ISLE OF MAN
FINANCIAL SERVICES AUTHORITY
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QIS5 EXERCISE FOR NON-LIFE INSURERS

CONSULTATION PAPER

CP18-03/T04

13 July 2018

This Consultation Paper is issued by the Isle of Man Financial Services Authority ("the Authority"), the regulatory authority responsible for the supervision of the financial services, insurance and pensions sectors in the Isle of Man.

What is it for?

This paper sets out the timescales for the fifth Quantitative Impact Study ("QIS5") exercise for non-life insurers and reinsurers, describes changes to the standard formula being tested in QIS5 compared with that for QIS4, and provides additional guidance on some aspects of the calculation in order to promote consistency of approach across respondents.

Who is affected by it?

This document will be of direct interest to all existing and prospective insurance companies undertaking non-life insurance business in or from the Isle of Man. In particular, it will be of interest to those with functional responsibility and oversight of the finance, actuarial and risk management functions within those companies. The accompanying draft Technical Specifications will be of interest to those with technical expertise in, and responsibility for, modelling, calculating, and reviewing and/or using the calculation of technical provisions, capital resources and risk-based capital requirements.

Other parties with an interest in the Isle of Man non-life sector may also find this discussion paper and the issues raised of interest.

What consultation feedback is required?

We request all Isle of Man non-life insurers, reinsurers and any other interested parties to complete the QIS exercise and return completed results templates and questionnaires at their earliest convenience and by 31 October 2018 at the latest.

Feedback is also requested on the technical specifications.

Confidentiality and Data Protection

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Please call ***+44 (0)1624 646000*** *if you have any queries.*

Issue date	***13 July 2018***
Closing dates for responses	***31 October 2018***

1. Introduction

1.1. In line with the Authority's 2018 Roadmap, we are launching the QIS5 exercise for non-life insurers and reinsurers (throughout the rest of this consultation paper 'insurers' will refer to insurers and reinsurers).

1.2. QIS5 is the third full QIS exercise to apply to non-life insurers and requires all non-life insurers to produce balance sheets and capital requirements using an approach reflecting our proposals for the framework for the new regulatory regime. QIS5 builds on the approach proposed for the QIS4 exercise, taking into account industry feedback from that exercise.

We anticipate QIS5 will be the final full QIS exercise for non-life insurers before the regime goes live in 2020. It is important that the submissions are as complete and accurate as possible. To this end we have provided an extended consultation period for QIS5.

Where a non-life insurer is still required to make significant approximations in their calculations, we request that a note be made of the issues and submitted to us, alongside the QIS returns. We are also happy to assist with any queries that arise during the consultation period and welcome early dialogue.

The Authority expects each non-life insurer to have plans in place to ensure it can produce the required information under the new capital and solvency regime in an accurate and robust manner when the new regime comes into force.

1.3. As part of the launch we are publishing the following in our consultation hub:

- this consultation paper;
- the QIS5 technical specifications TS03/T04 (10) and TS03/T04 (200);
- a set of Excel results templates to be populated by participants;
- a set of helper tabs for determining the interest rate risk SCR, spread risk SCR, counterparty default SCR and concentration risk SCR. Note - the use of these helper tabs is not mandatory;
- an instruction manual for completing the Excel results templates;
- a set of risk-free yield curves by currency; and
- a qualitative questionnaire.

1.4. All non-life insurers are required to complete and submit QIS5 results.

1.5. Non-life insurers must carry out the QIS5 calculations using data as at 31 December 2017. If this causes significant issues or is impractical, we are comfortable with non-life insurers using their most recent year-end date as the valuation date, but request they inform us of their intention to do so.

1.6. The submission deadline for QIS5 is 31 October 2018, however we encourage non-life insurers to submit their results earlier where possible.

1.7. The submission should include:

- Completed templates and helper tabs (where used). Note section 3.6 has additional submission requirement for non-life insurers who determined their premium volume measure net of commission;
- Completed qualitative questionnaire;
- Commentary on any significant changes since QIS4, either to the business, program or methodologies that are reflected in the QIS5 results, and explanations for any significant changes in the components of the SCR and to overall solvency.

1.8. The submission and any questions or requests for clarification relating to QIS5 should be submitted to:

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Finch Hill House
Bucks Road
Douglas
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1.9. Non-life insurers are invited to respond to the questions raised in this paper. The questions are set out in ***bold italics***, and responses should be provided in the questionnaire to be returned with the QIS5 results.

1.10. In particular we are keen to hear from non-life insurers whether there are any further areas in which the content, terminology or wording of the Consultation Paper and Technical Specifications might helpfully be further adapted to reflect the characteristics of the Island's non-life insurance sector.

We request feedback on the user-friendliness of all technical documents and would appreciate suggestions of how to improve them further ahead of the launch of the regime in 2020.

2. Valuation

2.1.1. Our proposed approach to recognising and valuing assets and liabilities, including technical provisions, has not changed since QIS4.

2.1.2. Ultimately we expect all non-life insurers to calculate technical provisions as the sum of a best estimate provision and a risk margin, and this approach is being mirrored by the updates to IFRS 17 which will require changes to the approach used for calculating technical provisions for accounting purposes, similar to that required by our new framework.

2.1.3. We recognise that for non-life insurers this may be a change from the current approach used for accounting and regulatory purposes and so for QIS5 we will again allow non-life insurers to use accounting provisions as a proxy for technical provisions.

2.1.4. The Authority strongly encourages firms to split their accounting provisions between their best estimate technical provisions and an explicit risk margin.

2.1.5. It is a matter of good governance that where there is any additional margin above best estimate in the accounting provisions that an insurer can articulate how much margin there is. In the absence of being able to quantify this margin then a prudent approach would be to consider the accounting provisions to be best estimate and determine an explicit risk margin. Insurers should note that the standard formula will apply a capital charge to any margins included in the best estimate.

2.1.6. The appendices to the technical specifications include a hierarchy of simplifications that insurers can use to estimate an appropriate risk margin. For example, the lowest rank of the hierarchy requires an insurer to estimate an appropriate risk margin as a percentage of their best estimate. Where insurers use a simplified approach they should include an explanation of the approach used in their results submission.

3. Changes to approach in QIS5 from QIS4

3.1. Confidence levels

3.1.1. In QIS4 we tested four confidence levels for the calibration of the SCR – 90% (1 in 10 year), 98% (1 in 50), 99% (1 in 100), and 99.5% (1 in 200).

3.1.2. For QIS5 we will only be testing two confidence levels for the calibration of the SCR, 90% (1 in 10) and 99.5% (1 in 200).

3.1.3. We intend for each insurer to calculate its SCR on only one confidence level.

3.2. Treatment of loans to group companies – counterparty default SCR

3.2.1. In QIS4 loans to group companies were included in counterparty default risk for all confidence levels, including the ‘1 in 10’ confidence level.

3.2.2. For QIS5 we will be maintaining the charge for loans to group companies in both the '1 in 200' and '1 in 10' regimes.

3.2.3. There will be an adjustment to the '1 in 10' counterparty default risk helper tab:

- In the QIS4 template the charge for a single exposure to an unrated counterparty was 100% of the loss-given-default. This is the charge that applies to '1 in 200' insurers. For QIS5 this will be amended to 50% of the loss given default for '1 in 10' insurers.
- Only insurers with an exposure to a single unrated counterparty will see a difference in their counterparty default charge as a result of this change. Insurers with multiple counterparties with multiple ratings receive a diversification benefit and their charge is calculated using a different approach. This methodology remains unchanged from QIS4.

3.2.4. In QIS4, where '1 in 10' insurers make use of loans to group companies, we understand that applying a capital charge for loan to group companies for insurers resulted in large SCRs for some of these insurers. For these '1 in 10' insurers the large charge was predominantly driven by fact that the group company receiving the loan did not hold a credit rating.

3.2.5. For QIS5 where the group company holds a rating determined by an ECAI that is not in the public domain, we will allow insurers use this rating in the counterparty default calculation. **Insurers must inform the Authority of their desire to use this approach.**

3.2.6. In addition, where the loan is to an unrated group company who is acting as the treasury function for the group, and the head of the group holds a rating, we will allow insurers to look through and use the rating of the head of the group in the counterparty default calculation for that exposure. **Insurers must inform the Authority of their desire to use this approach.**

3.2.7. In all other cases the loan must be treated as an unrated exposure.

3.3. Treatment of deposits with Isle of Man incorporated banks – counterparty default SCR

3.3.1. In QIS4 we requested non-life insurers treat deposits with unrated Isle of Man banks according to the technical specifications, which meant treating them as unrated in the counterparty default charge calculation.

3.3.2. In QIS5 we request non-life insurers use an alternative approach for the counterparty default calculation:

- For exposures to Isle of Man branches of international banks, non-life insurers should look through to the rating of the parent bank when determining the counterparty default charge.

  - Isle of Man banks which are branches of international banks include HSBC Bank Plc, Santander UK Plc, Barclays Bank Plc, Lloyds Bank International Limited, Bank of Scotland Plc, the Standard Bank of South Africa Limited, the Royal Bank of Scotland International Limited and the Royal Bank of Scotland plc.

- For exposures to Isle of Man incorporated banks, non-life insurers must use a fixed probability of default of 0.5% in the counterparty default charge calculation, rather than using the credit rating of the bank. This is equivalent to a credit rating mapped to a credit quality step of between 3 and 4. This reflects the fact the incorporated banks are also supervised by the Authority and have to comply with international capital standards.

- The helper tab has been amended to allow non-life insurers to enter their exposure to an Isle of Man incorporated bank against a specific 'IOM Inc. bank' category which will automatically determine the correct counterparty default charge for incorporated banks.

  - Isle of Man banks which are incorporated include Isle of Man Bank Limited, Standard Bank Isle of Man Limited, Nedbank Private Wealth, Cayman National Bank, and Conister Bank Limited.

3.4. Use of net premiums in Premium Risk module

3.4.1. For QIS4 we allowed non-life insurers who considered that the use of earned premiums gross of commission and expected profits materially overstated their premium risk to calculate their earned premium volume measures gross of commission and expected profits, where expected profits were to be calculated on a best estimate basis.

3.4.2. Affected non-life insurers were also asked to provide a detailed description of the contracts in question, and justify the assumed commission and expected profit components of earned premiums.

3.4.3. For QIS5, we are allowing non-life insurers to calculate their earned premium volume measure net of commission only. Expected profits must not be netted off.

3.4.4. Non-life insurers who determine their earned premium volume measure net of commission must submit two results templates as follows:

- One template using earned premium volume measures gross of commission.
- One template using earned premium volume measures net of commission.

3.5. Minimum Capital Requirement

3.5.1. In QIS5 we will be testing a provisional calculation for the Minimum Capital Requirement, MCR.

3.5.2. The MCR will be subject to an absolute floor.

3.5.3. The outcome of the MCR investigations will be communicated alongside the QIS5 results.

4. Additional guidance for QIS5

4.1. Ring-fenced funds

4.1.1. Non-life insurers' attention is drawn to Section 2.9 of the Technical Specification on ring-fenced funds.

4.1.2. In QIS4 we requested non-life insurers provide information on any own-funds they believe are ring-fenced. We have considered the information provided and have updated our advice on what constitutes a ring-fenced fund for QIS5.

4.1.3. A ring-fenced fund is a subset of the non-life insurer's own-funds that has been legally assigned to cover a specific contract or a specific claim within a contract. The key is that the ring-fenced own-funds are 'trapped' and cannot ever be used by the non-life insurer to cover losses on other contracts or claim payments i.e. these own-funds can only ever be used to meet the claims of a certain group of policyholders /beneficiaries.

4.1.4. Where a non-life insurer has allocated own-funds to a fronting insurer or a claims manager to cover claims, possibly through an escrow account or a cash backed letter of credit, should the contractual agreement with the fronting insurer or claims manager allow for excess funds to be returned to the non-life insurer upon the extinguishment of the liabilities, then this is not a true ring-fenced fund. The own-funds are not 'trapped' in perpetuity, and the non-life insurer will be able to use them to cover losses on other contracts, if required. This is not ring-fencing in its fullest sense. However it does represent a liquidity restriction in that there can be delays in accessing excess funds.

4.1.5. Non-life insurers should consider the liquidity risk imposed on the insurer by these types of contracts and determine an appropriate amount of capital to protect against the risk in their ORSA.

4.1.6. We suggest non-life insurers consider the details of each contractual arrangement they have in place to determine whether they meet the definition of ring-fencing as per the Technical Specification.

4.1.7. Where a non-life insurer determines it has a material ring-fenced fund, TS 2.9.4-2.9.9 set out how the assets and liabilities associated with the ring-fenced fund are identified, the calculation of the notional SCR for each ring-fenced fund and the remaining part of the non-life insurer, the subsequent calculation of the SCR for the non-life insurer as a whole, and the adjustments made to the non-life insurer's own funds in respect of ring-fenced funds.

4.2. Lapse SCR

4.2.1. Non-life insurers' attention is drawn to the lapse risk SCR.

4.2.2. For non-life insurers, lapse risk is the risk of an adverse impact on the own-funds of a non-life insurer should a policy lapse. This may be the case if the non-life insurer has to return any profit element to the insured that is has already anticipated in its own-funds or may be the case if there is a considerable administrative expense associated with the lapse that is absorbed by the non-life insurer.

4.2.3. Where a non-life insurer has chosen not to reflect anticipated future profits related to unearned exposures in its own-funds, essentially maintaining a traditional Unearned Premium Reserve, then it is unlikely that the lapse of a policy will have an adverse impact on the non-life insurer's own-funds.

4.2.4. Where lapse risk does not have an adverse impact on own-funds then the lapse risk SCR should be set zero.

4.3. Counterparty default SCR – Type 2 exposures

4.3.1. The capital charge for counterparty default risk consists of:

- a charge for 'type 1 exposures' which are defined as exposures which may not be diversified and where the counterparty it likely to be rated (these include reinsurance arrangements, cash at bank, securitisations, guarantees and loans to parents/group members); and
- a charge for 'type 2 exposures' which are defined as exposures which are usually diversified and where the counterparty is likely to be unrated (these include receivables from intermediaries, policyholder debtors etc.).

4.3.2. Non-life insurers' attention is drawn to the calculation of the type 2 counterparty default charge. The charge for type 2 exposures consists of two parts:

- a higher charge for type 2 exposures to intermediaries which have been overdue for more than 3 months; and
- a lower charge for all other type 2 exposures.

4.3.3. When analysing the QIS4 results we noticed that several non-life insurers had missed the distinction between the two categories of charge, and have allocated all exposures due over 3 months to the higher charge, including exposures to policyholder debtors. We recommend non-life insurers check how they have allocated their different exposures within this charge.

4.3.4. Furthermore we also noted that non-life insurers have allocated premiums as being overdue for contracts with terms that allow delayed payment, such as those using quarterly bordereaux approaches and profit share agreements. We recommend non-life insurers check the specifics of the contracts of the exposures they are including in their type 2 exposures, to ensure that they are not receiving a charge unnecessarily.

4.3.5. An example of the above would be a profit share arrangement where a deposit premium is paid up front for a one year policy commencing 01/01/2017. An adjustment premium is payable on completion, based on experience to 31/12/17. The contract also allows a further 3 month credit period for the adjustment premium to be paid, so the adjustment premium is actually due no later than 31/3/2018.

4.3.6. If the premium is due from an intermediary, the higher charge is payable once the premium has been overdue 3 months or more. Therefore the higher charge will only be applied if the premium is still over due on or after 01/07/18.

4.3.7. If the premium is due from an intermediary, the lower charge will be payable from the moment the premium becomes overdue, i.e. from the 01/04/2018 until it is 3 months overdue, i.e. to the 31/07/2018.

4.3.8. If the premium is due from any other source, such as a policyholder debtor or a fronting insurer, the lower charge will be payable from the moment they become a debtor, i.e. from the 01/04/2018.

4.4. Counterparty default SCR - Treatment of exposures to unrated insurers and reinsurers who are supervised by an approved supervisor

4.4.1. The technical specification has always allowed for a specific treatment of exposures to unrated insurers and reinsurers who are supervised by an approved supervisor. The helper tab has now been updated to enable non-life insurers to apply this treatment where necessary.

4.4.2. At this time, Supervisors that have been approved by the Authority include:

- the IOMFSA;
- the insurance supervisory authorities of the United Kingdom;
- an insurance supervisory authority of a country in the European Union; and
- an insurance supervisory authority in a solvency regime which has been assessed by EIOPA and considered to be equivalent, (either fully, provisionally or temporarily) to Solvency II.

4.4.3. Non-life insurers should allocate exposures to an insurer or reinsurer which meets the requirements above to the category in the helper tab which reflects the solvency coverage ratio of that insurer or reinsurer, determined using the rules in its home jurisdiction.

4.5. Counterparty default SCR - Treatment of exposures to South African insurers, reinsurers, banks and group companies

4.5.1. In QIS4, the credit rating of an exposure to a South African entity for all types of counterparty including banks, insurers, reinsurers and companies within the same group as the non-life insurer, was capped at the sovereign credit rating of South Africa.

4.5.2. For QIS5 non-life insurers should continue to use the same treatment for exposures to South African counterparties.

4.5.3. Where the exposure is to an unrated group company, non-life insurers are allowed to apply to the Authority to use a private rating, or look through to the parent entity where the group company is carrying out the treasury function for the group. However, the ultimate rating still cannot be higher than the sovereign rating.