THE INSURANCE COMMISSION
OF THE BAHAMAS

General Insurance Capital Adequacy

DRAFT- Guideline

8/2/2018

This Draft Guideline outlines the capital adequacy requirements for general insurance companies. It details the approach to determining the required risk-based capital and the available capital taking into consideration the quality of available capital.

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General Insurance Capital Adequacy Guideline

Pursuant to s. 78, Insurance Act, 2005 and reg. 91, Insurance (General) Regulations, 2010

1. Citation

This Guideline may be cited as the General Insurance Capital Adequacy Guideline.

2. Definitions

In this Guideline:

"back to back, inter-institutional placement" refers to transactions by which a financial institution issues and places new shares/debentures with other financial institutions in exchange for issues of the other institutions' securities. The transaction appears to strengthen the capital base of the issuing institutions, but actually only increases interdependence among the institutions involved;

"catastrophe risk" stems from extreme or irregular events that are not sufficiently captured by the charges for premium adequacy and outstanding claims risk. Examples of catastrophe scenarios include but are not limited to: devastation to life and property from Category 5 hurricane land fall; fire causing total loss to the largest single insured property; LPG tanker collision with a cruise ship transporting numerous high net worth individuals;

"foreign insurer" means a branch of a foreign insurance company, which is registered to carry on insurance business in The Bahamas;

"hybrid instruments" generally combine both debt and equity characteristics e.g. a convertible bond, which has features of an ordinary bond but is heavily influenced by the price movement of the stock into which it is convertible;

"net claims" refers to the total general insurance claims paid in the immediately preceding twelve months, net of facultative and treaty reinsurance;

"net premiums" refers to the total general insurance premiums received in the immediately preceding twelve months, net of facultative and treaty reinsurance premiums (inclusive of any reinstatement costs paid), but not net of reinsurance commission amounts;

"net unearned premiums" means the amount as determined under section 75 of the Insurance (General) Regulations for general insurance business, net of facultative and treaty reinsurance;

"off balance sheet asset" refers to a resource controlled by the company and from which future benefits are expected to the flow to the company, that are not recorded on its balance sheet. Examples include swaps, forward rate agreements and undrawn commitments, such as the unused portion of a line of credit.

"off balance sheet liability" refers to any obligations of the company that are not recorded on its balance sheet. Examples include operating leases and guarantees.

"outstanding claims reserve" means the additional reserves as determined under section 94(a) of the Insurance (General) Regulations for general insurance business; and

"Own Risk and Solvency Assessment" is the insurer's comprehensive internal identification and assessment of its material risks, which used as the basis for the establishment of internal capital targets.

"Regulatory Capital Ratio" means the Regulatory Capital Available divided by Regulatory Capital Requirement.

"statutory funds" means the amount held in trust in accordance with s. 45(1) and s. 45(5) of the Act

3. Application

These Guidelines apply to both domestic and foreign insurers in respect of insurance business both in and outside of The Bahamas. The term "outstanding claims reserve" defined above applies equally to the outstanding claims reserve both inside and outside of The Bahamas. The Regulatory Capital Available and Requirement are to be determined using the unconsolidated financial statements of the insurer.

4. Regulatory Capital Available

Financial instruments will only be considered for regulatory capital where these instruments:

i. are permanent;
ii. are free of mandatory fixed charges against earnings; and
iii. have a subordinated legal position to the rights of policyholders and other creditors.

Total Available Capital consists of Tier 1 (core capital) and Tier 2 (supplemental capital). Tier 1 capital comprises the highest quality elements. Tier 2 elements fall short of either of the first two capital qualities but contribute to the overall strength of the company as a going concern.

Regulatory Capital Available for a domestic insurer is the sum of Tier 1 and Tier 2 Capital, less the deductions from capital as summarized in Part C of this section.

For a foreign insurer the Regulatory Capital Available is the sum of the total amount of initial deposit in accordance with s. 43, Insurance Act, 2005 ("the Act"), and the statutory funds held in trust in accordance with s. 45(5) of the Act, plus any excess assets in The Bahamas less the total liabilities and reserves required in The Bahamas.

A. Tier 1 Capital

Net Tier 1 (or core) Capital shall be the amount by which the value of Gross Tier 1 Capital defined in subsection (a) exceeds the total of the deductions defined in subsection (b).

a) Gross Tier 1 Capital shall be the sum of:
   1. ordinary share capital (issued and fully paid up);
   2. contributed surplus;
   3. retained earnings (or deficit);
   4. preference shares or other financial instruments that meet the requirements of Tier 1 Capital as outlined in this section;
   5. revaluation reserves approved by the Commission; and
   6. non-controlling interest.

b) The amount to be deducted from Gross Tier 1 Capital shall be any unrealized gains on assets included in retained earnings and revaluation reserves.

c) Financial instruments, unless specifically approved as Tier 1 capital by the Commission, may only be included in Tier 1 Capital if they meet the following conditions:
   a. they are of perpetual duration and fully paid;
   b. there is no option for redemption at the request of the holder;
   c. they are fully subordinated to the interests of policyholders and other creditors;
   d. dividends are not cumulative in the event of non-payment; and
   e. the amount does not exceed 33% of Tier 1 Capital excluding preference shares.

Net Tier 1 Capital must exceed the minimum stated capital prescribed in regulation 60 of the Regulations.

B. Tier 2 Capital

Tier 2 Capital is divided into Tiers 2A and 2B and shall not exceed 100% of Net Tier 1 Capital.

Tier 2A Capital comprises the following:

a. preference shares or other financial instruments that would have been included in Tier 1 Capital but for the limit in Tier 1 Capital;
b. hybrid capital instruments that do not meet the definition of Tier 1 Capital but meet the requirements for Tier 2A outlined below;
c. unrealized gains excluded from Tier 1 Capital with unrealized gains on real estate limited to 20% of Net Tier 1 Capital.

Hybrid capital instruments may only be included in Tier 2A Capital if they meet the following conditions:

a. they are of perpetual duration and fully paid up;
b. there is no option for redemption at the request of the holder;
c. they are fully subordinated to the interests of policyholders and other creditors;
d. dividends or interest are able to be deferred (as for example with cumulative preference shares) where the profitability of the company would not support payment; and
e. must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the insolvency, bankruptcy or winding-up of the insurer.

Tier 2B Capital includes limited-life instruments that meet the following criteria:

a. the initial minimum term is greater than five years;
b. they are fully paid up in cash or, with the approval of the Commission, in real or personal property;
c. they are fully subordinated to the interests of policyholders and other creditors; and
d. if the remaining term of the instrument is less than five years, the amount of the instrument included in Tier 2B Capital is amortized according to the following schedule:
    i. remaining term 4 years but less than 5 years 80%
    ii. remaining term 3 years but less than 4 years 60%
    iii. remaining term 2 years but less than 3 years 40%
    iv. remaining term 1 year but less than 2 years 20%
    v. remaining term less than 1 year nil

Limit: Tier 2B Capital shall not exceed 50% of Net Tier 1 Capital.

C. Deductions

The sum of Tier 1 and Tier 2 Capital shall be reduced by the following:

a. Goodwill and other intangible assets;
b. new capital issues between two or more companies that represent either directly or indirectly, back-to-back placements;
c. pension plan assets; and
d. investment in financial subsidiaries.

5. Regulatory Capital Requirement

a) The Regulatory Capital Requirement is the sum of the following:

   A. Asset Default Risk Charge;
   B. Off Balance Sheet Risk Charge;
   C. Foreign Currency Mismatch Risk Charge;
   D. Premium Adequacy Risk Charge;
   E. Outstanding Claims Risk Charge; and
   F. Catastrophe Risk Charge.

A. Asset Default Risk Charge

Asset Default Risk Charge is the sum of the balance sheet value of each asset multiplied by an appropriate risk factor for each asset class as shown in Table 1.

Table 1

Asset Class	**Factor**
-	
Cash, bank balances and bank deposits	0.00
Bank certificates of deposit	0.00
Treasury bills	0.00
Treasury notes/bonds	0.00
Government and government guaranteed securities	0.00
Government corporation/agency bonds (not guaranteed)	0.10
Corporate bonds – listed	0.20
Corporate bonds - not-listed	0.20
Real estate / Investment Property	0.15
Equity securities – listed	0.20
Equity securities - not-listed	0.20
Preferred shares – listed	0.15
Preferred shares - not-listed	0.15
Other debt instruments – listed	0.20
Other debt instruments - not-listed	0.20
Mortgage loans – performing	0.00
Mortgage loans - non-performing (overdue 90 days or more)	0.20
Mutual funds	0.20
Investment in financial subsidiaries	0.00
Investment in related parties if not financial subsidiary	1.00
Other investments	0.25
Policy loans	0.00
Due from reinsurers	0.00
Deferred acquisition costs	1.00

Asset Class	**Factor**
Receivables from agents:	
0 - 30 days outstanding	0.10
31 - 60 days outstanding	0.15
Over 60 days outstanding	0.25
Premium receivables:	
0 - 30 days outstanding	0.00
31 - 60 days outstanding	0.15
Over 60 days outstanding	0.15
Interest receivable on investments	0.00
Goodwill and other intangible assets	0.00
Land and building (used in operations)	0.15
Accounts receivable	0.15
Prepayments	0.15
Equipment and machinery	0.15
Office, furniture and fixtures	0.15
Computer software	0.15
Leasehold improvements	0.15
Motor vehicles	0.15
Other assets	0.25

For mutual funds, either the single factor listed above or a "look through" to the underlying assets and using their corresponding factors on a pro rata basis is permitted.

B. Off Balance Sheet Risk Charge

Off Balance Sheet Asset Risk Charge is the sum of the amount of the transaction undertaken through synthetic assets and derivatives multiplied by a risk factor based on the type of contract and its term to maturity as stated in these Guidelines.

The Off Balance Sheet Liability Risk Charge is the sum of the amount of the transaction multiplied by a risk factor that is based on the risk factor for the counterparty.

C. Foreign Currency Mismatch Risk Charge

The Foreign Currency Mismatch Risk Charge shall be

a. 2% of the total of the net open positions in any other currency issued by countries rated BBB and above, expressed in Bahamian dollars; and
b. 8% of the total of the net open positions in any currency issued by countries rated BBB- and below, expressed in Bahamian dollars.

The credit ratings referred to above shall be the Standard and Poor's ratings.

The net open position shall be the absolute value of the assets denominated in a currency less the liabilities denominated in that currency. The value shall be converted to Bahamian dollars using the prevailing selling rate at the valuation date as determined by the Central Bank of The Bahamas.

Where the actuary can demonstrate that provisions for foreign currency mismatch have been established within the policy liabilities, then such provisions can be offset against this capital requirement.

D. Premium Adequacy Risk Charge

The Premium Adequacy Risk Charge shall be the greater of 15% of the net premiums received in the immediately preceding twelve months and 15% of the net unearned premiums.

E. Outstanding Claims Risk Charge

The Outstanding Claims Risk Charge shall be 10% of the outstanding claims reserve.

F. Catastrophe Risk Charge

Method 1: The Catastrophe Risk Charge shall be the net claims anticipated for the reinsurance program in place for the forthcoming year multiplied by a factor of 10/25.

Method 2: The Catastrophe Risk Charge shall be determined by the following formula:

Risk Charge =

$$\sqrt{\sum_{t\neq 3,4,10,12} (c_t \times P_t)^2 + (c_3 \times P_3 + c_{12} \times P_{12})^2 + (c_4 \times P_4 + c_{10} \times P_{10})^2}$$

where

$P_{lob(t)}$ = Estimate of the net premiums for the individual lines of insurance business (LoB) during the forthcoming year

LoB(t) and the factors c_t are as defined in Table 2.

Table 2

LoB (t)	***Factor c_t***
1. Motor, 3rd-party	*0.15*
2. Motor, other	*0.075*
3. Marine / Aviation / Transport	*0.50*
4. Fire/Property	*0.75*
5. Liability	*0.15*
6. Credit	*0.60*
7. Legal expense	*0.02*
8. Assistance	*0.02*
9. Miscellaneous / Other	*0.25*
10. Reinsurance (Property)	*1.50*
11. Reinsurance (Casualty)	*0.50*
12. Reinsurance (Marine /Aviation / Transport)	*1.50*

Method 3: The Catastrophe Risk Charge shall be determined by the following formula for lines of business (LoB) exposed to catastrophe losses:

Risk Charge for each LoB(t) = $c_t * (S_t - F_t) + F_t - R_t + C_t$

where

$S_{(t)}$ = the gross sum insured (aggregates) under the reinsurance program in place for the forthcoming year

$F_{(t)}$ = the sum insured placed facultatively with the reinsurers under the reinsurance program in place for the forthcoming year

$R_{(t)}$ = amount recoverable from the reinsurers under the reinsurance program in place for the forthcoming year

$C_{(t)}$ = Cost of one reinstatement of catastrophe reinsurance cover in cases where the reinstatement reinsurance cover has not been pre-paid by the insurer or the branch

LoB(t) and the factors c_t are as defined in Table 3.

Table 3

LoB (t)	***Factor c_t***
1. Property	*0.15*
2. Motor	*0.025*
3. Other	*0.15*

6. Regulatory Capital Ratio and Capital Management

Regulatory Capital Ratio (RCR) means the Regulatory Capital Available divided by Regulatory Capital Requirement expressed as a percentage. Companies are required to establish a Target Capital Ratio (TCR) in excess of a Regulatory Capital Ratio of 150% and manage their capital levels such that the regulatory capital ratio is always in excess of its TCR.

The TCR should be determined based on the company's Own Risk and Solvency Assessment, necessary to cover the risks specified in the capital tests as well as all other risks of the insurer. The TCR should be based on stress testing and scenario testing to establish a capital buffer commensurate with the variability and risks in the business. A RCR below 150% will attract regulatory attention and require insurance companies to present a capital plan outlining how the company will return to a capital ratio in excess of the TCR. A drop in the capital ratio to a level below the Minimum Capital Ratio (MCR) of 120% will attract the most severe regulatory intervention including suspension of registration under the Insurance Act. The MCR is set at 120% rather than 100% to cover operational risks that are not explicitly measured, but form part of the minimum requirement under the RCR.

All insurers are required to assess the quality and adequacy of capital resources to meet regulatory requirements and other capital needs. This must be reported in the insurer's annual capital management plan.

7. Returns, Audit and Declarations

a. An insurer is required to submit to the Commission, Capital Adequacy Returns in such form as the Superintendent of Insurance may from time to time specify in accordance with the requirements of s. 58 of the Act;
b. In addition to the Capital Adequacy Returns required to be submitted under this Guideline and the Act, an insurer shall provide a declaration by the Chief Financial Officer, the Actuary, and a Director of the insurer in the format as set out in Schedule 1 of this Guideline.

8. Grandfathering Provision

Unrealized gains on real estate prior to the commencement of this Guideline that have not subsequently been realized, will be treated as though they were realized and shall not be subject to restrictions on regulatory capital in this Guideline.

9. Transitional Provisions

Reg. 73 of the Regulations states that "after relevant consultations, the Commission may, upon giving at least six months notice … change the nature and manner of determining the solvency margins…". The solvency margin requirement of general insurance business (Property & Casualty) is included in reg. 91. This will require an amendment to allow for this Guideline to be implemented.

In addition to the time required to make regulatory changes, the Commission will establish an appropriate transition period to provide insurers with sufficient time to prepare for changes to be in compliance with this Guideline once finalized.

Schedule 1- Declarations

Declaration by the Chief Financial Officer

I, …………………….., Chief Financial Officer of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the General Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of the Chief Financial Officer Date

Declaration by the Actuary

I, …………………………, Actuary of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the General Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of the Actuary Date

Declaration by a Director of the Company

I, …………………………, Officer of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the General Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of a Director Date