WEBINAR

Risk-Based Capital Regimes in Emerging Markets

17 September 2020

Speakers

World Bank
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Risk-Based Capital Regimes in Emerging Markets | Presentations

- Risk-Based Approaches| Craig Thorburn, Lead Financial Sector Specialist, World Bank
- Spectrum of Solvency Regimes| Eamon Kelly, Actuary (FIAA)
- Sri-Lanka Case Study| Chamarie Ekanayake, Director Supervision, Insurance Regulatory Commission of Sri Lanka

Why risk-based approaches to capital?

- For development
  - Compliance based rules constrain innovation, limit investment in technical skill development, and create a regime where blaming the rules is the default excuse for poor performance.
  - More risk-based approaches encourage insurance market development providing flexibility, encouraging technical skills, and incentivizing management to find solutions to challenges by adjusting their business operations.
- For efficiency
  - More risk-based approaches use less of a “one size fits all” approach with hidden dormant capital adding cost.
- For effective supervision
  - A more risk-based approach facilitates fair comparisons between insurers and over time, supporting risk-based ratings structures and proportionate intervention ladders.

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Types of risk-based capital rules

Flat Nominal	Index-based "greater of"	Index-based additive	Combinatorial	Model based
A fixed amount of local currency set out in the law. Now quite rare but some still exist.	A factor applied to premium, a factor applied to claims, etc. Required capital is the greater of one or the other. Kenny Rules Solvency I	More factors applied to premiums, claims, and usually asset side balance sheet items as well. Required capital is the sum of the results.	Risks measured and capital allocated on a risk-by-risk basis. Required capital is a statistical combination plus allowance for diversification / correlation, with a "square-root".	Customized to each insurer through data-based models reflect insurers' business. Leverages risk management of sophisticated insurers' internal models.

Less — Risk Sensitive — More

Less — technical management and supervisory skills, data needs, risk-based approach, granularity, cost, sophistication — More

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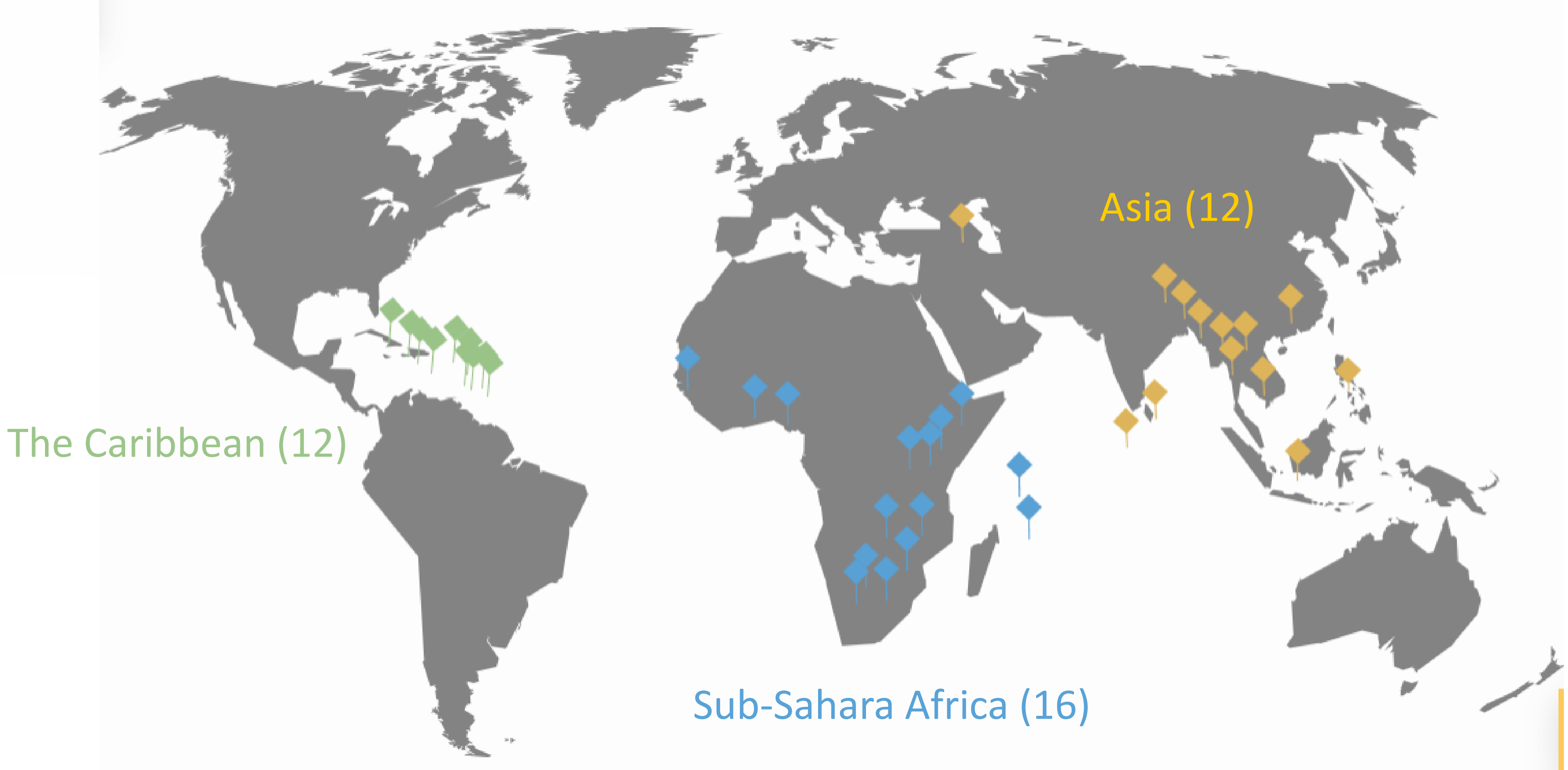
Capital adequacy frameworks in emerging markets



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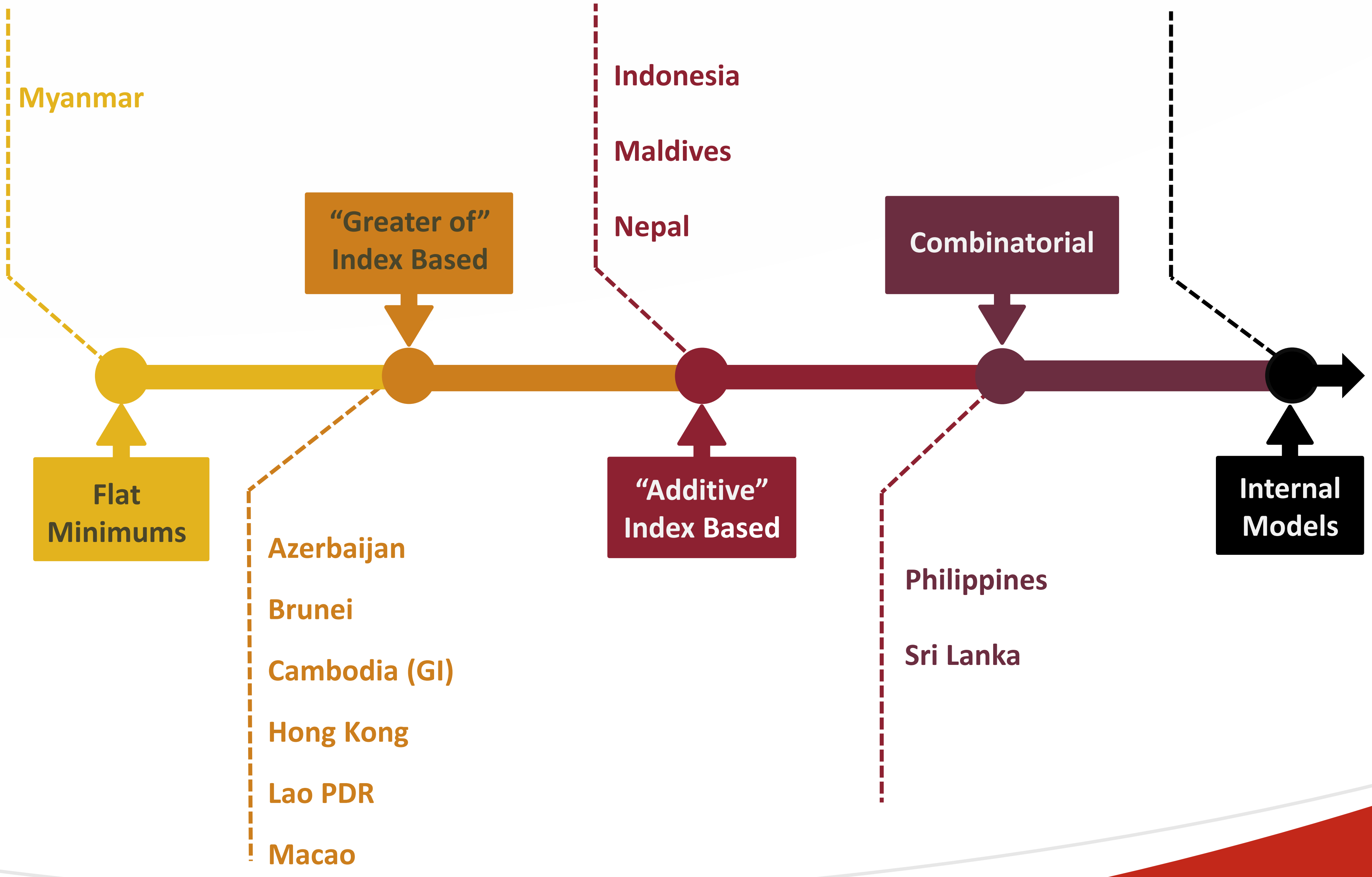
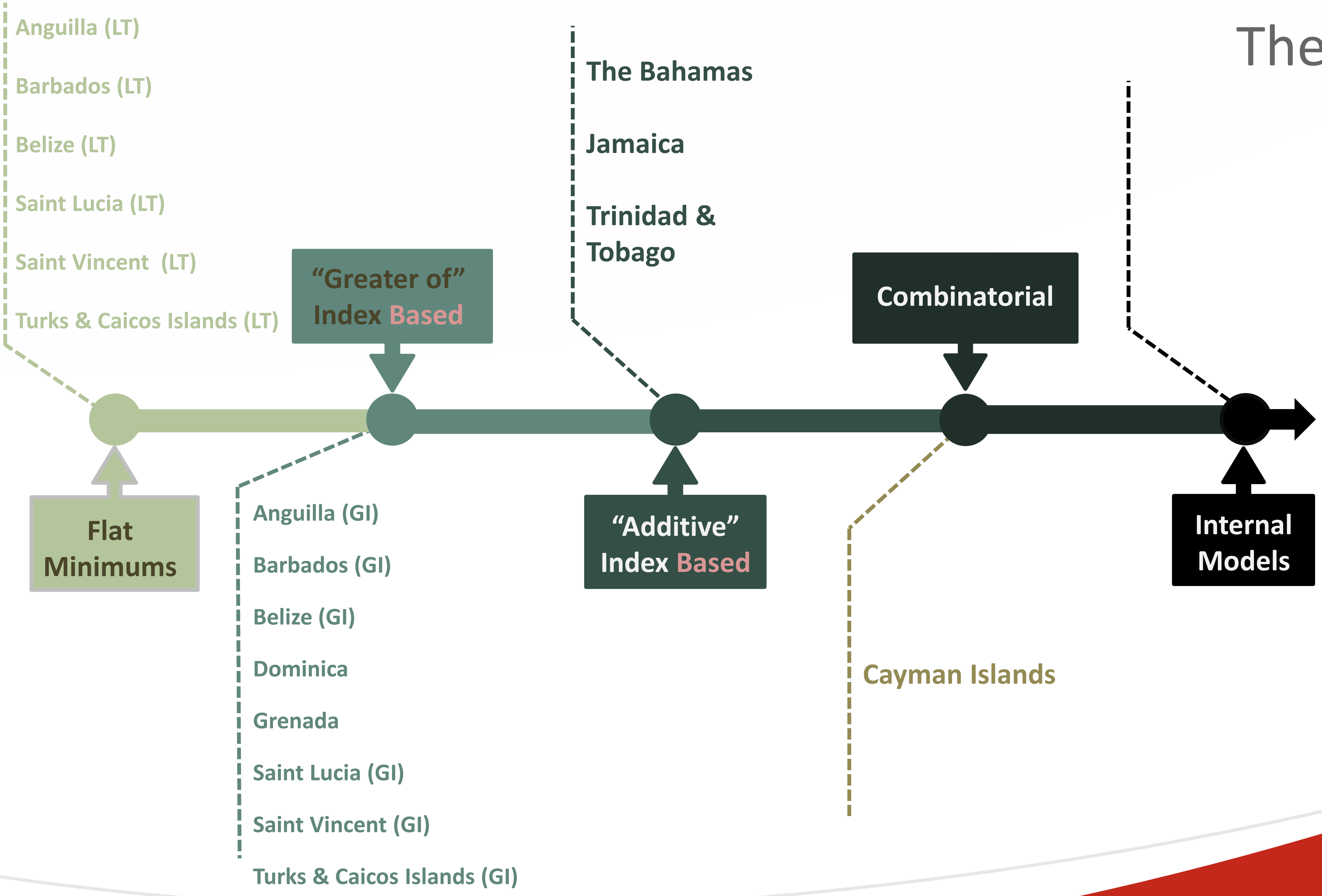
Asia

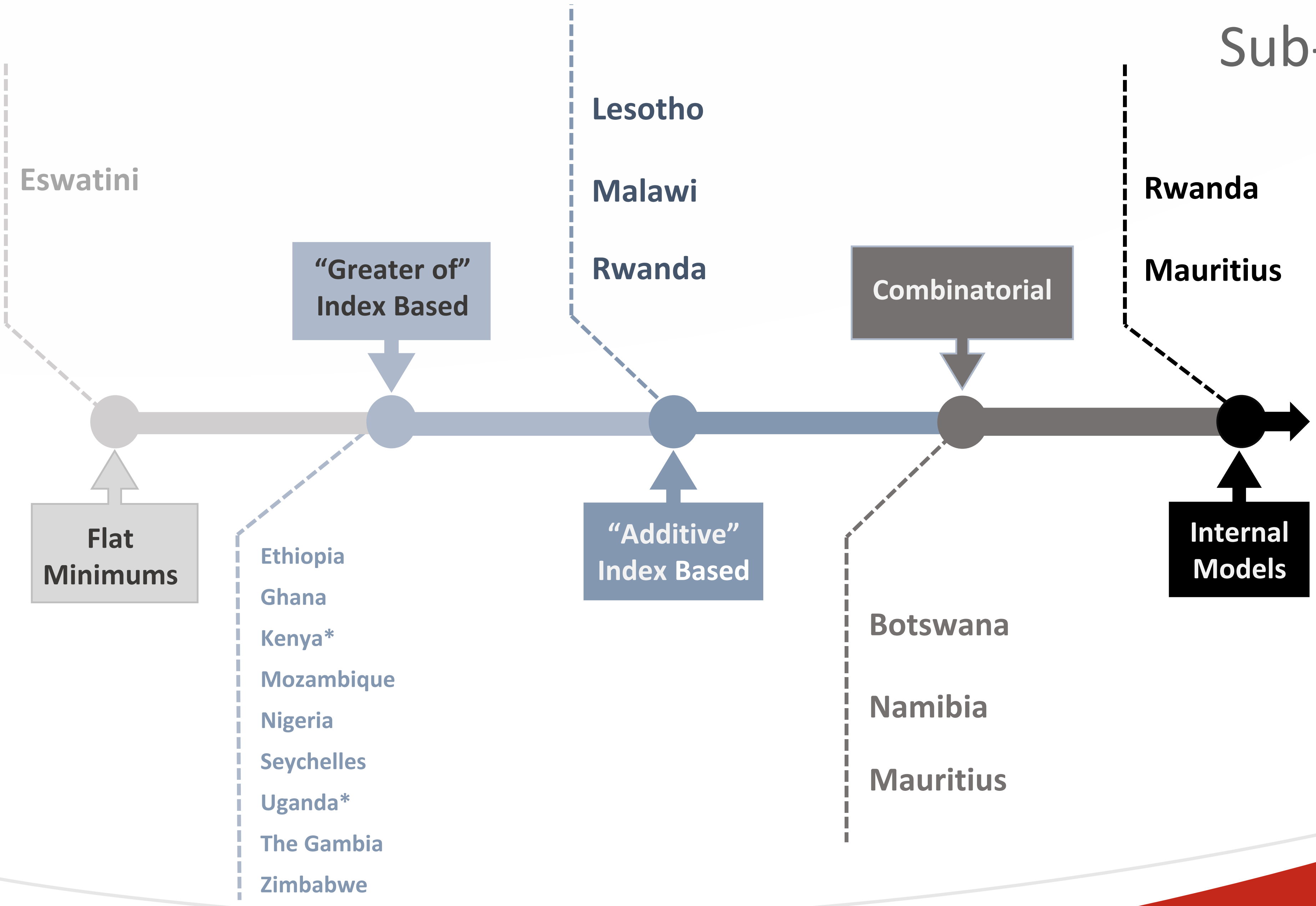


Myanmar
Flat Minimums
"Greater of" Index Based
Azerbaijan
Brunei
Cambodia (GI)
Hong Kong
Lao PDR
Macao
Indonesia
Maldives
Nepal
"Additive" Index Based
Combinatorial
Philippines
Sri Lanka
Internal Models

The Caribbean



Sub-Sahara Africa



Flat Minimum

- Often a “nominal” minimum ranging up to USD 5m
- For the Caribbean the flat minimum only applies to long-term (life) insurers and not general insurers
- Flat minimum is often retained alongside a more advanced regime.
- When the flat minimum is retained there is usually a different amount for life vs general insurers. Life sometimes higher than GI, but not always

Greater of

- For general insurers this is usually a set percentage of net EP (often 20%). In rare cases it may also include technical provisions
- For life insurers a range of approaches exist, including percentage of gross premium, technical provisions, sum insured at risk, net profits and/or a contingency margin determined by the Actuary

Additive - Index Based

- Pre-defined risk factors applied to some measure of risk.
- The measure of risk can vary; premium, technical provisions, sums insured, asset values (depending on the underlying risk being assessed)
- For life insurers capital requirements are sometimes set at different levels; statutory fund, shareholder fund and the insurer as a whole. For general insurers the focus is usually on premium risk and reserving risk
- There can be ranges of sophistication and complexity within this category, ranging from simple factors, to stress testing to re-valuation to multiple risk categories & risk exposures and varied treatment of (admissible) assets
- A key challenge is the determination of the risk factors “specific to the country”

Combinatorial

- This is the closest to Solvency 2 (without ‘internal model’), more like “Solvency 1.5”
- A key difference here is the allowance for diversification. Other key differences include;
  - underlying techniques beyond risk factors e.g. use of stress testing or stochastic modelling
  - level of granularity e.g. risk categories, risk exposures, risk transfers
  - requirements for life insurers vs general insurers
  - allowance for margins and actuarial judgement

Placement on the Spectrum

- Caribbean is the only region with a material number of countries using ‘Flat minimum’. Most other regions have countries at ‘Greater of’ or above.
- Significant “bunching” of countries at the first step i.e. ‘Greater of’
- ‘Greater of’ simplest first step, requires more resources & time to get beyond this to a risk factor type capital regime
- For those countries that have moved beyond ‘Greater of’ most of them use ‘Additive – Index Based’
- Very few countries using ‘Combinatorial’, and just 2 countries (in one region) provide the option of internal model

Sri-Lanka Case Study| Chamarie Ekanayake

RBC Implementation - Sri Lanka
Experiences and Challenges

Chamarie Ekanayake - Director Supervision

Insurance Regulatory Commission of Sri Lanka

INSURANCE REGULATORY COMMISSION OF SRI LANKA

Stages of Development …

Industry Consultation

- Market Assessment Report
  June 2010
- Qualitative Report
  Nov. 2010
- Quantitative Report
  Sept. 2011
- Draft RBC Framework
  March 2012
- Commencement of Road Test
  July 2012
- Draft RBC Framework issued to industry
  Aug. 2012
- Templates issued to industry
  Aug. 2012
- Continuation of Road Test
  June 2013
- Final Draft RBC Framework
  Sept. 2013
- Parallel Run of Solvency and RBC
  2014
- Parallel Run of Solvency and RBC
  2015
- Implementation of RBC
  2016

Experiences & Lessons Learnt from RBC Implementation

INSURANCE REGULATORY COMMISSION OF SRI LANKA

- Better understanding of risk profile of insurance companies and reflects market movement
- Encourage strong risk management for insurers.
- Significant responsibility to an Actuary to value policy liabilities.
- Make the industry resilient with adequate capital to absorb risk.

Post Implementation Challenges

- Need guidance on following points which was not addressed in terms of Solvency Margin (RBC) Rules 2015 :
  - Policy liability valuation method for Universal Life Products.
  - **One-off surplus created when migrating to RBC regime.**
  - Establishing negative liabilities for long term policy liability valuation etc.

Post Implementation Challenges

- Reliability of Risk Free Rate (RFR) for cash flow forecasts due to non availability of long term duration assets in the market.
- Not addressed the Pandemic risk, inflation risk
- If Internal models are allowed how significantly will capital position change
- Need revalidate the appropriateness and adequacy of risk charges
- Impact of IFRS 17 on RBC framework

One-off surplus created when migrating to RBC regime

Definition

"Surplus created due to change in Valuation Method of Policy Liabilities from Net Premium Valuation (NPV) to Gross Premium Valuation (GPV)"

As per the available information;

- Total one-off surplus of Insurance Companies amounted to USD 380 million (approx.)
- For participating business USD 224 million (approx.) and for non participating business USD 156 million (approx.)
- This is accounted for 45% of the total policy liabilities valued at GPV basis on 01.01.2016.

Matter has been identified after implementation and not during the Road test period

Why One-off became a challenge

As per the available information;

Insurance companies have used different methods to compute the one-off surplus in the absence of a proper definition and guidance.

Few examples

- Companies have used distribution basis, solvency basis, internal models.
- Companies have zeroed negative liabilities at policy level, product level, fund level.
- Policy liabilities relating to Universal life products have been treated differently by different companies.
- Some companies informed one-off surplus has not been computed due to no intention to distribute etc.

Shareholders began to demand though said surplus was derived due to change in regulatory framework

Solution -One-off Surplus

Direction was issued to all insurers addressing the following:

- The minimum requirements to compute one-off surplus
- The best method to apply (distribution or solvency)
- Procedures to follow when deriving policy liabilities in terms of different valuation methods (For example: though solvency allowed negative liabilities, appropriateness of allowing same for one-off surplus
- Maintaining records in the financial statements -whether to maintain same under policy liabilities or shareholders fund
- Maintaining assets to back one-off surplus
- Period of maintenance/ when allowing distribution
- Requirements when approving distribution of surplus

Challenges of RBC Implementation

- Lack of system support and actuarial expertise.
- Requirement for capacity building of supervisors.
- Industry guidance from the part of the regulator.
- Applicability of standard set of assumptions.
- Resource barriers to small scale companies.
- Accuracy and availability of data.

  - relevance, reliability and completeness

Way Forward

- Government of Sri Lanka has sought the support of development partners such as the World Bank to provide technical and financial support for activities aimed at developing the financial sector.

- **Sri Lanka Financial Sector Modernization Project (FSMP):** The World Bank has agreed to support FSMP over a period of 5 years, with the 3 financial sector regulators as the implementing partners: the Central Bank of Sri Lanka (CBSL), the Securities and the Exchange Commission of Sri Lanka (SEC) and the **Insurance Regulatory Commission of Sri Lanka (IRCSL)**

- For IRCSL, FSMP *“**aims to strengthen** legal, regulatory and supervisory frameworks as well as enhance supervisory expertise and powers.*

Activities under FSMP project

- Enhancing the Regulatory and Supervisory Frameworks including RBC Rules
- Development of a dedicated micro-insurance regulatory and supervisory framework
- Reviewing the Reinsurance Policy
- Strengthening infrastructure
- Mapping & Developing the HR Function of the IRCSL
- Market Development
- Strengthening the legal framework of Compulsory motor third-party liability insurance-

THANK YOU

Thank you.

Follow us on Twitter @a2ii_org, Youtube and LinkedIn

Implementation Partner:

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