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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SOLVENCY CONTROL LEVELS GUIDANCE PAPER

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[This document was prepared by the Solvency Subcommittee in consultation with members and observers.]

Solvency control levels guidance paper

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1. Introduction

1. The IAIS adopted a paper in January 2002 entitled *Principles on capital adequacy and solvency* that sets out principles that generally underlie solvency regimes for insurers. That paper sets out three principles regarding the level of solvency*: Principle 6 – Capital adequacy and solvency regimes have to be sensitive to risk, Principle 7 – A control level is required* and *Principle 8 – A minimum level of capital has to be specified.* This guidance paper addresses Principle 7, as a component of a solvency regime that it is assumed satisfies Principles 6 and 8. Guidance with respect to Principles 6 and 8 will be the subject of future papers.

2. The purpose of this guidance paper is to discuss why it is important to set a solvency control level, to identify key factors in setting a solvency control level, and to discuss possible supervisory actions when a solvency control level is breached. The form of the solvency control level varies between jurisdictions and may be based on capital levels or other financial measures related to the solvency regime of the jurisdiction (e.g., accounting practices and level of coverage of technical provisions by admissible assets). A survey of practices in IAIS Solvency Subcommittee member jurisdictions was conducted and the responses have informed the development of this guidance paper.

3. The paper discusses possible courses of supervisory action when a solvency control level is breached. It should be emphasised that there are many other reasons relating to the activities and/or financial position of an insurer that may warrant supervisory intervention. The ability to intervene in respect to a variety of concerns is an essential element of a supervisory system. The scope of this paper is not intended to address the full range of possible reasons for intervention.

4. It is important to note why solvency requirements are essential in the supervision of insurers and the protection of policyholders. An insurer's technical provisions should be sufficient to cover all expected claims and some unexpected losses, as prescribed by the applicable valuation requirements. The degree to which technical provisions will cover unexpected losses will vary by jurisdiction depending upon the local regulatory structure and philosophy. There should be sufficient capital to absorb unexpected losses to the extent not covered by the technical provisions on the risks specifically contemplated by the capital establishment process. Further, additional capital is required to absorb losses from risks not identified by the capital establishment process, including operational risk, and to provide for losses due to the business environment, including economic and systemic risk**.** In order to protect policyholders from undue loss, it is necessary to establish not only a minimum capital level,

but also a solvency control level, or series of control levels, which act as indicators or triggers for early supervisory action, before problems become serious threats to the insurer's solvency.

5. In addition to formal solvency control levels, some jurisdictions also have informal solvency control levels, which are used to determine the extent of supervisory activity related to insurers.

2. Solvency control level

6. As outlined in the IAIS *Principles on Capital Adequacy and Solvency* paper, "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. The control level may be supported by a specific framework or by a more general framework providing the supervisor a latitude of action."

7. A supervisor's goal in establishing control levels is to safeguard policyholders from excessive loss due to an insurer's inability to meet its obligations. In some jurisdictions, the supervisor's mandate extends to contributing to public confidence in the financial system. Insurers should operate above the minimum requirements to cope with volatility in markets and economic conditions, innovations in the industry and international developments.

8. Various global market events have highlighted the need for insurers to maintain strong solvency positions. These events put stress on the insurance industry that cannot be reliably quantified. Each insurer should maintain a financial position that provides a cushion of solvency above minimum requirements to enable it to cope with volatility in markets and economic conditions, innovations in the industry and other developments. An insurer should be able to weather such stresses without triggering supervisory consequences, and to address its capital needs through ongoing market access.

9. The control level should be set high enough to allow intervention at a sufficiently early stage in an insurer's difficulties so that there would be a realistic prospect for the situation to be rectified. At the same time, the reasonableness of the control levels should be examined in relationship to the nature of the corrective measures. Early corrective measures may be kept confidential in order to not risk an insurer's reputation and thus worsen the situation.

10. An insurer may continue to take on new risks, on a going concern basis, during a period of stress. Therefore, the control level must be set high enough to provide an acceptable level of solvency, when considering the potential growth in an insurer's portfolio, throughout the period that may be required for the resolution of problems or the recovery from unusual or catastrophic events.

11. When establishing solvency control levels, it is recognised that views about which level is acceptable may differ from jurisdiction to jurisdiction. The control level should be high enough to ensure that if an insurer's failure is inevitable, it can be managed with minimum loss to policyholders. Where permitted by the supervisory framework, it is also useful for a supervisor to have flexibility on a case-by-case basis to vary the solvency control level for an individual insurer, based upon its risk profile. Some insurers may warrant a higher control level if they are undertaking higher risks, such as new products where creditable experience is not available to establish technical provisions, or if they are undertaking significant risks that are not specifically covered by the solvency test. Particularly in cases where legal action may be taken in response to an insurer violating its control level, the criteria used by the supervisor to establish solvency control levels should be transparent. Section III of this paper discusses a number of factors that should be taken into consideration when establishing a solvency control level.

12. While it is important that a supervisor have the authority to establish a solvency control level, insurers should also be encouraged to operate with higher solvency margins to support the risks that they undertake, both on and off the balance sheet. Insurers should be encouraged to develop and review, from time-to-time, their own internal target solvency levels to ensure that such targets prudently reflect their risk profile. While senior management may develop target levels, to encourage accountability the targets should be reviewed and approved by the insurer's Board of Directors.

3. Considerations in setting a solvency control level

13. There are a number of general issues that supervisors should take into consideration when setting a solvency control level. They include, but are not limited to:

Risk coverage issues

- quality of capital – supervisors should consider the quality of capital available, to ensure that there are adequate levels of permanent capital available to absorb losses during ongoing operations. For example, it may be necessary to establish control capital levels not only for total capital but also for the level of permanent capital (e.g., retained earnings and equity instruments which can absorb losses during ongoing operations, versus debt instruments which are not permanent). A strong level of permanent capital allows an insurer to conserve resources when it is under stress, since it provides the insurer with discretion as to the amount and timing of distributions

- sensitivity of solvency requirements to risks – the solvency control level may be based upon a going concern assessment of the financial position of the insurer that recognises the dynamic pressures and possible changes in economic and market conditions. Stress tests[1] of the financial condition of the insurer against these more dynamic assumptions and scenarios are a useful supervisory tool, that can assist the supervisor in assessing whether an individual insurer's risk profile warrants a solvency control level that differs from the industry-wide norm

- the minimum solvency level – the amount of the minimum level determines the cushion that it provides to absorb losses. There may or may not be a direct relationship between the solvency control level and the minimum level. In some jurisdictions, the solvency control level is a function of the minimum capital level (e.g., in Canada, the solvency control level for life insurers is 125% of the minimum capital level)

- risks not covered by the solvency rules – the extent to which there are risks not covered in the calculation of the solvency requirements will influence both the minimum level and the control level. Examples of significant risks that are often not explicitly captured by capital adequacy rules are operational risk and liquidity risk

[1] In Canada, the appointed actuary is required to dynamically test the insurer's capital adequacy on an annual basis and report on the future financial condition to the Board of Directors in the Dynamic Capital Adequacy Testing (DCAT) Report. The Canadian Institute of Actuaries has issued a Standard of Practice on DCAT that provides guidance to the actuary. The process involves analysing and projecting the trends of an insurer's capital position to understand the risk profile of the insurer and potential threats to its capital adequacy given current circumstances, its recent past and its intended business plan under a variety of plausible future adverse scenarios. The purpose is to identify: plausible threats to satisfactory financial condition, actions that lessen the likelihood of those threats, and actions that would mitigate a threat if it materialised. The principle goal is to help prevent insolvency by arming the insurer with the best information on the course of events that may lead to capital depletion, and the relative effectiveness of alternative corrective actions.

- mix of business and investments which results in a higher level of risk than the average level that is implicit in the standard solvency requirement

- the level of security in a broad sense – the amount of risk coverage provided by the technical provisions and requirements regarding investments, as protection of policyholders from undue loss.

Supervisory and jurisdictional issues

- the powers of the supervisor, which are derived from the legislative framework within a jurisdiction, will be a key determinant of the ability of the supervisor to establish and adjust minimum and control levels of solvency, both on an industry-wide and insurer-specific basis. In some jurisdictions the minimum and control levels are established by legislation, whereas in other jurisdictions the supervisor has the authority to impose alternative solvency requirements

- need for flexibility – an insurer's individual risk profile should be assessed to determine whether the industry solvency control level should be applied or a higher level applied, e.g., there may be non-capital-related supervisory concerns within an insurer that may cause the supervisor to require that a higher solvency level be maintained until a problem is rectified

- prudence of the accounting and actuarial standards – the level of conservatism in the requirements for valuation of the assets and liabilities and the accounting practices within the jurisdiction should be evaluated to determine the additional margins required to protect policyholders

- licensing requirements – a minimum amount of capital is required to be licensed to write business in a jurisdiction. However, a separate control level may be established for new insurers to provide for growth of new business or other risks related to their operating plans

- legal status of policyholders – the legislative protection provided to policyholders relative to other creditors is an important factor in setting both minimum and control levels of solvency

- extent to which the preconditions for effective supervision, as set out in the IAIS Insurance Core Principles, exist.

Other issues

- overall level of capitalisation in the industry – a transition period may be required to achieve the desired level of capital for the industry within a jurisdiction

- developments within the industry – e.g., new products, globalisation, increased competition

- competitiveness – the solvency control level must not unduly impede the ability of the insurance industry to compete in the global marketplace. This is a balance between the protection of policyholders and the need for insurers to earn a return on equity which is competitive with other financial services sectors and other enterprises generally

- economic environment in the jurisdiction – e.g., level of inflation and interest rates

- development of capital markets in the jurisdiction – e.g., affects the insurer's ability to raise capital

- risk management in the jurisdiction – e.g., the sophistication of the risk management systems prevalent in the insurance industry

- policyholder protection/guarantee fund – existence of a fund should not be considered in setting the solvency control levels. To do so would raise issues such as potential moral hazard, competitive equity, and geographic, product or amount limitations on protection.

14. If supervisors establish unique solvency control levels for individual insurers, they should also consider the following insurer-specific issues in addition to those discussed above:

- quality of management, risk management systems and internal controls within the insurer. Where the capabilities of management or the quality of a risk management framework within an insurer are weak, the supervisor should consider prescribing a higher level of solvency

- ratings requirements – capital levels required to maintain adequate ratings by external rating agencies. Insurers may have ratings they need to maintain in order to participate in certain markets (e.g., reinsurance) or to access capital on acceptable terms

- insurers' own internal target levels – insurers' own risk modelling and assessment, and their own evaluation of the economic capital required to cover the risks of their business, to the extent considered credible.

4. Possible supervisory actions

15. Supervisory regimes typically provide a variety of powers that may be invoked by supervisors and refer to measures they may take to address various practices and situations that are of concern. It is common for supervisors to identify possible supervisory actions that could be taken in the event an insurer breaches the solvency control level or is trending towards a breach. These actions may or may not be strictly tied to the solvency control level and may or may not be formalised in legislation or regulatory documents. It is important that the supervisor have adequate authority to take action to attempt to ensure that solvency control levels are maintained, in order to provide adequate protection to policyholders.

16. It is also important that insurers be aware of the range of possible supervisory actions that could be taken if they breach the solvency control level. Awareness within the industry of the possible consequences may act as a disciplinary force to encourage the maintenance of the solvency control levels. In most jurisdictions surveyed, the severity of the supervisory intervention increases as an insurer's solvency position falls below the solvency control level towards the minimum solvency level.

17. Supervisory actions should be directed towards strengthening the insurer's solvency position and maintaining or returning it to a level above the solvency control level.

18. Possible supervisory actions, which may be taken separately or jointly, may be categorised as follows:

- measures that directly address the problem of not enough capital, e.g., requesting capital and business plans for restoration of solvency levels, vested asset injections, limiting redemption/repurchase of equity instruments, limitations on dividend payments

- measures that are punitive, e.g., refusing, delaying or imposing conditions on requests or applications submitted for regulatory approval, such as innovative capital instruments, acquisitions and redemptions or repurchases of equity, limiting growth in business

- measures that are intended to protect policyholders pending strengthening of the solvency position, e.g., business restrictions on licences, premium volume limitations, restrictions on certain types of business or investments, limitations on shareholder dividends, restrictions on acquisitions, business dispositions and reinsurance arrangements

- measures that are intended to enable the supervisor to better assess and control the situation, whether by formal or informal means, e.g., increased supervision activities and guidance, requiring auditors to enlarge or extend the scope of their examinations, requiring additional stress testing and scenario analysis, requiring actuaries to modify actuarial assumptions as appropriate to the circumstances, commissioning independent actuarial reviews, and applying prudential limits and restrictions more rigorously

- measures that strengthen or replace an insurer's management.

19. In the event that measures taken to improve the solvency position of an insurer are not successful and its solvency level continues to deteriorate, the severity of supervisory actions should progressively increase. These actions may include invoking statutory powers to rectify the situation, e.g., issuing a directive to increase capital and/or liquidity, a divestment order, a direction of compliance, removal of management and taking control of assets or the insurer.

20. Conversely, the supervisory regime may provide for benefits to insurers that are operating well above the solvency control levels. This may include streamlining specified regulatory approvals, reducing reporting requirements and increasing investment flexibility. These actions may be viewed by the industry as inducements to maintain stronger solvency positions.

5. Disclosure of solvency control level

21. In many jurisdictions, the possible supervisory consequences of falling below the minimum and solvency control levels are transparent to the public in either legislation or other forms of regulatory guidance.

22. The *Principles on capital adequacy and solvency* paper states, "The capital adequacy and solvency regime should be supported by appropriate disclosure." In general, public disclosure of information regarding an insurer's solvency position enhances policyholders' and the market participants' ability to exercise discipline with respect to insurers. Market discipline is enhanced by transparency of the solvency control level requirements and imposes strong incentives on insurers to conduct their business in a safe, sound and efficient manner. However, the sensitivity of the market to publicity regarding an insurer's solvency position should be considered when establishing disclosure requirements. While not all jurisdictions require information about individual insurers' solvency positions to be made available to the public, this can be a powerful supervisory tool which should be considered. It should be noted that while the disclosures provide an indication of the solvency position of the insurer, they are not the only indicator of the financial condition of an insurer and should not be used in isolation.

23. Once a solvency control level and its meaning are well known, there may be convergence towards that level or a higher level, as disclosure of individual insurer solvency levels can provide an incentive to maintain a strong solvency position as a cushion against potential future losses arising

from its risk exposures. Market discipline reinforces supervisory efforts to promote safety and soundness in insurers and will encourage insurers to ensure that their solvency positions do not fall significantly below those of their peers.