

GUERNSEY FINANCIAL SERVICES COMMISSION

GUIDANCE NOTE ON LICENSED INSURERS' OWN RISK AND SOLVENCY ASSESSMENT

This guidance note is applicable to all insurers licensed by the Commission including international insurers and domestic insurers (other than branches of EU regulated insurers), which write general insurance business and long term insurance business and applies to all PCCs and ICCs licensed to write insurance business.

1. Introduction

The consultation document on changes to The Insurance Business (Bailiwick of Guernsey) Law, 2002 (“the Law”) published in April 2007 included a new requirement for licensed insurers to justify their own view of an appropriate solvency margin requirement, subject to an absolute minimum level calculated in accordance with Schedule 2 of the Law. The wording of Schedule 2 has been amended to emphasise that the margin of solvency calculated in accordance with this Schedule is the minimum that should apply.

The Commission has always had the power to require licensed insurers to hold a specified level of capital resources in addition to technical provisions to meet unexpected future losses. In addition, maintaining adequate capital and liquidity have always been requirements under the Minimum Criteria for Licensing.

In accordance with recent developments of standards and guidance on solvency by the International Association of Insurance Supervisors, individual capital assessments have been introduced by several jurisdictions. This follows the growing international recognition that the boards of directors of insurance companies are themselves in the best position to assess their own solvency requirements.

The Commission is therefore issuing this guidance on the methodology and factors which may be taken into account when assessing the solvency margin requirements for licensed insurers. This guidance is intended to be general in its nature because each licensed insurer’s solvency requirement depends upon its specific circumstances, which will be taken into account by the Commission in assessing the adequacy of the solvency established by each licensed insurer.

2. Terminology and General Requirements

For ease of reference, the process of a licensed insurer determining its own level of capital resources for solvency purposes will be referred to as an “Own Risk and Solvency Assessment”. The minimum solvency margin requirement calculated by the formulae laid down in Schedule 2 of the Law will be referred to as the “Minimum Solvency Capital Requirement” (MSCR), whilst the licensed insurers’ own assessments of their solvency margin requirements will be referred to as the “Own Solvency Capital Assessment” (OSCA).

The Commission requires notification of the licensed insurers' OSCA at least annually to be provided with the annual returns. The OSCA need not necessarily be assessed at the company's year end if it is felt more appropriate to conduct the assessment at another time of year; for example at renewal of the insurance programme or on receipt of an actuarial report. Where there has been a material business plan change with an impact on solvency, the licensed insurer should provide a revised OSCA at the time the change is notified to the Commission. An OSCA is also required to be submitted with all new applications. All OSCAs should be accompanied by the supporting rationale for the calculation.

For those licensed insurers where the board of directors consider the MSCR to be sufficient, 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.

Companies which go into run off should update the OSCA, excluding those risks which are no longer applicable, and thereafter review the OSCA annually to take account of any material developments. A company which is dormant with no outstanding insurance liabilities need not produce an OSCA.

The Commission may also consider the adequacy of the solvency assessments when performing on-site inspections or on an ad hoc basis where, for example, there has been a significant change to the insurer's financial position such as a substantial new notified claim, which justifies a significant reserve, or a material change in an incurred claim.

3. Methodology

It is not the intention of the Commission to give prescriptive guidance about the methodology which must be used by licensed insurers to calculate their OSCAs. The following general comments are given to licensed 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 licensed 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, regulatory risk (particularly in the jurisdiction where the risk is located) or the exposure to related parties.

4. Suitability of capital

Licensed insurers may wish to consider the nature of the capital resources needed to cover the OSCA. Whilst technical provisions and the MSCR must be covered by approved assets, additional capital resources can sometimes take the form of the unpaid element of partly paid share capital, letters of credit or loans to a parent or group company. In addition, certain liabilities such as subordinated loans could be treated as capital for this purpose. Intangible or illiquid assets, such as goodwill or property, are generally not acceptable for solvency purposes.

5. Supervisory intervention

Upon receipt of the OSCA, the Commission may request further information or clarification concerning assumptions and methodology used if this is unclear or appears inconsistent with information already on file. If it is considered that the rationale is inadequate, the Commission may request that the OSCA be reconsidered and resubmitted. In cases where the Commission finds that it is unable to approve an OSCA, the Commission will specify the level of capital that a licensee is required to hold.

The degree of intervention by the Commission in the event of a future shortfall in capital resources will be determined by the actual level of solvency relative to the MSCR and OSCA. A breach of the MSCR will require immediate action to rectify, such as an injection of further capital or a reduction in business levels. On the other hand, in the event of a breach of the OSCA, the Commission may require a recovery plan for the rectification of the breach and will monitor the position more closely, for example by requiring quarterly management accounts or requiring the approval of new loans or dividend payments to the parent company.

Appendix A - Format of the OSCA

It is not the intention of the Commission to be prescriptive in the format required for the OSCA, however, the following is a list (not exhaustive) of items that it is expected will be addressed in order for the Commission to determine that the methodology used is appropriate:

- i. An executive summary to include –
 - a. A statement as to the amount of the OSCA
 - b. An indication of which risks have carried the most weight when deriving the OSCA
 - c. Confirmation that the Board has considered and approved the OSCA
- ii. Data utilised in the assessment – including comment on the availability and reliability of data
- iii. Assumptions – inflation, interest rates, claims inflation etc. – including justification of those assumptions and level of sensitivity of the OSCA to those assumptions
- iv. The level of uncertainty surrounding provisions for outstanding claims and claims incurred but not reported, including actuarial assessment if applicable.
- v. The allowance for the volatility of future claims
- vi. Underwriting risk – the risk of an inaccurate assessment of the expected level of future claims leading to a premium deficiency
- vii. Exposures – gross and net of reinsurance taking into account aggregate caps where applicable
- viii. The allowance that could be made for diversification of risks
- ix. Catastrophe/accumulation risk
 - x. Reinsurer security and level of reliance on reinsurers
 - xi. Liquidity risk
 - xii. The extent to which assets and liabilities are matched
- xiii. Foreign exchange risk
- xiv. Investment risk – factors which could adversely affect performance and return
- xv. Counterparty credit risk
- xvi. Regulatory risk in jurisdictions where the risk or fronting company may be situated
- xvii. Operational risk
- xviii. Level of reliance on unapproved assets
- xix. Financial strength of the parent if there is unpaid capital or loans to the parent.

Insurers writing long term business should also include:

- xx. Mortality risk
- xxi. Longevity risk
- xxii. Allowance for future expenses

Reference should also be made to any other risks which are identified in the Licensed Insurers' Corporate Governance Code and which are of relevance to the solvency of the licensee concerned.

The level of detail included on each item will need to be appropriate to the size, nature and complexity of the licensee.