Labuan Financial Services Authority

CONSULTATION PAPER ON INSURANCE CAPITAL ADEQUACY FRAMEWORK

Issuance Date: 23 January 2014

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Labuan FSA
Financial Services Authority

1.0 Executive Summary

1.1 Labuan IBFC regards the need to strengthen the insurance regulations as important in order for it to partake effectively and promote stability in the regional as well as the international insurance business. This is particularly important after the Global Financial Crisis in 2008, where the world's financial systems are now more interconnected and therefore, regulatory conformance to international standards has become a necessity.

1.2 Labuan IBFC's commitment is detailed further in Malaysia's Financial Sector Blueprint 2011, which includes Labuan FSA's strategy to enhance the capital standards for the (re)insurers and (re)takaful operators (collectively referred to as "licensees" in the Consultation Paper unless otherwise specified). While the existing statutory Margin of Solvency (MOS) framework has served its basic purpose in the past, it is no longer regarded to be sufficient. Its one-size-fits-all approach ignores the risk profile of the licensees and does not address the adequacy of reserving as well as asset and liability valuation for solvency computation purposes.

1.3 To address these inadequacies, Labuan FSA proposes a transition towards a risk-based capital approach via the "*Insurance Capital Adequacy Framework*" (ICAF). The ICAF is developed based on Insurance Core Principles (ICPs) of the International Association of Insurance Supervisors (IAIS); and good practices of other jurisdictions. In this regard, Labuan IBFC's intends for ICAF to have broad consistency with Malaysia's Risk Based Capital Framework, but with sufficient differentiation to cater for Labuan IBFC's international insurance business circumstances.

1.4 The Consultation Paper broadly explains the various ICAF components and the required implementation phases in the next few years. By doing so, Labuan FSA hopes this will provide the industry an overview on the intended roadmap prior to issuing any relevant guidelines. In view of the extensive works envisaged, Labuan FSA seeks feedback on the details of proposed ICAF to be adopted by the licensees.

2.0 Background

2.1 While the existing statutory solvency framework, which relies on top-line driven based purely on retained business volume, has served its purpose in providing rudimentary capital buffer, it is not sufficiently transparent or risk-focused to adequately reflect the true financial conditions of licensees in the new business environment. With the increasing volatility and uncertainties in the global insurance industry, there is a need for a sufficiently robust capital regime which provides the needed shock absorber to address any sudden, unwanted business adversity. The capital components should also be more transparent to avoid any hidden margins and reserves, whilst also maintaining sufficient prudential consistency between one licensee's capital management approach to another.

2.2 As depicted in the Financial Sector Blueprint 2011-2020, the Labuan IBFC's insurance capital standards will be enhanced by adopting risk-based model. As such, the current solvency requirements will be enhanced into a set of cohesive financial requirements to form the intended risk-driven capital framework i.e. ICAF for both insurance and takaful sectors. In line with the recommendations arising from the Financial Sector Assessment Programme (FSAP) in 2012, the ICAF formulation will be guided by the principles under the relevant ICPs promulgated by the IAIS:

(i) *ICP 14: Valuation of assets and liabilities*;

(ii) *ICP 15: Investment;*

(iii) *ICP 16: Enterprise Risk Management for Solvency Purposes;* and

(iv) *ICP 17: Capital adequacy.*

2.3 In defining the ICAF's design and methodology, we also benchmark against the capital developments of the region, particularly Malaysia's and Singapore's Risk Based Capital Framework (RBC) as well as that of other international developments such as the Europe's Solvency II. While ICAF is broadly consistent to Malaysia's RBC due to the significant interlinkages with the onshore's insurance sector, we will make differentiating refinements to suit the international business landscape.

2.4 Ultimately, Labuan FSA intends for the ICAF to provide:

(i) consistent valuation of assets and liabilities as well as suitable forms of capital resources in arriving at the required capital adequacy level; and

(ii) a robust, risk-based capital framework that takes into account all material risks of a licensee.

3.0 Scoping of ICAF

3.1 To ensure regulatory harmonisation, ICAF will be applicable to both (re)insurers and (re)takaful operators. However, as the latter has some distinctive business and model differences to the former, the details of the ICAF and their implementation phase may slightly differ between the two sectors. The same is articulated further in Sections 4.3 – 4.5.

3.2 We also take cognisant of the different business scope of captives vis-à-vis commercial-based licensees'. In this regard, Section 7.2 will also touch on the proposed capital treatment for captives when the ICAF is rolled out.

4.0 ICAF Approach

4.1 In detailing the ICAF, Labuan FSA has identified key features to address the gaps identified under the existing MOS regime which:

(i) requires the licensee to hold capital at a level that commensurates with its risk profile and above a minimum level common for the industry which will be determined by Labuan FSA;

(ii) uses granular solvency components comprising assets and liabilities of the licensee;

(iii) provides greater transparency in the reserving of the insurance/takaful liabilities via pre-determined sufficiency;

(iv) caters for asset-related risks (i.e. interest rate risk, market risk and credit risk) relating to asset volatility and the credit standing of counterparties; and

(v) can be calibrated to Labuan FSA's supervisory approach in order to link the capital adequacy level as inputs to the determination of the licensee's

supervisory rating and triggers for any required supervisory pre-emptive measures.

4.2 To allow orderly implementation of ICAF, the framework will be implemented in two phases commencing from 2014 to 2017 to cater for both insurance and takaful sectors. The phased approach is to ensure the industry readiness and any regulatory cost incurrence will be gradual and minimised.

4.3 An overview of the ICAF phases are depicted in the following table:

ICAF Phases	Details of the phased requirements
PHASE I	**Harmonising Asset-Liability Valuation** **(*Insurance*: *2014-15* ; *Takaful*: *2015-16*)**
(i) Valuation of assets and liabilities to be **streamlined to main internationally-recognised Financial Reporting Standards**. This will allow uniformity in the licensee's capital computation under ICAF. (ii) Building a consistent **prudent reserving level of insurance/takaful liabilities** with additional risk margins to cater for instances of under-reserving of liability mis-estimations.	
PHASE II	**Strengthening the Capital Buffer** **(*Insurance*: *2015-16* ; *Takaful*: *2016-17*)**
Building on from Phase I, the capital requirements will be implemented in the following manner: (i) enforcing **capital risk charges for assets and insurance/takaful liabilities** that reflect Labuan IBFC's past business experience. These risk charges will vary according to the riskiness of the different types of assets and insurance/takaful business lines; (ii) considering for a **differentiated risk charges** between the insurance/takaful liabilities of direct insurance/takaful; to that of the reinsurance/retakaful business; (iii) setting a **minimum Capital Adequacy Ratio** which is akin to the Risk-weighted Capital Ratio for the banks, to assess the sufficiency of the available capital resources vis-a-vis the level of capital required under ICAF; and (iv) allowing **flexibility for licensee's investment activities** as long as these are supported by sufficient capital and are in line with the investment prudential requirements.	

4.4 Each of the phases is expected to take up at most a year plus long; and will entail research and development works, drafting of exposure drafts, industry consultation and the finalisation of the guidelines. The enforcement date of the requirements as well as any need for a parallel run (i.e. for Phase II) will be determined in consultation with the industry.

4.5 In terms of the sectoral timing, the ICAF works will commence first for the conventional insurance sector (i.e. 2014-16) followed by the takaful sector (2015-17). This is necessary to allow sufficient modifications to the ICAF for takaful business be developed in order to take into account the (re)takaful's business uniqueness based on Shariah principles e.g. risk sharing concept, fund/sub-fund segregation etc. Notwithstanding this, there will be overlapping implementation between the two sectors as the commencement of takaful's Phase I will coincide with the insurance's Phase II.

Question 1:

Is the proposed timeline for the implementation of Phase I (Reserving) and Phase II (Capital Requirement) appropriate? If not, please propose an alternative timeline and the rationale.

5.0 PHASE I: Harmonising Asset-Liability Valuation

5.1 Under the *ICP 14: Valuation of assets and liabilities,* there is a need for regulatory requirements relating to the valuation of assets and liabilities for the purpose of ascertaining the solvency of licensees. Under the current MOS regime, Labuan FSA does not dictate such requirements but rather leaves these to be valued under the respective accounting policies adopted by the licensees. In this regard, Labuan FSA requires that the Financial Reporting Standards (FRS) that can be adopted to be internationally recognised. This, however, leaves wide interpretation for the type of FRS that the industry adopts. Based on our study, some licensees have even adopted FRSs which are not recognised globally e.g. Private Entity Reporting Standards which is meant only for Malaysian small or medium enterprises (SMEs).

5.2 Under the proposed valuation regime of ICAF, Labuan FSA will maintain its stance by having the valuation regime to largely rely on the broad asset and liability requirements of the FRSs. This is to avoid the licensees having to prepare a separate financial basis for regulatory purposes. Notwithstanding this, to ensure meaningful and largely consistent valuation bases are used in arriving at the insurance capital adequacy:

(i) Labuan FSA will confine the choice of international FRSs to four (4) mainstream FRSs:

- *the Malaysian FRS;*
- *the International FRS (IFRS);*
- *the UK Generally Acceptable Accounting Practices (GAAPs);* and
- *the US GAAPs*.

These mainstream FRSs are selected based on their regional/international stature and to a large extent, their ongoing convergence to the global accounting standards. Such move would bring the financial reporting of the licensees in Labuan IBFC a step closer towards harmonisation with the global reporting standards and information comparability. Labuan FSA will be communicating separately with the industry on the harmonised FRS requirements tentatively in the first quarter of 2014.

(ii) where necessary, Labuan FSA may also provide further specification to the asset and liability valuation in order to ensure sufficient level of prudency in the accounting treatment of these items.

Question 2:

What are the major issues faced by a licensee in changing their accounting policy to adopt any of the four mainstream FRSs?

Valuation of Assets

5.3 The asset valuation will be driven entirely by the FRSs and at this juncture, Labuan FSA has no additional valuation requirements to be imposed. However, Labuan FSA expects for the asset valuation to be governed sufficiently by the licensees' own investment prudential requirements in line with the requirements

of the *Guidelines on Investment Management for Insurance and Takaful Business* which was released as an exposure draft on 5 December 2013 and will be finalised soon.

5.4 Labuan FSA recognises that there are other issues regarding the assets invested by licensees which can affect their capital adequacy position. Issues such as over-concentration to particular type(s) of assets, excessive exposures to counter parties and valuation volatility due to market risks, including currency risk, will be addressed via investment risk management and governance measures as outlined in the *Exposure Draft on the Investment Management for Insurance and Takaful Business* which is planned to be finalised in early 2014. In addition, these may also be accompanied by other specific capital requirements under Phase II of ICAF.

Valuation of Insurance/Takaful Liabilities

5.5 Currently, the insurance/takaful liability recognition and ongoing valuation are governed by the FRSs which emphasise on timing and use of best estimates. This can result in undisclosed margins and approximations with undetermined level of prudency, which can bring about non-comparability between one licensee's reporting to the other.

5.6 The proposed valuation regime intends to make a fundamental shift away from the said valuation philosophy; towards one that emphasises greater transparency and more accurate reflection of the licensees' liability position. Using more realistic valuation methodology and bases, ICAF proposes to explicitly recognise the volatility in liability estimation by considering the underlying risk assumptions and factors. To add greater reliability on the liability reserving, ICAF requires the liability valuation to be certified by an actuary similar to the current requirements for life liabilities.

I. Valuation of General Insurance/Takaful liabilities

5.7 Under the ICAF, the valuation for Unearned Premium Reserves (UPR) and Claims Outstanding Reserves will be expanded to cater for potential under-reserving via a risk-based reserving approach. This is similar to the general liabilities reserving requirements adopted by Malaysia's and Singapore's RBC Framework.

5.8 Here, Labuan FSA proposes to maintain but expand the following components of general insurance/takaful liabilities:

(i) the UPR to take into account prospective insurance risks in respect of insurance services which have yet to be provided (termed as "*the Premium Liabilities*") i.e. future expenses incurred for unexpired period of the policies e.g. future overheads, cost of reinsurances, administration costs etc; and

(ii) the Claims Outstanding Reserves relating to retrospective insurance risk of outstanding claims that have been incurred but not yet settled (i.e. termed as "*the Claims Liabilities*").

5.9 In respect of the Premiums and Claims Liabilities, Labuan FSA proposes to determine them based on:

(i) The Best Estimates (BE) of these insurance/takaful liabilities i.e. the liability value that would normally be regarded as minimally sufficient; and

(ii) Additional risk margin as add-on provisions to cater for mis-estimation of the liability values or future uncertainties [i.e. termed as provision of adverse deviations (PAD)] to at least 75% level of sufficiency.

5.10 The sum of the abovementioned BE and PAD shall be the minimum amount of which general licensees will need to reserve for the Premiums and Claims Liabilities.

5.11 The Premium and Claims Liabilities will consider the different lines of general business (e.g. fire, motor etc) that the licensee underwrites and its composition in arriving at the aggregated value. Under ICAF, the effects of business diversification may be considered in reducing the liabilities to be reserved for the Premium and Claims Liabilities.

II. Valuation of Life Insurance/Takaful Liabilities

5.12 At present, Labuan FSA does not govern the actuarial method of valuing the life insurance/takaful liabilities and it is left to the discretion of the life licensees. In this regard, ICAF proposes to adopt the "gross premium valuation" i.e. the GPV method. This differs from the traditional and historically-driven "net premium

valuation", as the GPV method provides a more realistic valuation for life insurance/takaful liabilities which consists of the net premium[1] and the loading[2].

5.13 Similar to the valuation of General Insurance/takaful liabilities as described in Section 5.10, the Life Insurance/takaful liabilities' will be the aggregate of the policy liabilities i.e. summation of the liabilities of ordinary life policies and investment linked policies.

5.14 In line with the methodology described in Section 5.9 for General Insurance/takaful liabilities, the policy liability (of ordinary policy or investment-linked policy) will comprise:

(i) BE based on the projection of future cash flows using realistic assumptions (e.g. mortality and morbidity rates, expenses, lapse rates);and discounted using appropriate interest rates; and

(ii) PAD to be determined using conservative assumptions in the cash flow projections to reflect the inherent uncertainty of the BE.

Question 3:

(i) What are the major concerns arising from the requirement for the valuation of insurance/takaful liabilities (particularly for general liabilities) to be certified by a qualified actuary?

(ii) Labuan FSA seeks feedback whether there are any major concerns for licensees in adopting the proposed liability valuation as explained in Sections 5.7 – 5.14.

6.0 PHASE II: Strengthening the Capital Buffer

6.1 Under Phase II of ICAF, Labuan FSA intends to reinforce the Phase I requirements via capital adequacy requirements which comprise:

(i) the Fund Solvency Requirement to be applied to each insurance fund which is established and maintained by the licensee in respect of its different classes of business; and

[1] An amount which is expected to provide the policy benefits under the net premium valuation method.
[2] An additional charge added to the net premium to cover the expenses, contingencies and profit.

(ii) the Capital Adequacy Requirement (CAR) which needs to be computed at the organisational level of the licensee. This requirement will replace the existing MOS requirements.

Fund Solvency Requirement

6.2 Under the current regime, there is no requirement for licensees to ensure that their insurance funds are solvent at all times. Absence of such requirements may result in individual funds with asset deficiency to be indirectly supported by the favourable performance of other insurance funds. Here, Labuan FSA proposes to require for the assets of each insurance fund to be in excess of or equal to that of the fund's liabilities.

Question 4:

Are there any practical issues in complying with the Fund Solvency Requirement? Please elaborate on the issues and other alternative proposal in respect of ensuring fund-own sustainability.

Capital Requirement

6.3 A key capital indicator under the Phase II of ICAF is the Capital Adequacy Ratio (CAR) which measures the sufficiency of the licensee's capital resources to support the capital requirements of the organisation as a whole. The formula to compute the CAR is as follows:

$$CAR = \frac{\text{Total Capital Available}}{\text{Total Capital Required}} \times 100\%$$

I. Total Capital Available (TCA)

6.4 The TCA comprises the aggregate of Tier 1 and Tier 2 capital of the licensee net off deductions. The capital tiering will depend on the permanence of the capital

instrument and whether it is free from any encumbrances, which is in line with the Basel capital requirements for the banks:

(i) Tier 1 Capital

Tier 1 capital instruments are those that can absorb losses on an on-going basis. They should not have any maturity date, nor should they be redeemable at the option of the holder of the instruments. They should be issued and fully paid-up, and non-cumulative in nature. They should be ranked junior to policyholders, general creditors, and subordinated debt of the licensee. Tier 1 resources should neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that may legally or economically enhance the seniority of the claim vis-à-vis the policyholder. Tier 1 resources will generally be represented by the aggregate of the surpluses of a licensee's insurance funds.

(ii) Tier 2 Capital

Tier 2 capital instruments are "less permanent" relative to Tier 1 instruments, but can still be available as part of the buffer to absorb any losses incurred by the licensee.

6.5 To strengthen the composition of the TCA, the following adjustments need to be made:

- the amount of Tier 1 capital would need to be at least that of the Tier 2 capital amount to ensure TCA is predominantly permanent capital resources; and
- deductions will be made from the aggregate of Tier 1 and Tier 2 capital in order to discount assets which are intangible in nature or those which have been pledged or represent investments in subsidiaries. To ensure consistency, the said assets will also not be part of the Asset Risks portion of Total Capital Required as outlined in Section 6.6.

II. Total Capital Required (TCR)

6.6 The TCR are essential aggregation of the risks emanating from a licensee's assets and liabilities and can be grouped as follows:

(i) Component 1 (Insurance Risks)

This component relates to insurance risks undertaken by a licensee:

- For general insurance business, the requirement is calculated by applying specific capital risk charges on a licensee's premium and claims liabilities which are valued in accordance to Section 5.7-5.11. The capital risk charges applicable to different business lines will vary according to volatility of the underlying businesses.
- For life insurance business, the requirement is calculated by computing the difference between the adjusted value of the life insurance/takaful liabilities and that computed in accordance to Section 5.12-5.14 of the Consultation Paper. The adjusted value of the life insurance/takaful liabilities is determined by applying specific stress factors to key parameters affecting policy liabilities e.g. mortality, morbidity, expenses and policy termination rates where Labuan FSA plans to specify further in the Guidelines on capital requirements.

(ii) <u>Component 2 (Assets Risks)</u>

This component relates to risks inherent in a licensee's asset portfolio. It is calculated based on a licensee's exposure to various markets including debt, equity, property, and foreign exchange.

(iii) <u>Component 3 (Other Risks)</u>

Labuan FSA understands the limitations of the abovementioned risk components; as other specific risks such as operational risks, or concentration risks are not catered for due to their subjectivity. It is proposed that the capital risk charges for such risks to be computed based on appropriate proxies. For instance, operational risk charges can be determined based on a certain fraction of the total assets; whilst concentration risks can be computed as exposures in excess of certain limits prescribed by Labuan FSA.

6.7 The TCR will be computed for all insurance funds and the shareholders' funds (or working fund for a branch licensee) to reflect the overall organisational capital requirement.

6.8 In respect of TCR for life insurance/takaful business, in the case of an investment-linked fund, TCR shall be predominantly computed for the non-unit

portion of the fund which represents the insurance/takaful element of the business.

Question 5:

Please provide comments on the appropriateness of the TCA and TCR approach as explained in Sections 6.4 – 6.8.

III. CAR various requirements

6.9 Under ICAF, Labuan FSA proposes to have two levels of CAR to be observed by the licensees beyond the 100% mark:

- The minimum CAR (MCAR) will be the statutory level to be prescribed by Labuan FSA and licensees must maintain their CAR above the MCAR as part of their licence commitment. It is noted that neighbouring jurisdictions had adopted a MCAR of 120% to 130% to allow sufficient supervisory interventions be made before the financial standing of the licensee is seriously impaired i.e. CAR is eroded below 100%. It is likely that Labuan FSA will pitch ICAF's MCAR at similar or thereabout levels so that pre-emptive supervisory measures can be undertaken to address cases of capital deficiencies before these deteriorate to become actual insolvencies.
- The supervisory target CAR (SCAR) is the organisational specific CAR level to be determined by the licensee based on risk management assessment taking into account its current business plans, strategies and risk tolerance/appetite. Should the licensee's CAR falls below the SCAR level, this would be a "*financial resources warning red flag*" event and the licensee is required to notify Labuan FSA as well as submit a recovery plan to reinstate its CAR to a level above its SCAR. On ongoing basis, Labuan FSA will also assess the sufficiency of the SCAR level selected via its risk-based supervisory assessment, and where it is deemed insufficient; the licensee may be required to adjust its SCAR to a more appropriate level.

Question 6:

Labuan FSA seeks feedback whether there any issues for a licensee in complying with the proposed two-tier CAR requirements i.e. the MCAR and SCAR.

7.0 Implementation Matters

7.1 To ensure smooth transition to ICAF, Labuan FSA proposes that the licensee to continue to meet the MOS requirements prior to the full implementation of Phase II i.e. Phase II's full compliance. As regards the insurers with takaful windows, they will only need to comply with Phase II's ICAF requirements in respect of their conventional insurance business only. The takaful window's business therefore will continue to comply with MOS requirements until the enforcement of Phase II for the takaful sector.

Question 7:

Labuan FSA seeks feedback on:

(i) any difficulties and challenges faced by Labuan (re)insurers and (re)takaful operators in adopting ICAF; and
(ii) possible ways in addressing or minimising these issues.

7.2 We acknowledge that captive licensees are set up to insure risks from within their related companies i.e. group-related risks. As such, to the "clients" of a captive licensee, the benefit of enhanced buffer and transparency offered by the ICAF may be less significant compared to its commercial counterparts. As such, Labuan FSA proposes to exempt captive licensees from ICAF as long as they only underwrite group-related risks. In this regard, captive licensees will continue to observe the current MOS requirements. Going forward, Labuan FSA has plans to enhance the capital requirements for captives to ensure of its ongoing effectiveness in tandem with ICAF's robustness.

Question 8:

Labuan FSA seeks feedback on any enhancement needed in the current Margin of Solvency requirements for captive insurers in lieu of the ICAF which will not be made applicable to them.

Question 9:

Labuan FSA seeks comments on the overall proposed ICAF 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 ICAF roadmap. Written feedback should be submitted by **24 February 2014** to:

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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.