Labuan Financial Services Authority

RESPONSE TO THE CONSULTATION PAPER ON INSURANCE CAPITAL ADEQUACY FRAMEWORK

Issuance Date: 11 July 2014

1.0 Introduction

1.1 Labuan FSA issued the *Consultation Paper on Insurance Capital Adequacy Framework* (ICAF) [referred to as "the CP"] on 23 January 2014. The Consultation Paper had explained Labuan FSA's policy intention and plans to transition from the current Margin of Solvency (MOS) requirements to the risk based capital regime, ICAF, in two phases:

(a) Phase I: *Harmonising Assets & Liabilities requirements* (Phase I); and

(b) Phase II: *Strengthening Capital Buffer* (Phase II).

It outlined the key requisite elements of ICAF and the planned phases of its rollout, so as to expose the industry on the overarching roadmap towards implementing ICAF as the risk-based capital framework.

1.2 The insurance industry and the public at large were given a period of one month to provide feedback on the CP and from which, numerous comments were received by Labuan FSA. Given that the insurance industry in Labuan IBFC is predominantly reinsurance business, as expected, majority of the respondents were reinsurers. The remaining half of the respondents comprised insurance intermediaries, insurance captives as well as other relevant agencies.

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 ICAF requirements. Most comments are recommendations to refine so as to facilitate ICAF's rollout via more focussed requirements implementation period needed and ICAF possible re-scoping.

2.2 In terms of key areas touched, more than 40% of the comments received were on implementation logistics of ICAF, while 30% revolved around technical issues

and administrative matters. The remainder of the feedback discussed on possibilities of modification to the scoping of ICAF requirements. The generally positive feedback received reflects the industry's acceptance for a more robust, risk-based capital framework that will incorporate all material risks of a (re)insurer or (re)takaful operator (to be referred to thereafter as "insurers") in determining the suitable capital adequacy level to be maintained.

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 ICAF (RP) has been prepared covering the following topical areas:

(i) Implementation timeline;
(ii) Valuation harmonisation;
(iii) Actuarial requirement;
(iv) Fund segregation;
(v) Treatment for branches;
(vi) Capital adequacy level and computation method;
(vii) Recognition of deferred acquisition cost; and
(viii) Compliance cost.

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 ICAF CP Feedback

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.

Comments Received:

Generally, most respondents were agreeable with the proposed timeline. However, some industry players proposed for the **implementation period of Phase I and II to be delayed by one (1) year (for each phase)** to allow for preparatory efforts. Clarifications were also sought by one respondent on **whether capital deficiencies under ICAF can be covered by a parental guarantee or in the form of pledged deposit** and the **period required by Labuan FSA for the insurer to meet the applicable capital when transitioning** from MOS into ICAF.

Labuan FSA's Response:

The implementation timeline under the CP for Phase I and Phase II which will take approximately a year-and-a-half each should already provide sufficient preparation time for the industry. Notwithstanding this, Labuan FSA acknowledges potential challenges in ICAF's full implementation of Phase II as it will entail expanding further the capital buffer based on constituent capital risk charges within the Capital Adequacy Ratio (CAR) requirements. In this regard, at the end of Phase II, Labuan FSA plans to roll out ICAF as an initial 1-year parallel run prior to its full implementation in the following year as follows:

	Year(s) of Implementation	
ICAF Stages	**Insurance ICAF**	**Takaful ICAF**
Phase I & II as per CP	2014 – 16	2015 – 17
Parallel run implementation	2017	2018
Full implementation	2018	2019

During the parallel run period, the Labuan insurers will be required to compute its CAR vis-à-vis the Phase II finalised requirements, while adhering to the minimum existing MOS requirements and ensure that all requisite systems are put in place to support the capital computation. In this regard, the minimum CAR will only need to be complied within the following year (to the parallel run year) as reflected in the earlier table. This should provide the industry sufficient time to address any implementation challenges before transitioning into ICAF.

Question 2:

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

Comments Received:

Majority of the respondents do not have any issue on accounting policy as they have been operating under the four prescribed FRS mainstreams. Several industry players, however, commented on the **challenges faced arising from financial standards transition** particularly on the reserving and disclosure requirement required under the International Financial Reporting Standards (IFRS) or Malaysia Financial Reporting Standards (MFRS). It was suggested that **Labuan FSA continuously monitors the development of international accounting standards** i.e. IASB and FASB in developing an economic balance sheet approach that both assets and liabilities are valued on a consistent basis for solvency purposes.

Labuan FSA's Response:

Under the *Directive on Financial Reporting Standards for Labuan Financial Institutions* dated 18 March 2014 issued by Labuan FSA, Labuan insurers are required to adopt any of the four mainstream FRSs for the financial year beginning 1 January 2016. The approximately two (2)-year period should allow ample transition time for Labuan insurers which are currently operating outside the prescribed financial reporting

standards. The prescription was necessary to ensure that the range of valuation bases from which ICAF solvency requirements are built on are, to certain extent, harmonised and will conform to the international standards and practices. Furthermore, the ongoing convergence exercise between IFRS and US GAAP will eventually minimise any material differences between the two standards. Labuan FSA will assess, from time to time, any significant developments in the international accounting standards should the valuation bases distort significantly the CAR computation envisaged under ICAF.

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.*

Comments Received:

The industry players sought Labuan FSA's clarification with regard to:

(a) leveraging on **group actuarial resources** for ICAF certification includes actuaries who hold other statutory actuarial appointments within the Group;

(b) the scope, frequency, deadlines and formats of **actuarial report submission**. It was also suggested that the review of valuation is undertaken on annual basis (year end figure) and quarterly reporting based on sensible estimation using the internal methodology suggested by the actuary;

(c) various matters regarding **actuarial valuation methodology** with regard to the possibility of adopting simplified approach for insurers without sufficient reliable data, selection of discounting factors for liability reserving, provisioning at 75% level of sufficiency and the extent of appointed actuary's discretion on the level of factors in deriving the liability valuation; and

(d) whether **asset liability matching** can be undertaken internally by an actuary or a

specific tool and other regulatory requirements to be imposed for the valuation of liabilities.

Labuan FSA's Response:

To the extent possible the following are Labuan FSA's clarification on the matters raised. At this juncture, we are unable to furnish more details as this would be dependent on the detailed requirements that will be developed during Phase I and II of the ICAF:

(i) Labuan FSA generally allows an insurer to utilise its group actuarial resources including those with multiple statutory appointments. However, this is provided that the appointed actuary utilised maintains professional accountability and impartiality needed in providing his actuarial services to the Labuan insurer. The Phase I guidelines will provide more details on Labuan FSA's minimum expectations on the appointed actuary including the recognised certifications as well as the expected roles and responsibilities;

(ii) generally, Labuan FSA agrees on the proposal for annual actuarial reporting based on the audited financial statements. Here, Labuan FSA shall maintain the requirement for the financial statements to be submitted within six (6) months from the financial-year-end – a sufficient period for the actuarial certification exercise under ICAF.

Notwithstanding this, insurers will be required to maintain a pro-forma valuation in the interim periods (e.g. quarterly basis) which may be subject to be part of statutory returns to and supervisory review by Labuan FSA. The expected scope, frequency, format and submission requirements of an actuarial report will also be part of the detailing of the Phase I guidelines later;

(iii) at this point, the broad requirements of the valuation and reserving of the insurance liabilities which Labuan FSA envisaged have been provided by the

earlier issued CP. Other details will be specified as part of the Phase I guidelines; and

(iv) the asset liability mismatch risks would need to be managed in accordance to the requirements of the *Guidelines on Investment Management for Labuan Insurance and Takaful Business* issued on 11 February 2014. Guidelines to be issued in Phase I and II (referred to as "Phase I Guidelines" and "Phase II Guidelines", respectively) may provide additional regulatory requirements as regards the valuation of the insurance 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.*
Comments Received: Feedback from the industry players on the principles revolves around the **scope of the Fund Solvency Requirement (FSR)** as intended by Labuan FSA. The comments received pertained to placements of assets backing the individual funds and classification of these individual funds under FSR. A suggestion was also made by respondents for Labuan FSA to consider providing exemption from the FSR for insurers with small operations e.g. branch and rely on overall solvency sufficiency only. Other queries posed relate to the perceived increase in compliance cost and expected complexity in fund calculation as well as increased efforts in monitoring.

Labuan FSA's Response:

What Labuan FSA intends for the FSR is similar to the requirements practised in Malaysia's and Singapore's Risk Based Capital (RBC) Framework. At this juncture, the FSR segregation is envisaged to be based on:

- general business fund; and

- life/family business.

There is also a possibility to further segregate the above to sub-classification i.e. sub-funds based on risk origins which can allow for further capital differentiation:

- Malaysian risk; and
- Non-Malaysian risks.

The full details of FSR and the abovementioned classification shall be part of the requirements of the Phase I guidelines. This should address any concerns of the insurers on their difficulty in monitoring and effecting the FSR. The perceived complexity in FSR is also not founded as it is a fundamental principle used as explained in the CP i.e. at the individual fund level, fund assets must be at least equal to the corresponding fund liabilities. As it is already a norm practised in other insurance markets to prudently avoid any comingling of the funds and ensure fund own-sustainability, there is no need to provide an exemption from the FSR.

Question 5:

Please provide comments on the appropriateness of the Total Capital Available (TCA) and Total Capital Required (TCR) approach as explained in Sections 6.4 – 6.8 of the CP.

Question 6:

Labuan FSA seeks feedback whether there are any issues for a licensee in complying with the proposed two-tier Capital Adequacy Ratio (CAR) requirements i.e. the Minimum CAR (MCAR) and Supervisory CAR (SCAR).

Comments Received:

(i) CAR Levels & Computation Method

a. TCA and TCR

On TCA and TCR related matters, the industry players requested for clarification in respect of **Component 2 (Assets Risk) on inclusion of counterparty risks** and the

alternative bases for **Operational risk computation under Component 3 (Other Risk)**. In addition, there were suggestions on **alternative proxies to be used to measure operational risk** (i.e. premium and outstanding claims instead of total asset as proposed under the CP).

Explanations were also sought on **allowable deductions from** TCA and recognition of **diversification benefits in the TCR** calculation. Furthermore, respondents also suggested for:

- further guidance to be given with regard to the **methodology** expected under ICAF;
- **capital adequacy computation to be carried out on annual basis** and sufficient time is given to fund capital deficits where the situation arises; and
- a **materiality concept threshold to allow for simplified approaches** be adopted for immaterial amount.

b. Two-tier CAR

The industry players suggested that **minimum CAR ratio to be at 100% level** combined with "financial resources warning events" if it falls below 120% or on an exceptional basis, a higher set level as deemed appropriate by Labuan FSA based on in-depth risk-assessment done for a specific insurer (SCAR as determined by the organisation). The criteria for such an individually set higher SCAR should be clearly and transparently defined and SCAR assessment being undertaken in consultation with the insurer prior to its finalisation with the aim to identify those high risk insurance.

There was a query as to **whether SCAR can be below the minimum CAR** and what would the consequent action by Labuan FSA be when a branch licensee's CAR falls below the MCAR. In addition, the industry players also enquired whether Labuan FSA plans to adopt a standard model and the possibility of allowing for internal capital model.

(ii) <u>Treatment for Branches</u>

The industry players proposed that ICAF should be made applicable to Labuan's incorporated entities whereas more **simplistic approach to be adopted for branch**

setups. In this regard, the industry players suggested for a milder standard for well-capitalised branches e.g. no minimum CAR/SCAR as it is difficult to maintain on standalone basis and may lead to ineffective use of capital resources.

In addition to the CP's suggestion on possible capital differentiation between direct insurers and reinsurers, it was also suggested that a **differentiated ICAF approach is considered for the businesses based on risk origins** i.e. Malaysian versus non-Malaysian business. The industry players also enquired whether the parent entity needs to demonstrate similar or at least equivalent capital requirements under ICAF.

(iii) Recognition of "deferred acquisition costs" (DAC)

One respondent enquired **whether the DAC can be recognised as part of Tier 1 capital** in the TCA.

Labuan FSA's Response:

(i) CAR Levels & Computation Method

a. TCA and TCR

As a point of clarification, Component 2 risks will include the counterparty risk in the form of receivables. Labuan FSA will also consider premium and outstanding claims as alternative proxies for operational risk when developing the Phase II guidelines.

As briefly explained in the CP, intangible assets, pledged assets and investment in subsidiaries will be outrightly deducted from TCA. The CP also mentioned that diversification benefits will be considered under the insurance liabilities computation for the TCR. In relation to the recommendations given by the respondents, Labuan FSA is of the view that:

- the Phase II guidelines will furnish more details on the methodology parameters; guidance as well as the template to be used for determining the TCA and TCR;

- the maintenance of CAR will be an ongoing basis so as to adhere to the MCAR and the SCAR selected by the insurer. Any capital breaches will need to be immediately rectified with pre-defined plans which will be stipulated further under Phase II guidelines. The Phase II guidelines will also provide the manner in which insurers are to submit the statutory reporting of their CAR to Labuan FSA which will be at least on quarterly basis; and
- Conceptually, Labuan FSA is open to provide a differentiated, simplified approach but only for certain type of insurance licensees and their legal status. Labuan FSA's response on the planned capital treatment for branches may be relevant to the industry's proposal.

b. Two-tier CAR

Labuan FSA disagrees with the proposal for the minimum CAR to be at 100% as this is the very bare minimum level of solvency and will leave no or very little opportunity for the ailing insurer to be resuscitated. As explained in the CP, MCAR of, for example at, 120% is imperative to allow sufficient supervisory interventions to be made before the financial standing of the ailing insurer is eroded to the point of gone concern.

Labuan FSA also intends to clarify further on the CP's recommendation that under a business-as-usual situation, individual insurers are required to have a CAR threshold that is higher than the MCAR. In this regard, Labuan FSA wishes to re-designate the terminology of SCAR to Internal CAR (ICAR) – which gives a more apt definition to capture the minimum level of capital adequacy that individual insurers need to maintain taking into account their risk management assessment; current business plans, strategies and risk tolerance/appetite. Notwithstanding this, as part of Labuan FSA's own risk profiling of the insurers, Labuan FSA will have the prerogative to re-assess and request for modification be made to the ICAR to be pitched to the capital level which is deemed more appropriate. Phase II guidelines

will provide a set of parameters to be considered in determining ICAR as guidance for insurers.

As explained in the CP and the previous paragraph, the ICAR (previously termed as SCAR) is to serve as a red flag to both the insurer's management and Labuan FSA. It has to be sufficiently higher than MCAR so as to allow the insurer adequate "time to act" margin before it deteriorates below MCAR, the no-fly-zone capital threshold. Any capital deteriorations to the level between ICAR and MCAR will provide the insurer with the ability to institute capital rectification plans. Should the CAR continue to deteriorate to MCAR and below, prompt corrective measures and interventions from Labuan FSA will be instituted with varying stringency. The interventions may include de-licensing and winding-up of the ailing insurer. This general rule will apply to all insurers regardless of their legal status as a branch or otherwise. As such, Labuan FSA regards any breaches of ICAR or MCAR to be serious. Should an insurer's CAR deteriorate below the MCAR level, Labuan FSA expects prompt and effective rectification to be undertaken which may include injection of capital (or additional assets for the working fund of branches). Prior to the full implementation of ICAF, Labuan FSA shall allow for a parallel run as explained under Question 1.

For simplicity and consistency in the implementation of ICAF, at this juncture, Labuan FSA will only allow standard approach to be adopted by Labuan insurers. Internal models and other innovations will only be considered once Labuan FSA deems the industry has attained full maturity and capability in operationalising ICAF in a sound manner.

(ii) <u>Treatment for Branches</u>

Notwithstanding the blanket mechanics of ICAF's CAR thresholds, Labuan FSA acknowledges that the capital treatment for a branch entity can be differentiated by using simpler components to compute its TCR and therefore, its CAR. The same

can be said as regards the non-Malaysian business which may vary from one entity to another. Any simplification, relaxation or exemption that can be allowed under ICAF shall be governed by parameters to be pre-determined by Labuan FSA, such as parental guarantee or reliance on home supervisory authority etc. Further details of the proposed differentiation will be tackled under the requirements of the Phase II guidelines.

(iii) Recognition of DAC

Under Phase II, as DAC is an intangible asset, it would not be recognised as part of TCA for the CAR computation.

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.

Comments Received:

Clarification was sought on the **capital treatment for captives using the protected cell company (PCC) and rent-a-captive (RAC) structure** which comprise elements of closed third party exposure. In fact, despite ICAF's proposed exclusion for captives, one player suggested that a captive that underwrites third party business should still be subjected to ICAF requirements. As regards the proposed MOS enhancement for captives, some industry players indicated that such enhancements are not crucial as long as **captives underwrite their own-Group/related risks.**

Labuan FSA's Response:

ICAF requirements as envisaged under the CP are not suitable for captives due to its inherent business nature whereby it underwrites concentrated risks related to its Group's. Even in the case of captives with PCCs and RACs structure, although their

business can relate to third party risks, these are still limited to third-party group's. Therefore, ICAF would not be applicable for such arrangements.

However, in the absence of comprehensive capital requirements such as ICAF, Labuan FSA is of the view that captives need to adopt more robust MOS. This can potentially be benchmarked against other jurisdiction's MOS requirements which also consider the materiality of claims provisioning in addition to the size of net premiums. However, the works will only be considered once ICAF development is on a good track in terms of its implementation timeline.

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.*

Question 9:

Labuan FSA seeks comments on the overall proposed ICAF and on any matters relevant to be considered in relation to its implementation.

Comments Received:

Some players anticipated some implementation challenges of ICAF which included compliance cost in the form of time spent and additional manpower requirements.

Labuan FSA's Response:

In developing the overall ICAF requirements and the implementation timeline of the Framework, Labuan FSA took account the efforts and indirectly the type of expenses that may be incurred by the industry in effecting ICAF and adopted the following approach to ease the transition into ICAF regime:

(i) two-stage implementation instead of a big-bang approach to phase in the ICAF requirements to allow expected infrastructures and resources are systematically put in place. This should spread the compliance cost over the ICAF period which otherwise would be an immediate and onerous cost implication to the insurers;

(ii) the proposed one (1)-year parallel run as explained in Question 1 will provide the industry effectively an additional transition year to ease in and build up the expected ICAF capital buffer by the full implementation date targeted; and

(iii) where possible insurers will be allowed to leverage on their group resources particularly on the actuarial expertise and systems.

5.0 Conclusion

Labuan FSA appreciated the feedback received in response to the ICAF CP as this provides invaluable input that will facilitate Labuan FSA in setting the right pitching and intensity of ICAF including the implementation time needed for the framework's implementation. Based on the feedback, Labuan FSA will develop the Phase I and Phase II where more detailed ICAF requirements will be specified in the future guidelines. In developing these ICAF guidelines, Labuan FSA will firstly issue exposure drafts to obtain industry's feedback prior to finalising the ICAF's requirements for implementation.

6.0 Respondents to the CP

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

No.	Respondents to CP on ICAF (*in alphabetical order*)
1.	ACE Tempest Reinsurance Ltd.
2.	Allianz SE General Reinsurance Branch Labuan
3.	Allianz SE Life Reinsurance Branch Labuan
4.	Bank Negara Malaysia
5.	Hansard International Limited, Far East
6.	Labuan IBFC Inc
7.	Labuan Reinsurance (L) Ltd
8.	Labuan International Insurance Association (LIIA) – Council Member
9.	Marsh Management Services (L) Ltd.
10.	Mitsui Sumitomo Insurance Co. Ltd.
11.	Mitsui Sumitomo Reinsurance Limited
12.	MS Frontier Reinsurance Limited
13.	RGA Global Reinsurance Company Ltd, Labuan Branch
14.	Swiss National Insurance Company (Labuan Branch) Ltd
15	Taiping Reinsurance Co., Ltd., Labuan Branch
16.	Takaful Re Limited, Labuan Branch
17.	Tokio Marine Global Re Asia Ltd
18.	Trust International Insurance and Reinsurance Co. B.S.C. (C) Trust Re, Labuan Branch