

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS



PRINCIPLES ON CAPITAL ADEQUACY AND SOLVENCY

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Principles on Capital Adequacy and Solvency

This document sets out principles that should serve as the basis for solvency regimes. The terms capital adequacy and solvency regime are defined in Paragraph 25.

The paper takes into account details set out in the Issues Paper on Solvency, Solvency Assessment and Actuarial Issues. It is anticipated that further work, which may lead to standards and guidance papers, will be undertaken on each principle.

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I. Background

1. The IAIS Insurance Core Principles (October 2000) describes capital adequacy, inter alia, as an area that has to be addressed in the legislation or the regulations laid down by the insurance regulatory authorities or other competent bodies in each jurisdiction.

2. The purpose of supervising insurers is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. Capital adequacy and solvency regimes is one of the most important elements in the supervision of insurance companies.

3. An insurance company is solvent if it is able to fulfil its obligations under all contracts under all reasonably foreseeable circumstances.

4. Insurance regulatory authorities require insurers to maintain assets or surplus capital in excess of liabilities, that is, a solvency margin.

5. The Principles on Capital Adequacy and Solvency as set out in this paper are applicable to all insurance companies and are relevant for evaluating the solvency of life insurance undertakings and non-life (or general) insurance undertakings. The extent to which the principles will be directly applied with respect to reinsurers will depend on the degree of regulation of the reinsurance industry within the relevant jurisdiction.

6. Adherence to these principles by insurance regulatory authorities does not eliminate the need for consumers to take the utmost care in assessing the risks and the suitability of an insurance product to their needs. Insurance companies should be required to disclose relevant information to the public.

7. In addition, the principles do not remove the need for an insurer to carefully manage the risks of the business it undertakes. A sound supervisory system has to combine capital adequacy and solvency regimes with requirements for risk management systems for risk reduction and mitigation. The purpose of the solvency margin is to provide a safety buffer against events that may occur that are outside the expected range of events for which risk reduction measures have been taken.

8. The supervision of individual insurance undertakings by the insurance supervisory authority remains the essential basis of insurance supervision. In addition the regime has to address other issues that arise as a result of membership of a group.

II. Principles on Capital Adequacy and Solvency of Insurers

<p>Principle 1: Technical provisions</p>

<p>Technical provisions of an insurer have to be adequate, reliable, objective and allow comparison across insurers</p>

9. Adequate technical provisions are the cornerstone of a sound capital adequacy and solvency regime. Accordingly, technical provisions have to be calculated in a reliable, objective and consistent manner across insurers.

10. The methodologies and accounting practices used in establishing the technical provisions and in the treatment of the assets, particularly those available to cover the technical provisions, have to be considered when forming the solvency requirements that build upon the technical provisions. As noted in Principle 6, the capital adequacy and solvency regime needs to take into account the valuation of liabilities including the technical provisions.

11. Technical provisions should be valued on a prudent and transparent basis. The technical provisions have to be adequate to meet the obligations to policyholders. An insurer has to have regard to its own experience and, where appropriate, market experience in determining its

technical provisions. The technical provisions should include allowance for outstanding claims, for future claims and guaranteed benefits for policies in force, as well as expenses.

12. Reliability and comparability of technical provisions is enhanced by the use of experts.

13. The objective assessment of provisions means an unbiased assessment using an objective process, even though the valuation of insurance business includes some uncertainty in the estimation of claims.

Principle 2: Other liabilities

Adequate provisions must be made for all other liabilities insofar as they are not included in the technical provisions

14. Supervisors should ensure that an insurer makes adequate provisions for all of its liabilities. This may include obligations to third parties and amounts owed that are in dispute.

Principle 3: Assets

Assets have to be appropriate, sufficiently realisable and objectively valued

15. Insurance companies have to invest having regard to safety and return. The assets also must be sufficiently diversified and spread and should secure liquidity of the insurance company in order to ensure that the liabilities under insurance contracts can be fulfilled as they fall due.

16. For example, assets held with related parties on a non-commercial basis and intangible assets may not be readily marketable, may have a value other than that which can be used to fulfill policyholder obligations, or may be unavailable due to encumbrances, special privilege or other third-party interests, and therefore, are generally inadmissible or not available for solvency purposes.

17. The regulatory framework or insurance supervisory authority may impose other requirements on the assets to allow for items such as:

- a. concentration risk;
- b. credit risk;
- c. market risk;
- d. liquidity risk; and
- e. liquidation risk.

18. In dealing with concentration risk, supervisory rules may prohibit the holding of an individual asset or a class of assets in excess of a certain level. Alternatively, rules may not

limit such holdings. In the case where concentrated holdings are permitted, the capital and solvency regime should ensure that only a certain level of the holding is able to be counted toward meeting the capital adequacy and solvency requirement.

19. Objective and consistent valuation of assets is based on prudent and transparent accounting standards and practices and can be enhanced by the use of experts.

20. Solvency and capital adequacy regimes must take account of the basis used in the valuation of the assets. Prudent accounting standards and practices should be encouraged.

Principle 4: Matching

Capital adequacy and solvency regimes have to address the matching of assets with liabilities

21. The capital adequacy and solvency regimes should address the risk of loss arising from mismatches in the:

- a. currency;
- b. timing of cash flows; and
- c. amount of cash flows,

of the assets and the liabilities of the insurer adjusted to take account of off-balance sheet exposures.

Principle 5: Absorption of losses

Capital requirements are needed to absorb losses that can occur from technical and other risks

22. Insurance companies must be able to evaluate the risks that they underwrite and to establish an adequate level of premiums. Nevertheless, under-pricing can occur by underestimating the risks, changes in the claims experience, or inadequate underwriting. Insurance companies need to have sufficient capital to absorb the unforeseen losses which can result.

23. This capital is also needed to absorb losses from other risks including other technical risks.

24. Among the risks that capital adequacy and solvency regimes should have regard to include:

- a. other current technical risks (including deviation risk, risk of error, evaluation risk, reinsurance risk, operating expenses risk and risk associated with major or catastrophic losses or accumulation of losses caused by a single event);

- b. special technical risks (including liquidation risk and the risk of excessive or uncoordinated growth);
- c. operational, market, organisational and conglomerate risks; and
- d. investment risks (including risks related to the use of financial derivative instruments and also depreciation, liquidity, matching, interest rate, evaluation and participation risks).

Principle 6: Sensitivity to risk

Capital adequacy and solvency regimes have to be sensitive to risk

- 25. The capital adequacy and solvency regime comprises the:
 - a. valuation of liabilities (including the technical provisions);
 - b. requirements on assets (including requirements for valuation of assets);
 - c. definition of appropriate forms of capital; and
 - d. required solvency margin.
- 26. The valuation of assets and liabilities depends on the accounting framework of the jurisdiction.
- 27. The required solvency margin should reflect risks not taken into account in valuing liabilities and requirements on assets. This includes off-balance sheet exposures.
- 28. The capital adequacy and solvency regime as a whole has to be related to the risk faced by an insurer and should remain adequate at all times as this risk changes over time.
- 29. Supervisors may consider the use of internal capital models as a basis for a capital requirement as long as this model is assessed as adequate for the purpose by the supervisor.

Principle 7: Control level

A control level is required

- 30. Insurance regulatory authorities have to establish a control level, or a series of control levels, that trigger intervention by the authority in an insurer's affairs when the available solvency falls below this control level. These control levels may be supported by a specific framework or by a more general framework providing the supervisor a latitude of action.
- 31. The control level has to be set sufficiently high to allow intervention at an early enough stage in an insurer's difficulties for there to be a realistic prospect that this action might rectify the situation.

32. The supervisory regime must provide for some means for the orderly exit of insurers from the market and for clearly identifying or establishing the status of policyholders vis-a-vis other creditors.

Principle 8: Minimum capital

A minimum level of capital has to be specified

33. The regulatory framework has to set out a threshold minimum capital requirement for companies.

34. This minimum level of capital is designed to provide a minimum assurance of the financial capacity and soundness of the insurer.

35. The amount of the minimum capital should take into account the types of risk that are intended to be covered. The required minimum capital should by no means be used to compensate for normal foreseeable fluctuations in the development of certain risks. Nor should the setting-up costs of a new enterprise be covered by this minimum capital. Insurance regulatory authorities may impose a higher level of initial capital on the start-up of an insurer to support the business during its formative years.

Principle 9: Definition of capital

Capital adequacy and solvency regimes have to define the suitable form of capital

36. The capital adequacy and solvency regime has to define the form of capital that is deemed suitable to provide support when an insurer encounters an unexpected or extreme event.

37. In determining the form of suitable capital, insurance regulators should consider the extent to which the capital element:

- a. represents a permanent and unrestricted investment of funds;
- b. is freely available to absorb losses;
- c. does not impose any unavoidable charge on the earnings of the insurer; and
- d. ranks below the claims of policyholders and other creditors in the event of the insurer being wound up.

38. The regulatory framework has to set limits on the amount of capital instruments that may be counted toward capital adequacy and solvency requirements where they do not fully meet the criteria of paragraph 37.

Principle 10: Risk Management

Capital adequacy and solvency regimes have to be supplemented by risk management systems

39. The required solvency margin has to be considered the last resort after all other measures taken by the insurer to secure its financial stability have failed. The insurer also has to have in place risk management systems appropriate to the complexity, size and mix of the insurer's operations.

40. These risk management systems have to be comprehensive and cover all risks to which the insurer is exposed. These risk management systems have to be supported by comprehensive monitoring and internal control systems. Risk management systems have to be supported by the regulatory framework, the insurance supervisory authority and, if applicable, the use of experts.

Principle 11: Allowance for reinsurance

Any allowance for reinsurance in a capital adequacy and solvency regime should consider the effectiveness of the risk transfer and make allowance for the likely security of the reinsurance counterparty

41. Reinsurance arrangements are a primary tool for risk transfer. Any credit for reinsurance should consider the effective transfer of insurance risk under the contract of reinsurance.

42. Where allowance is made for reinsurance in determining the valuation of technical provisions, the reinsurance has to be assessed with regard to adequacy, reliability, objectivity and consistency.

43. The likely security of the reinsurance counterparty has to be considered in determining whether, and to what extent, allowance should be given for reinsurance.

Principle 12: Disclosure

The capital adequacy and solvency regime should be supported by appropriate disclosure

44. Insurers should be required to publicly disclose appropriate qualitative and quantitative information about risk exposures and the components that make up their capital.

45. The disclosure of appropriate risk exposures increases the ability of the financial markets, and to a lesser extent, consumers to make judgements about dealing with a particular insurer. In addition, it encourages insurers to adopt sound risk management policies and practices.

Principle 13: Solvency assessment

Insurance supervisory authorities have to undertake solvency assessment

46. Insurance supervisory authorities have to consider the following elements when undertaking solvency assessment:

- a. the adequacy, reliability, consistency and objectiveness of technical provisions, assets and liability valuations and statutory reporting;
- b. compliance with the required solvency margin and control levels;
- c. the adequacy of the internal risk assessment processes of the insurer; and
- d. the risk management systems of the insurer.

47. It is the responsibility of the Board of Directors and senior management of an insurer to manage its risks. If efficient control systems are not in place to monitor risk exposures, an insurer will not be able to adapt quickly enough to changing market situations.

Principle 14: Double gearing

Capital adequacy and solvency regimes have to address double gearing and other issues that arise as a result of membership in a group

48. Capital adequacy and solvency regimes for insurers that are part of a group also should take a group-wide view. When considering insurance companies that are part of a group, it is important that steps are taken to avoid double gearing of capital.

49. Consideration should be given to the capacity for intra-group funding.

50. For an insurance group, the treatment of transactions between members of the same group should be considered as part of a capital adequacy and solvency regime.

51. In addition, insurance supervisors should consider reputation and contagion risk that may arise as a result of problems in an associated company.