Labuan Financial Services Authority

RESPONSE TO THE CONSULTATION PAPER ON CAPITAL ADEQUACY REQUIREMENT FOR LABUAN CAPTIVE INSURANCE BUSINESS

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TITLE	Response to the Consultation Paper on Capital Adequacy Requirement for Labuan Captive Insurance Business		

1.0 Introduction

1.1 Labuan FSA issued the *Consultation Paper on Capital Adequacy Requirement for Labuan Captive Insurance Business* [referred to as "the CP"] on 14 December 2018. The Consultation Paper conceptualised Labuan FSA's policy intention and the broad plan to transform the current Margin of Solvency (MOS) requirements of the captive insurance business to be aligned with the international standard and best practices.

1.2 The Labuan insurance industry and the public at large were given a period of one and a half month to provide feedback on the CP and from which, numerous comments were received by Labuan FSA. Majority of the respondents were captive professionals which included captive insurers, insurance intermediaries, consulting and actuarial firms.

2.0 Overview of Areas Commented

2.1 After reviewing the feedback received, Labuan FSA is pleased to inform that majority of the respondents were supportive of the proposed transition towards the enhanced solvency requirements for Labuan captives. Notwithstanding this, several recommendations were put forward for Labuan FSA's consideration when finalising the captives solvency requirements.

2.2 In terms of the feedback received, majority of the comments revolved around issues pertaining to the minimum paid up capital and the proposed solvency requirements while the remainder of the feedback discussed on other operational and administrative matters.

3.0 Overview of the Response Paper

3.1 In providing the summary of the issues raised as well as Labuan FSA's own stance on them, the Response Paper on Capital Adequacy Requirement for Labuan Captive Insurance Business (RP) has been prepared covering the following topical areas:

(i) Minimum paid-up capital (PUC);
(ii) Solvency requirement for general captives;
(iii) Solvency requirement for life captives;
(iv) Approved assets concept;
(v) Implementation timeline; and
(vi) Other matters.

3.2 To facilitate structured response by Labuan FSA, the comments provided by respondents on the above areas were grouped in accordance to the questions of the CP as provided in Section 4.

4.0 Response to CP Feedback

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.*
Comments Received: A number of respondents are **comfortable with the current minimum capital requirement** as it is deemed to be in line with the requirements adopted by popular captive jurisdictions and competitive to attract new potential captive users to set up in Labuan IBFC. Some

recommended for the minimum capital requirement to be **increased by a range between RM100,000 and RM500,000** depending on the types of captive licence, given that the current requirement is at the lower end of the band range in comparison with other captive jurisdictions. They were of the view that the increment will not be detrimental to Labuan captives whilst at the same time would encourage stronger commitment amongst the captives.

Labuan FSA's Response:

The current minimum capital requirement will remain status quo so as to not further burden Labuan captives following the introduction of substance requirements which took effect on 1 Jan 2019. Besides, captive is only exposed to related party/ associates risks and therefore pose minimal financial stability issue, if any.

Question 2:

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

Comments Received:

One respondent suggested to consider **line of business** and **cession to reinsurance market** for the computation of general captive solvency while others commented that **the factors considered are sufficient** and consistent with those adopted by other captive jurisdictions. Another observation acknowledged that majority of the benchmarked captive jurisdictions **do not implement risk based capital** for their captive insurance business.

Labuan FSA's Response:

Labuan FSA took note of the comments received. The proposed computation for solvency has already taken into account cession to reinsurance market i.e. on net basis either on the premium or claim provisions. Furthermore, the reinsurance arrangement of Labuan captives is also monitored by Labuan FSA to address counterparty risk.

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.

Comments Received:

There were **mixed reactions** to the suggestion of including the provision for outstanding claims as part of the solvency requirement. One respondent was of the opinion that a percentage of outstanding claims **may not** be an ideal factor as it would cause a squeeze on the capital in the event of an unexpected large loss. Should it also trigger a need for additional capital injection to make good the solvency breach, this might lead to an over-capitalisation situation if the provision for outstanding claims proves to be temporary; resulting in vast swings in the margin of solvency which may not truly reflective of the business operation and causing administrative burdens to shareholder having to raise capital. The respondent further commented that such factor is worthwhile to consider only for captives that underwrite third party risks.

Two respondents were **agreeable** with the proposed additional factor as this approach will increase the robustness of the capital requirement, specifically to ensure that mature or run-off companies with significant outstanding claims would be adequately capitalized, without over-penalising the average company.

In addition, clarifications were also sought on the detailed calculation of the provision for outstanding claims, the requirement to obtain a confirmation by actuary for the solvency and the timeline for the rectification of the solvency breach**.**

Labuan FSA's Response:

The introduction of an additional factor i.e. % of provision for outstanding claims provides another perspective to ensure that captive has the capability to fulfil its future obligation including claims. The following are Labuan FSA's clarification on the matters raised:

(i) The provision for outstanding claims is calculated on a **net basis**.

(ii) In the case of captive business, only life captive (re)insurer is required to appoint an actuary to undertake the valuation of its life insurance liabilities.

(iii) Labuan FSA expects prompt and effective rectification to be undertaken to make good of any solvency deficit within the prescribed timeline, otherwise supervisory intervention will be instituted.

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.

Comments Received:

The industry players were unaware of any approach other than those mentioned in the Consultation Paper on Capital Adequacy Requirement for Labuan Captive Insurance Business. Notwithstanding this, one respondent commented that the approach to have actuarial investigation of policy liabilities is fairly similar to other jurisdictions though not entirely the same.

Labuan FSA's Response:

Labuan FSA took note of the comments received.

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.

Comments Received:

All respondents were of the view that **current approach** i.e. based on the % of actuarial liabilities **should be retained** since an actuarial investigation of the policy liabilities has to be carried out regardless. In addition, actuarial liabilities are required to be backed by assets, hence making it a more robust basis as compared to the proposed % of assets. Although the proposed approach is simpler to understand, it may be more volatile over time depending on the actual assets held. Besides, moving away from a measure using actuarial liabilities to a measure using total assets would penalise companies with a high equity to liability ratio, though reducing to x% might counterbalance this.

Labuan FSA's Response:

Labuan FSA agrees to maintain the current approach which involves the actuarial valuation of liabilities for life business, the approach which has been well accepted by the industry. In addition, Labuan FSA would also consider reviewing the rate to make it comparable to the common practice adopted by other popular captive jurisdictions.

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.*
Comments Received: Majority of the respondents were of the opinion that the approved assets approach **should not** be incorporated into the solvency requirement for Labuan captives to ensure consistency with the financial reporting standard whereby the quality of assets is well reflected in the asset valuation of financial reporting. Hence, for the purpose of calculating capital adequacy, any asset should be recognised fully as long as it is not impaired in accordance to the financial reporting standard. One respondent was agreeable with the approved assets concept subject to it **commensurate with the risks underwritten by captive insurers** i.e. third party business. Other jurisdictions that have adopted this approach allow their captive insurers to write certain percentage of third party business. Notwithstanding this, the respondent suggested Labuan FSA continue allowing captive insurers the flexibility to loan back their funds to the group treasury centre to generate better investment returns.

Labuan FSA's Response:

Taking cognisant of the fact that Labuan captives underwrite related-party risks, Labuan FSA agrees not to introduce the approved assets concept under the solvency requirement for captives and rely on the financial reporting standards on assets valuation for the purpose of calculating the capital adequacy as practised by many captive jurisdictions.

Question 7: *Is there any other methods that can be considered for captive solvency without compromising the safety and soundness of captive business? Please provide justification for your suggestion.*
Comments Received: One respondent recommended a solvency requirement to be simpler by having a positive net assets i.e. **total assets greater than total liabilities** for pure captive with general insurance business. Another respondent suggested that Labuan FSA consider allowing **internal capital model**, which is also in line with the market practice for captives in Europe, as an additional avenue to Labuan FSA's solvency requirement in order to attract specialized captives with different business profile.

Labuan FSA's Response:

Labuan FSA disagrees with the positive net assets as a proxy for solvency given that this will leave no or very little opportunity for an ailing captive to be resuscitated. The proposed solvency requirement for pure captive aims to ensure adherence to ICPs requirements i.e. to have solvency trigger point for supervisory intervention.

For simplicity and consistency in the implementation of captive's solvency requirement, the standard approach would be adopted by Labuan captives. Notwithstanding this, Labuan FSA may consider any deviation from the prescribed requirement i.e. internal capital model subject to the model being no less stringent than the standardised requirement. In addition, a verification of the model by an independent expert i.e. actuary may be required and the cost will be borne by the captive itself.

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.
Comments Received: One respondent suggested that the Solvency Capital Requirement (SCR) should be the **higher of MCR, 10% of net premium income (NPI) (instead of the existing 20% rate) and 10% of provision for outstanding claims (POC)** for general insurance as well as the **higher of MCR and 0.5% of total assets (or 3 % of actuarial liabilities)** for life insurance. This will better reflect the average levels of the relevant benchmarked jurisdictions and not causing any market disruptions. Setting SCR at 1.2 of MCR is effectively increasing the paid-up capital requirement by a multiple of 1.2. Another respondent did not envisage any negative impact in applying the proposed requirement, but **disagree with the inclusion of 20% of the provision for outstanding claims** as part of the solvency requirement for general insurance business for the same reasons as provided in comments box of Q3 above.

Labuan FSA's Response:

Labuan FSA agrees to proceed with the proposed requirement and maintains the current approach of actuarial liabilities but may consider to reduce the rate from the existing 3%, (instead of 0.5% of total assets) for captive's life insurance business. Furthermore, Labuan FSA will consider to review the rate of 20% of NPI and POC based on the practices adopted by other well-known captive jurisdictions but will keep the SCR at the minimum 120% MCR. Labuan FSA disagrees to consider setting the SCR at the PUC level as this is the minimum licensing requirement and failing to keep the minimum level will compromise the captive licensing status i.e. risk of licence revocation. In addition, there is a need for the SCR to provide triggers for supervisory intervention.

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.*
Comments Received: One respondent proposed Labuan FSA to give an alternative timeline or **grandfathering options** for captives with multi-year or locked-in business. Another respondent suggested for a differentiated timeline for new entrants and existing captives with the option of early adoption.

Labuan FSA's Response:

Although Labuan FSA plans to provide a common timeline for both new and existing captives i.e. by 1 Jan 2021, early adoption is encouraged. Notwithstanding this, any exceptional cases may be considered on a case-by-case basis.

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.*
Comments Received: The overall feedback from the industry players revolves around the reporting requirement and suggestions for Labuan FSA to ensure that the development of the policy would not dampen the competitiveness of Labuan IBFC vis a vis other jurisdictions. Clarification was also sought on the formula of SCR considers factors other than the provision for outstanding claims such as the unexpired risk reserves.

Labuan FSA's Response:

Labuan FSA acknowledges the need for Labuan IBFC to remain competitive but at the same time must ensure that the requirement meets the international standard and best practice i.e. the safety and soundness of Labuan captives' business is not compromised. In terms of the reporting requirement, Labuan FSA will incorporate the solvency reporting form into the Statistical Management System similar to the current arrangement. In the transition, manual reporting may be needed. In order to minimise complexity and to be consistent with the practices of other prominent captive jurisdictions, Labuan FSA will introduce the provision for outstanding claims as the additional proxy for captive's solvency.

5.0 Conclusion

Labuan FSA appreciated the feedback received in response to the CP as this provides invaluable input that will facilitate Labuan FSA in setting the right pitching and intensity of solvency requirements for Labuan captives. Based on the feedback, Labuan FSA will develop the guidelines and issue an exposure draft to obtain industry's feedback prior to finalising it for implementation.

6.0 Respondents to the CP

The list of respondents to the Consultation Paper on Capital Adequacy Requirement for Labuan Captive Insurance Business, except for one respondent who requested to be anonymous, is as follows:

No.	Respondents to CP on Capital Adequacy Requirement for Labuan Captive Insurance Business (*in alphabetical order*)
1.	Brighton Management Limited
2.	GIA Company Ltd.
3.	Japan Risk Specialist Ltd.
4.	Labuan Insurance Management Services Limited via Nicholas Actuarial Solutions Sdn Bhd
5.	Marsh Management Services Labuan Limited
6.	Taiping Reinsurance Company Limited, Labuan Branch