# Isle of Man Changes for Non-Life Insurers

"Whether or not a non-life insurer qualifies as a captive will have a material effect on the amount of capital it has to hold"

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## Jargon Buster

BEL Best estimate of liabilities

CoC Cost of capital requirement

MCR Minimum capital requirement

SCR Solvency capital requirement

### What is happening?

The Isle of Man is changing its valuation and solvency regulations for non-life insurers. This is another milestone on the island's roadmap for updating its regulatory framework for insurance business.

Two draft regulations were issued by the Isle of Man Financial Services Authority earlier this year:

- Insurance Regulations 2020 which relates to whether an insurance entity qualifies as a captive insurer (class 12)
- Insurance (Non Long-Term Business Valuation and Solvency) Regulations 2020 which introduces a risk-based capital framework for non-life insurers on the island

Both sets of draft regulations had recent consultations that have now closed; the regulations are expected to be finalised before the end of 2019, with both scheduled to come into force on 1 July 2020.

The new approach to valuation and solvency has many similarities to the EU's Solvency II standard formula and, as a result, many insurance managers will be familiar with most of the features. Whether or not a non-life insurer qualifies as a captive will have a material effect on the amount of capital it has to hold.

### Reporting and Approach

As well as specifying how valuation and solvency must be calculated for non-life insurers, the draft regulations also specify some reporting requirements. An insurer must submit a written report to its board of directors at least annually. This must cover a number of topics relating to the valuation of the insurer's technical provisions and solvency capital requirements, including:

- methodologies
- key assumptions
- expert judgements made
- results determined

In addition, the report must identify any deficiencies in the data used or the approaches taken, as well as recommending how they might be remedied.

### A "CoC and BEL" Story

Assets and liabilities must be valued on a market value basis, at the amount for which they could be transferred or settled, between knowledgeable willing parties in an arm's length transaction. For most assets this is fairly straight forward, but for insurance liabilities and reinsurance assets it represents a departure from current approaches.

All non-life insurers will have to calculate their technical provisions for solvency purposes as the value of a best estimate of liabilities (referred to as "BEL" under Solvency II notation), plus a risk margin.

Captive insurers are allowed some flexibility in how they arrive at the value of technical provisions. The standard method in the regulations, to calculate the BEL, is to take a discounted cash flow approach, based on a projection of the expected cash outflows and inflows. Captives have the option of basing the BEL on their accounting reserves and considering where explicit prudence in these reserves can be removed.

Whether this represents an attractive option for captives may depend on the attitude of external auditors to the approach. In practice, it may be easier to follow the standard approach of a cash flow projection, which is most likely to result in lower capital requirements.

The second part of the technical provisions is the risk margin. The insurance assets and liabilities will attract a certain amount of solvency capital requirement (SCR) that needs to be held. The risk margin represents the cost of capital (CoC) in relation to holding the SCR.

As with the determination of the technical provisions, captive insurers are again given some leeway in how to arrive at the risk margin. As a general rule, the approach is to estimate the SCR in each future year, apply a cost of capital of 5% and discount those values to the reporting date. Captive insurers may use some approximations in the calculation of the risk margin. As with all approximations, they must be documented and justified.

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### Solvency Capital

The SCR is the regulatory capital an insurer is required to hold to be able to meet its obligations over the next 12 months, with a probability as defined by the relevant confidence level:

- for captive insurers, a 90% confidence level,
- for non-captive insurers, a 99.5% confidence level.

Or to put it more simply, capital is required such that a captive can withstand 1 in 10 year events, while non-captives must hold enough capital to withstand 1 in 200 year events.

The SCR is measured by applying different types of stress to both the assets and the liabilities. The resulting net change forms a component of the SCR. Different components are grouped together as either market risk, counterparty default risk, underwriting risk, intangible asset risk or operational risk. The groups of components are then combined to form a total SCR. At each level of aggregation, some allowance is made for diversification between the different types of risk. In that respect, the total SCR is less than the sum of its parts. This is achieved by applying correlation matrices when combining the different components. All of the parameters, including the stresses to be applied and the correlation matrices, are defined within the regulations.

In addition to an SCR, a minimum capital requirement (MCR) is also calculated. An insurer must hold own-funds of an amount that is equal to or greater than its MCR. For non-captives the MCR is the greater of 35% of the SCR and £500,000, whilst for captives it is the higher of 75% of the SCR and £100,000. At first glance the higher percentage of SCR for captives looks strange. However this reflects that, whilst the SCRs for captives and non-captives are based on different confidence intervals, the MCRs are targeted at the same level.

As might be expected, slightly more complex rules apply to protected cell companies.

### How to Qualify

Non-life captives are described as "class 12" in the Isle of Man. The draft regulations describe the criteria that must be met for an insurance company to qualify as class 12. This is important as it is this class 12 qualification that determines whether an insurer can take advantage of the less stringent aspects of the valuation and solvency regulations.

### Proposed criteria for class 12 authorisation:

- Policyholders are directly or indirectly related to the insurer.
- Policyholders are sophisticated parties that have consented, on an informed basis, to being insured by a class 12 insurer.
- Reinsurance business is fronted reinsurance by a commercial reinsurer.
- For reinsurance business the underlying direct insurance is ancillary to a main non-insurance activity of the reinsurer's group.
- Non-class 12 insurance business represents less than 5% of business.

The regulations set out the details of assessing the class 12 criteria, including what constitutes a related party, the meaning of informed consent, and how to measure the 5% de-minimis rule.

### How BWCI can help

BWCI has many years' experience working both with captives, as well as with insurance companies reporting under similar solvency regimes to that proposed in the Isle of Man. We can help assess the financial impact of the regulations, assist in calculating best estimate liabilities and solvency capital requirements. We can also provide the necessary documentation of methods and assumptions to satisfy the reporting requirements.

### Class 12 Captive Advantages

- Some level of approximation is allowed in calculating the BEL and risk margin
- The use of a 90% confidence interval, as opposed to a 99.5% confidence interval, results in the stresses applied being approximately half those for a non-captive
- A simplified calculation for the spread risk component of market risk
- Captives are exempt from the operational risk SCR component
- Captives are exempt from the catastrophe risk SCR component that falls within underwriting risk
- The absolute minimum MCR is £400,000 lower