Guernsey Financial Services Commission

GUIDANCE NOTE ON LICENSED INSURERS' OWN SOLVENCY ASSESSMENT

1. Introduction

The Commission has the power under The Insurance Business (Bailiwick of Guernsey) Law, 2002 ("the Law") to require licensed insurers to hold a specified level of capital resources and, in addition, the maintenance of adequate capital is a requirement under the Law's Minimum Criteria for Licensing. The Commission sets regulatory solvency requirements through the Prescribed Capital Requirement ("PCR") and the Minimum Capital Requirement ("MCR") prescribed by The Insurance Business (Solvency) Rules 2015 (the "Rules").

Complementary to the regulatory solvency requirement under the Rules, and in accordance with standards and guidance issued by the International Association of Insurance Supervisors an insurer is expected, under the Rules, to perform its own assessment of the adequacy of its solvency position.

The Rules require a licensed insurer to perform an Own Risk and Solvency Assessment (ORSA) comprising:

(a) the licensed insurer's own assessment and calculation of its solvency requirements (an Own Solvency Capital Assessment or OSCA);

(b) the licensed insurer's assessment of risk management; and

(c) the licensed insurer's assessment of the adequacy of capital resources to meet future capital requirements.

This document provides insurers with guidance on the methodology and factors which may be taken into account when assessing the solvency 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. Scope

This guidance note is applicable to all licensed insurers required to perform an ORSA under the Rules.

A licensed insurer meeting at least one of the following criteria is not required to perform an ORSA –

(a) A licensed insurer classified as a Category 6 licensee;

(b) A licensed insurer which is dormant with no outstanding insurance liabilities;

(c) A licensed insurer that would otherwise be required to perform an OSCA only (see below) and whose board of directors considers the PCR to be sufficient. In such cases, 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; and

(d) A licensed insurer notified in writing by the Commission.

Unless otherwise notified in writing by the Commission, a licensed insurer meeting at least one of the following conditions need not perform the assessment of risk management and the adequacy of capital resources to meet future capital requirements and may limit their assessment to an OSCA only -

i. a Category 1 licensed insurers writing life business with a MCR below £350,000;

ii. a Category 2 licensed insurer with a MCR below £7,500,000;

iii. a Category 3 licensed insurer with a MCR below £1,500,000;

iv. a Category 4 licensed insurer with a MCR below £7,000,000;

v. a Category 5 licensed insurer; and

vi. a Protected Cell Company.

3. Frequency of Assessment and Reporting

With the exception of insurers performing OSCA only, the Commission requires that the ORSA document is available upon the request of the Commission within 6 months of the assessment date. In addition, all insurers required to perform an ORSA (including OSCA only) are required to provide the ORSA document to the Commission at least annually with the

insurer's annual return. The ORSA need not necessarily be performed 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 ORSA at the time the change is notified to the Commission. An ORSA is also required to be submitted with all new applications. All ORSAs should be accompanied by the supporting rationale for the calculation.

Companies which go into run off should update the ORSA, excluding those risks which are no longer applicable, and thereafter review the assessment annually to take account of any material developments.

The Commission may also consider the adequacy of 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.

4. OSCA 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, concentration risk, catastrophe risk, regulatory risk (particularly in the jurisdiction where the risk is located) or the exposure to related parties.

The Appendix sets out further guidance with respect to the format of the OSCA.

5. Full ORSA Methodology

The purpose of a full ORSA is to assess whether the insurers risk management and solvency position is currently adequate and likely to remain so. It should encompass all reasonably foreseeable and relevant material risks. The full ORSA should consider the impact of future changes in economic conditions or other external factors and should include appropriate stress testing.

Licensed insurers required to perform a full ORSA should follow the guidance for the OSCA process in section 4 above and should also meet the additional requirements applicable to the full ORSA under the Rules.

As part of its ORSA, a licensed insurer is required to –

(a) identify the relationship between its risk management and the level and quality of financial resources needed and available;

(b) determine the overall financial resources it needs to manage its business given its own risk tolerance and business plans, and to demonstrate that supervisory requirements are met;

(c) base its risk management actions on consideration of its ORSA;

(d) assess the quality and adequacy of its capital resources to meet its future regulatory capital requirements and any additional capital needs

(e) use appropriate forward-looking quantitative techniques such as risk modelling, stress testing, including reverse stress testing, and scenario analysis (an appropriate range of adverse circumstances and events should be considered, including those that pose a significant threat to the financial condition of the insurer, and management actions should be identified together with the appropriate timing of those actions); and

(f) analyse its ability to continue in business, and the risk management and financial resources required to do so over its planning horizon, which is expected to exceed one-year. The continuity analysis is required to address a combination of quantitative and qualitative elements in its medium and longer-term business strategy and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements. As a result of continuity analysis, a licensed insurer must maintain a contingency plan and procedures for use in a going and gone concern situation. A contingency plan should identify relevant countervailing measures and off-setting actions that the licensed insurer could realistically take to restore/improve its capital adequacy or cash flow position after some future stress event and assess whether actions should be taken by the insurer in advance as precautionary measures.

6. Suitability of capital

Licensed insurers may wish to consider the nature of the capital resources needed to cover the ORSA. Whilst the PCR must be covered by regulatory capital resources, additional capital resources could sometimes take the form of certain liabilities such as subordinated loans for this purpose. Intangible assets, such as goodwill, are generally not acceptable for solvency purposes.

7. Supervisory intervention

Upon receipt of the ORSA, 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 ORSA be reconsidered and resubmitted.

Broadly speaking, the Commission would not require action to increase capital held or reduce risks undertaken provided the insurer's capital remains over the PCR. (However, this would not preclude the Commission from intervening or requiring action by the insurer for other reasons, such as weakness in the risk management or governance of the insurer.)

Appendix - 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. Financial strength of the parent if there is unpaid capital or loans to the parent.

xix. 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.