

OFFSHORE GROUP OF INSURANCE SUPERVISORS



**GUIDELINES
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Quality Of Assets And Capital Adequacy

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GUIDELINES ON QUALITY OF ASSETS AND CAPITAL ADEQUACY

The provision of audited Reports and Accounts and Financial Statements annually, or in some cases unaudited Accounts and Financial Statements on a more frequent basis, by an insurer to its supervisor is the main method by which the supervisor can form an opinion about the strengths and weaknesses of the insurer and assess its ability to trade and meet its expected liabilities in the future. While legislation and accepted practice may define basic criteria for evaluation, a prudent supervisor should not follow this rigidly, but should also take into account any special circumstances specific to the insurer when forming his opinion.

This paper sets out to address the main issues surrounding three major elements of an insurer's balance sheet, and the ways in which a supervisor should review them in order to come to as accurate a view as possible of the insurer's financial position.

The universally accepted method of ascertaining the financial viability of an insurer is the calculation of a minimum solvency margin, which aims to prove that the insurer has assets to meet its expected liabilities to a set value or percentage over and above those liabilities. In reviewing an insurer's accounts, this should be one of the first exercises carried out by the supervisor, since the parameters are usually defined by the laws of the relevant jurisdiction, and the result should give the supervisor a preliminary indication of the financial strength of the insurer at the balance sheet date.

Experience may show that a minimum margin of solvency as defined in the relevant legislation is too lax or too tight for proper regulation to be applied, or it may be out of step with other jurisdictions. A supervisor must be prepared to consult with the insurance industry, with consumer groups, and to propose legislative changes if necessary, so that the regulatory framework within which the industry operates is firm but fair.

However, the aim of the insurance supervision is not only to examine the financial position of an insurer at a given date, but also to review the operating conditions, which may determine its ability to trade in the future. The supervisor must therefore review the bases by which liabilities have been valued in order to satisfy himself that all factors which could reasonably be known have been taken into account, (this is the subject of a separate paper). He must also verify as far as possible that the assets backing those liabilities are appropriate and properly valued, and that the level of capitalization within the insurer is adequate and appropriate for the classes of insurance business carried on.

Insurance supervisors should establish standards in connection with the assets held by an insurer, not only in relation to valuation but also with regard to the selection and

concentration of assets by type. The basis of valuation for some assets can be established relatively easy, being based upon published indices or original cost:

Listed securities
Unlisted investments
Bonds and gilt-edged securities
Short-term deposits

There are, however, other assets where the supervisor must take extra care, since the valuation may be based on a more subjective assessment either by the insurer or by an independent evaluation.

Property Unquoted investments

The supervisor should review the valuation basis and should be prepared to discount all or part of the value of such investments for solvency purposes if there are doubts about their value or their reliability.

Futures and options

Such instruments can be complex and a supervisor must be prepared to ask questions of the insurer about such investments in order to understand the arrangements which have been made and to be satisfied that the value attached is reasonable.

Reinsurance Recoverable

Reinsurance transactions should be closely monitored. The supervisor should be able to review such arrangements to assess the degree of reliance placed on them and to determine how appropriate such reliance really is. Enquiries about the reinsurers themselves should also be made to ascertain their soundness and to form an opinion as far as is possible that any claims under these contracts are likely to be met in full.

Debtors

Many insurers belong to an industrial or insurance group and where sizeable debtor balances exist with other group companies the supervisor should be prepared to disallow some or all of the value of such asset if the ability of the other group company to pay is in doubt.

The supervisor should also examine any other material debts, and discount them wholly or partially if there is any likelihood that they may not be honoured.

Foreign currencies

The supervisor should consider the imposition of currency matching requirements in order to prevent exchange risk in cases where assets supporting technical provisions are held in foreign currencies.

Regardless of the type of asset, if reasonable grounds exist, the supervisor should always be prepared to disallow or discount its value in order to evaluate the real worth of assets being

used to support liabilities, and as a means of establishing an insurer's real solvency margin or capital adequacy.

In addition to the problem of attributing a reasonable value to assets, the supervisor must also review the relative liquidity of the assets, taking into account the type of insurance business being carried on, in order to be comfortable that the insurer will be able to meet likely claims promptly, without incurring sudden, unexpected losses from disposals. If necessary the supervisor should have the power to impose limits or restrictions on the selection of assets, or financial limits on the amounts that can be invested in any one type of asset.

As stressed previously, the role of the insurance supervisor does not exist solely to check that an insurer meets a set minimum solvency calculation once a year. While the solvency test is a very important part of the regulatory process, being a kind of buffer against the possible adverse development of liabilities, the supervisor must also be satisfied that the insurer will be able to trade in the future and meet its expected liabilities, not least as an element of protection for policyholders.

Most jurisdictions operate a policy of setting a minimum level of share capital applicable to insurers, while recognizing that in special circumstances there may be a case for either allowing a lower level or insisting upon a higher level. Supervisors should take account of the kind of risks the insurer is covering and the claims history of such insurance along with a review of the overall level of claims to which the insurer is exposed, when coming to any decision on the adequacy of an insurer's level of capital. The supervisor should also consider the imposition of a minimum level of assets held as deposits if circumstances warrant it. It may also be appropriate to include the size of any free reserves that the insurer may have in such an analysis, but the important element is the supervisor's review of an insurer's possible exposures against its ability to meet them, and the ability of a supervisor to insist on an increase in capitalization if he has grounds for the view that the insurer is unduly exposed, primarily as a means of safeguarding the policyholders' expectations of receiving prompt, full settlement of valid claims.

Minimum solvency margins and capital adequacy are indicators / measurements which are applied by a supervisor for the purpose of monitoring the financial health of an insurer. Both require proper realistic valuation of the assets supporting the insurer's liabilities and the supervisor must ensure that standards are in place which allow for a fair assessment for these areas of an insurer's business.