Introduction of a Risk-Based Capital Regime

General Insurance Sector

July 5, 2018

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Agenda

- Rationale and objectives of introducing Risk-Based Capital (RBC)
- Overview of the proposed RBC Framework
- Other issues
- Next Steps

RATIONALE AND OBJECTIVES FOR IMPLEMENTING RISK-BASED CAPITAL

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RISK-BASED CAPITAL

Risk-Based Capital is a method used to measure the minimum amount of capital that an insurer needs to support its overall business operations and to absorb the risks from unexpected losses and shocks.

RBC is used to set capital requirements considering the size and degree of risk taken by the insurer.

Insurance Core Principles (ICPs)

ICP 14 Valuation

The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.

ICP 15 Investment

The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by the insurer

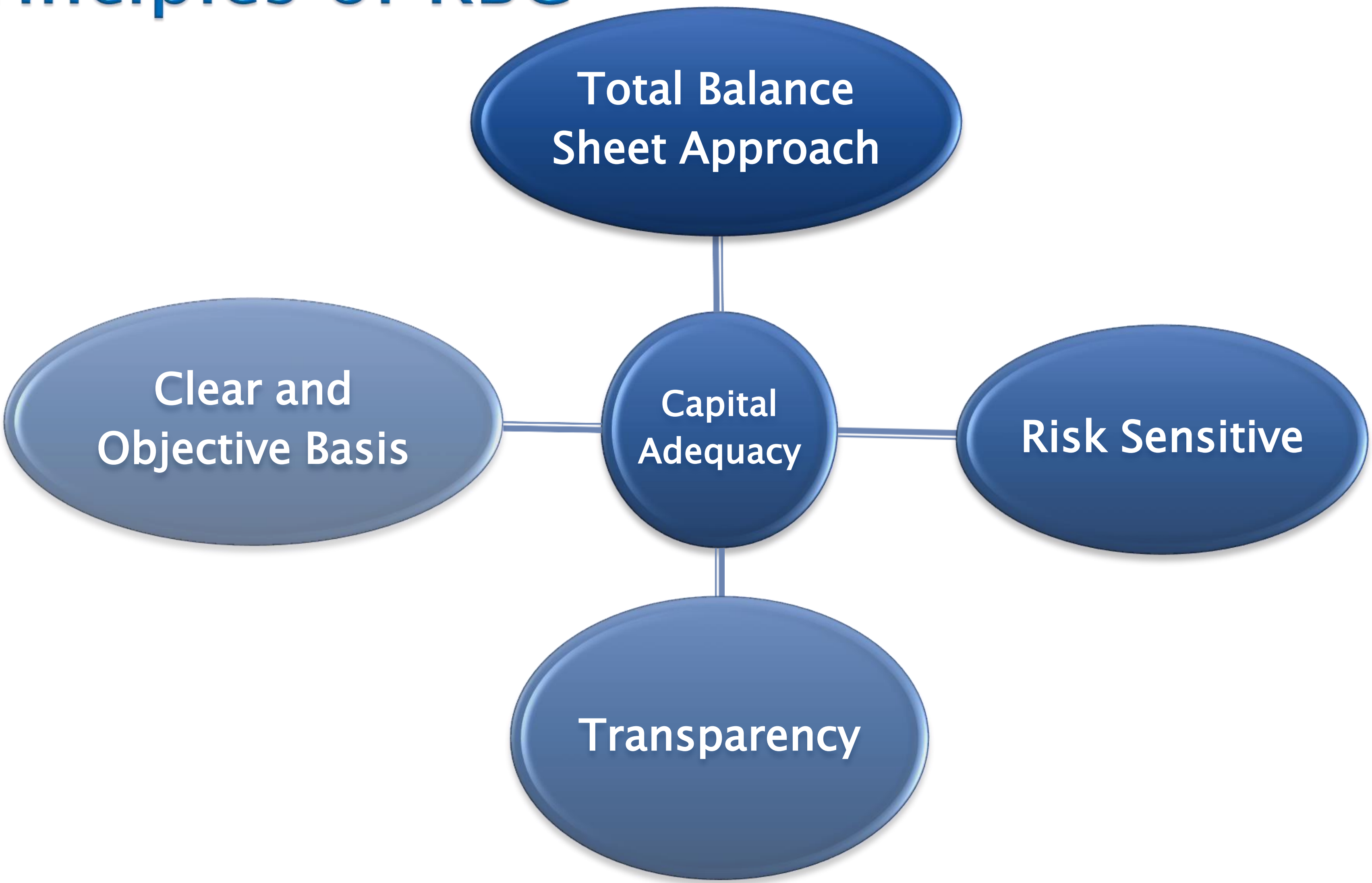
ICP 16 Enterprise Risk Management for Solvency Purposes

The supervisor establishes enterprise risk management requirements for solvency purposes that require insurers to address all relevant and material risks.

ICP 17 Capital Adequacy

The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.

Principles of RBC



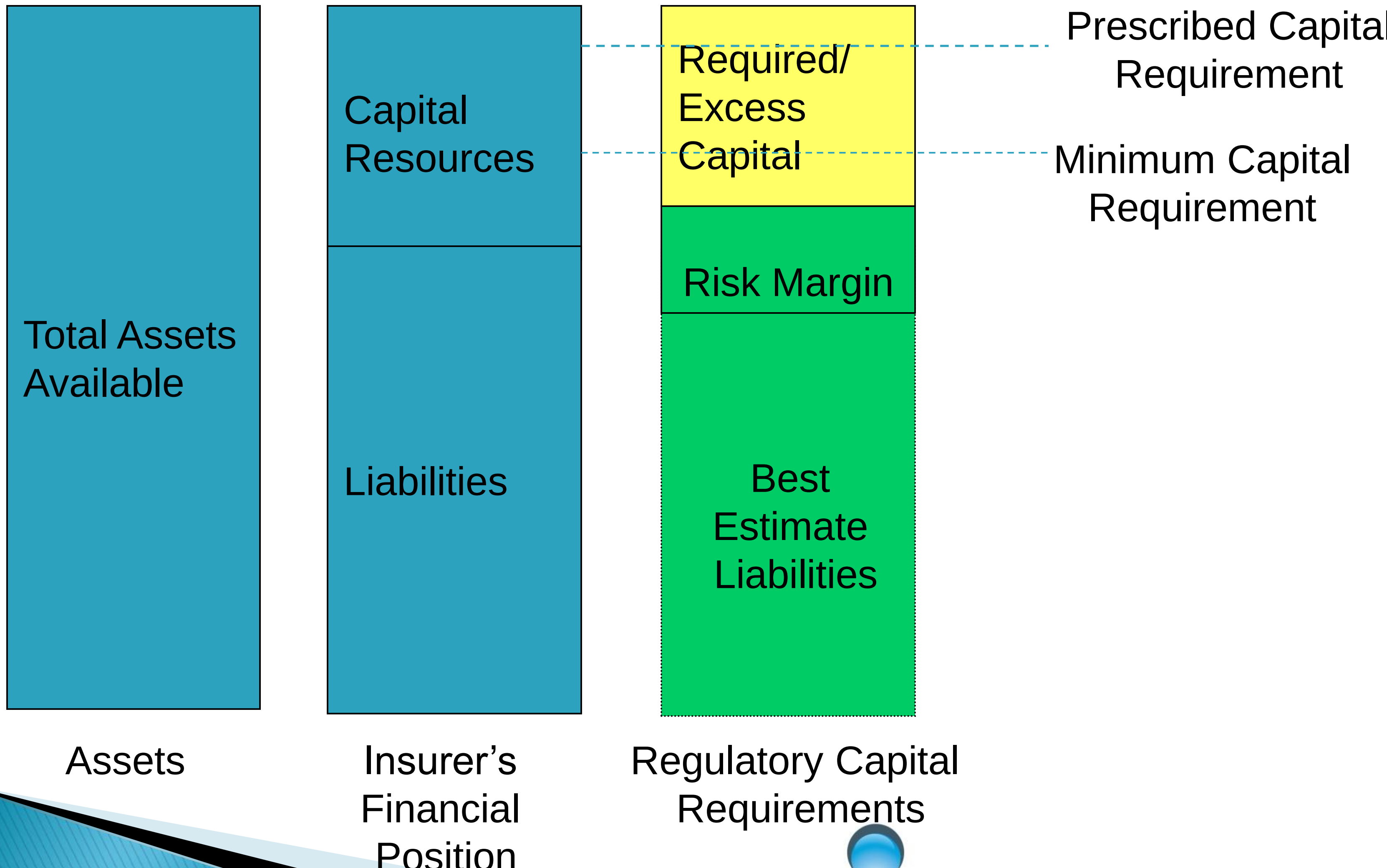
Current Capital Requirements

- **Capital Available** = Discounted Assets – Liabilities
- Less
- **Capital Required** = 20% of Net Premiums (subject to a limit on reinsurance), plus $2 million ($1 million for branches)
- = **Capital Surplus / (Shortfall)**

Capital Ratio =

$$\frac{\text{Available Capital}}{\text{Required Capital}}$$

Proposed RBC Framework



Proposed RBC Framework (cont'd)

- The Regulatory Capital Ratio will be based on the company's total business, and calculated using the formula:-

$$\frac{\text{Total Regulatory Capital Available}}{\text{Total Regulatory Capital Required}}$$

- Minimum Regulatory Capital Ratio – 120%
- Prescribed Capital Ratio – 150%
- Target Capital Ratio – >150%

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OVERVIEW OF THE RBC FRAMEWORK

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Proposed RBC Framework

<u>Domestic Insurer: Total Regulatory Capital Available</u>

- Defined in terms of the quality of capital
  - Tier 1 Capital (Core Capital) comprises the highest quality capital elements.

  - Tier 2 Capital (Supplemental Capital) instruments are lower quality but contribute to the overall strength of the company as a going concern.

Proposed RBC Framework

Domestic Insurer: Tier 1 or Core Capital

Tier 1 Capital or Core Capital comprises:

- Ordinary shares (issued and fully paid up)
- Contributed surplus
- Retained earnings (or deficit)
- Perpetual, non-redeemable, non-cumulative, and fully subordinated preference shares
- Revaluation reserves approved by ICB
- Non-controlling Interest

Tier 1 Capital or Core Capital Deductions:

- Unrealized gains on assets in retained earnings and revaluation reserves

Proposed RBC Framework

<u>Domestic Insurer: Tier 2 or Supplemental Capital</u>

Tier 2 Capital or Supplemental Capital comprises:

- 2A – Preference shares and unrealized gains not in T1; hybrid instruments that meet specified criteria
- 2B – Limited life instruments that meet specified criteria

Limits:

- Total T2 capital must not be greater than Net T1 capital.
- Unrealized gains on real estate assets limited to 20% of Net T1 capital.
- T2B capital must not be greater than 50% of Net T1 capital.

Proposed RBC Framework

<u>Domestic Insurer: Regulatory Capital – Deductions</u>

The sum of Tier 1 and Tier 2 Capital is reduced by:

- Goodwill and other intangible assets;
- New capital issues between companies that represent either directly or indirectly back-to-back placements;
- Pension plan assets; and
- Investment in financial subsidiaries.

Proposed RBC Framework

<u>Foreign Insurer: Regulatory Capital Available</u>

- Initial Deposit (s.43 Insurance Act, 2005)

PLUS

- Statutory funds held on trust (s.45(4) Insurance Act, 2005)

PLUS

- Excess assets in The Bahamas

LESS

- Total liabilities and reserves required in The Bahamas

Proposed RBC Framework

Regulatory Capital Required

- Sum of:
  - Asset Default Risk Charge
  - Off Balance Sheet Risk Charge
  - Foreign Currency Mismatch Risk Charge
  - Premium Adequacy Risk Charge
  - Outstanding Claims Risk Charge; and
  - Catastrophe Risk Charge

Asset Default Risk Charge

- Sum of total assets for each class multiplied by risk factor
  - Factors range from 0% to 100%
  - Lowest for cash, government securities; highest for Investment in related parties that are not financial subsidiaries and deferred acquisition costs.

Off Balance Sheet Asset Risk Charge

- Sum of the amount of the transaction undertaken multiplied by risk factor
  - Factors vary based on the type of contract and its term to maturity.

Foreign Currency Mismatch Risk Charge

- Sum of the net open positions in any other currency, expressed in Bahamian dollars, multiplied by risk factor
  - Factors vary based on the issuing country's Standard and Poor's credit rating.

Currency	Factor
Countries rated BBB and above	2%
Countries rated BBB- and below	8%

Premium Adequacy Risk Charge

- Greater of:
  - 15% of Net Premiums
  - 15% of Net Unearned Premium Reserve

Outstanding Claims Risk Charge

- 10% of Outstanding Claims Reserve

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Catastrophe Risk Charge

Method 1

- Net claims multiplied by a factor of 10/25

Method 2

- $\sqrt{\sum_{t \neq 3,4,10,12} (c_t \times P_t)^2 + (c_3 \times P_3 + c_{12} \times P_{12})^2 + (c_4 \times P_4 + c_{10} \times 10)^2}$

- Factors (c_t) vary by line of business

- Pt = net premiums for the individual lines of business

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Catastrophe Risk Charge

Method 3

- $c_t \times (S_t - F_t) + F_t - R_t + C_t$

- Factors (c_t) vary by line of business
- S_t = gross sum insured
- F_t = gross sum insured placed facultatively
- R_t = gross sum insured recoverable from reinsurers
- C_t = cost of one reinstatement of catastrophe reinsurance cover in cases where the reinstatement reinsurance cover has not been pre-paid

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Regulatory Capital Ratios

- Minimum Capital Ratio (MCR) 120%
- Prescribed Capital Ratio (PCR) 150%
- Target Capital Ratio (TCR) Above 150%; set by insurer

Regulatory Capital Ratio	Supervisory Action
Below MCR	most severe regulatory intervention including suspension of registration
Between MCR and PCR	attract increased supervision and require insurers prepare a plan to raise capital above TCR

Returns and Declarations

- Capital Adequacy Returns

- Declaration by
  - Chief Financial Officer,
  - Actuary, and
  - Director of insurer

- Calculation determined in accordance with guideline and instructions of the ICB

Considerations

- Regional practice
- Company internal practices
- Level of complexity and cost of implementation
- Size and type of market
- Current solvency requirement

Req Capital Factor Comparison

Required Capital	BAH	CAN
Asset Default Risk Charge	0% – 100%	0% – 100%
Off Balance Sheet Risk Charge	0% – 100%	0% – 100%
Foreign Currency Mismatch Risk Charge	2%/8%	10%
Premium Adequacy Risk Charge	15%	Auto Liability: 15% Auto Personal: 15% All Other: 15%-30%
Outstanding Claims Risk Charge	10%	Auto Liability: 10% Auto Personal: 10% All Other: 10%-25%
Catastrophe Risk Charge	Multiple	Multiple

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RBC Comparative Study

- Preliminary investigation considered:
  - Existing requirements for general insurers
  - Risk based framework developed for life insurers
  - Any gaps in the current legislation
  - Risk based frameworks in existence or proposed by Canada, Jamaica and Trinidad Tobago
  - The potential impact on the current solvency status of the general insurance industry

RBC Comparative Study

Aggregate Results

- Most companies appear to be adequately capitalized.

- The objective of the RBC framework:
  - Is to align the industry's capital requirements to its risk profile
  - Is not to increase the industry's capital requirement

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NEXT STEPS

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Next Steps

- Quantitative Impact Studies (QIS)
- Company Specific Meetings as Requested
- Industry Feedback

Next Steps (cont'd)

- Amendments to the Insurance General Regulations

- Final RBC Guidelines

- Implementation of RBC for General Insurers

Thank you for your attention!!
Questions/Comments