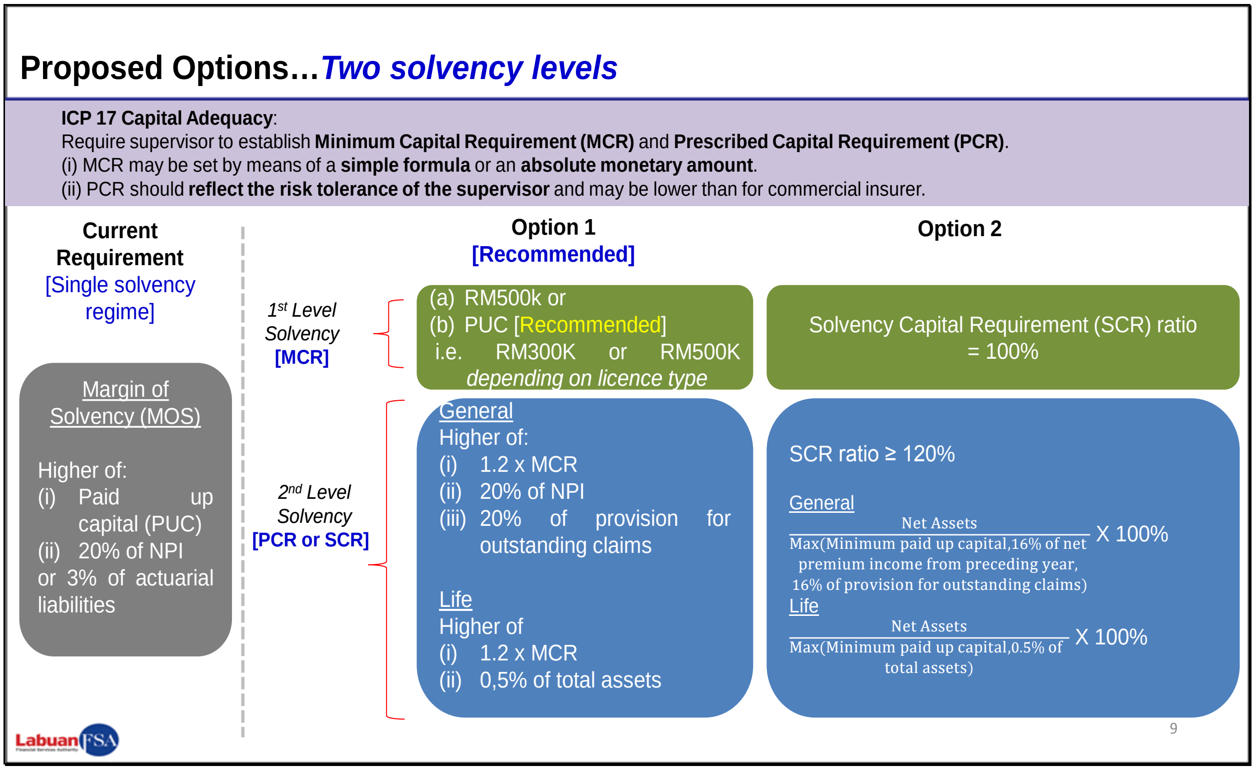
5.8 We observed that some jurisdictions adopt the approved assets concept whereby only certain percentage or types of assets (depending on the level of assets' liquidity) are admissible for solvency computation purposes.

5.9 In general, cash, bonds, debentures, equities and net accrued investment income are admissible while amount receivable from associate, intangible fixed assets and outstanding debts for more than a year are non-admissible.

5.10 Given the fact that the majority of assets composition of Labuan insurers are plain vanilla i.e. cash and short-term investments, Labuan FSA does not plan to consider the approved assets for the solvency requirement of Labuan captives.

> **Question 6:**
> Do you think that Labuan FSA should incorporate the approved assets approach into the solvency requirement for captives? Please provide justification to support your recommendation.

6.0 Proposed Solvency Requirement



6.1 The current solvency requirement i.e. the Margin of Solvency (MOS) requirement does not meet the IAIS ICP 17: Capital Adequacy requirement which requires two levels of solvency. In order to meet this requirement, Labuan FSA has come out with two (2) proposals to enhance the existing requirement as follows:

(i) **Option 1**

Labuan captive insurer is required to maintain at all times a surplus of assets over liabilities, which is at least the amount of both solvency levels as follows:

<u>Minimum Capital Requirement (MCR)</u>

(a) RM 500,000 for all types of captive licences; or

(b) To be based on paid-up capital of captive licence i.e. RM300,000 for pure captive and RM500,000 for rental captives e.g. Protected Cell Companies captives, etc.

Solvency Capital Requirement (SCR)

The SCR for captive business is **the highest** of:	
General captive business	***Life captive business***
(a) 1.2 x MCR; (b) 20% of the net premium income for the preceding year; or (c) 20% of provision for outstanding claims	(a) 1.2 x MCR; or (b) 0.5% of total assets

(ii) **Option 2**

Labuan captive insurer is required to maintain at all times a surplus of assets over liabilities, which is no less than the ratio of both solvency levels computed as follows:

The Solvency Capital Requirement (SCR) is a ratio-based formula as follows:

General captive business	$$\frac{\text{Net assets}}{\text{Max (PUC, 16\% NPI, 16\% provision for outstanding claims)}} \times 100\%$$
Life captive business	$$\frac{\text{Net assets}}{\text{Max (PUC, 0.5\% total assets)}} \times 100\%$$

Minimum Capital Requirement (MCR)

The MCR shall be no less than 100%.

Solvency Capital Requirement (SCR)

The SCR shall be no less than 120%.

Question 7:

Is there any other methods that can be considered for captive solvency without compromising the safe and soundness of captive business? Please provide justification for your suggestion.

Proposed Options...*level of non-compliance rate based on two-level of solvency*

Option			Non-compliance	
			MCR	SCR
Option 1 (a)	MCR: RM 500k	SCR (General): Higher of (i) 1.2 x MCR or (ii) 20% NPI or (iii) 20% provision for outstanding claims SCR (Life): Higher of (i) 1.2 x MCR or (ii) 0.5% total assets	5 (12.5%)	10 (25%)
Option 1 (b)	MCR: RM500K or RM300K depending on licence type	SCR (General): Higher of (i) 1.2 x MCR or (ii) 20% NPI or (iii) 20% provision for outstanding claims SCR (Life): Higher of (i) 1.2 x MCR or (ii) 0.5% total assets	0 (0%)	6 (15%)
Option 2	MCR: 100% of SCR	SCR ratio ≥ 120%: General biz : Net Assets/ Max (PUC, 16% NPI, 16% provision for outstanding claims) x 100% Life biz: Net Assets / Max (PUC, 0.5% total assets) x 100%	2 (5%)	6 (15%)

Recommended Option

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6.2 Based on the analysis undertaken on the proposed options using 2017's audited financial statement, Labuan FSA noted that the level of compliance for each level of solvency ranges from 75% to 100%.

6.3 In order to minimise the disruption to the current practice and at the same time meet with international standard expectation, Labuan FSA proposes to adopt **Option 1 (b)** and the solvency requirements are as follows:

Minimum Capital Requirement (MCR)

To be based on paid-up capital of captive licence i.e. RM300,000 for pure captive and RM500,000 for rental captives e.g. Protected Cell Companies captives, etc.

Solvency Capital Requirement (SCR)

The SCR for captive business is **the highest** of:	
General captive business	***Life captive business***
(a) 1.2 x MCR; (b) 20% of the net premium income for the preceding year; or (c) 20% of provision for outstanding claims.	(a) 1.2 x MCR; or (b) 0.5% of total assets

6.4 The rate of compliance with Option 1 (b) by the existing Labuan captives are 100% and 85% for MCR and SCR, respectively.

6.5 Labuan FSA is of the view that the proposed Option 1(b) meets the intended principles of the capital adequacy requirements for captive business in Labuan IBFC which is simple, adheres to market practice and fit for purpose.

Question 8:
Labuan FSA seeks comments on the appropriateness of the recommended Option 1 (b) as compared to other options mentioned above. Please provide justification for any comments provided.

7.0 Action Plan

Action Plan…*phase implementation to minimise transition issues*

No.	Action Plan	Target Timeline
1.	Develop and Issue Exposure Draft Guidelines on Capital Adequacy Requirements for Labuan Captive Insurance Business	Q2'19
2.	Finalise and issue the guidelines	Q4'19
3.	Implement the new requirement (1 year transition period)	1 Jan 2021

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7.1 Labuan FSA plans to issue and finalise the Exposure Draft on Guidelines on Capital Adequacy Requirements for Labuan Captive Insurance Business in 2019.

7.2 Notwithstanding this, Labuan FSA intends to effect the new capital adequacy requirement by **1 January 2021** as to provide the industry with sufficient transition time.

> **Question 9:**
> Is the targeted timeline for the implementation of Guidelines on Capital Adequacy Requirements for Labuan Captive Insurance Business appropriate? If not, please propose an alternative timeline and the rationale to support your recommendation.

> **Question 10:**
> Labuan FSA seeks comments on the overall proposed solvency requirement for Labuan captives and on any matters relevant to be considered in relation to its implementation.

8.0 Feedback Submission

8.1 Labuan FSA invites interested parties to provide their views and comments on the proposed solvency requirements for Labuan captive insurance business. Written feedback should be submitted by **31 January 2019** to:

Prudential Policy Unit II
Labuan Financial Services Authority
17th Floor, Main Office Tower,
Financial Park Complex, Jalan Merdeka
87000 Federal Territory Labuan, Malaysia

Fax: (+6087) 453442
Email: ppu2@labuanfsa.gov.my

8.2 Please note that all submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.