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Dear Sir

FSC supervisory actions in the insurance company sector.

As we approach the middle of 2013 and the final audited financial statements and statutory returns for 2012 are being submitted and many of you will be looking forward to establishing your business plans for 2014 I wanted to take the opportunity of providing you with background on the areas on which the FSC's Insurance Division is intending to focus in its supervision of Gibraltar insurers as we move towards 2014. There are four distinct and key areas, which are also closely linked, on which we will be focussed. These are set out below:

1. *Capital Adequacy – Whether the firm's capital position is adequate to support the level of current and anticipated business activity, taking into account the risks to which it is exposed.*

You will be aware from discussions that have taken place between the FSC and the Gibraltar Insurance Association ("GIA") that the FSC has been taking action to require certain Gibraltar insurers to increase the level of capital that they hold above the minimum levels required by existing EU Directives. This action has been taken in the knowledge that existing minimum capital requirements are likely to increase for most insurers as regulators across Europe implement the yet to be finalised Solvency II framework. It has also been taken to reflect the view of the FSC that the existing solvency of a number of insurers leaves them highly susceptible to adverse market conditions or stresses to their businesses.

For open market insurers the FSC will always impose additional capital requirements on licensing, which will take account of likely Solvency II SCR requirements. Often the prospective capital requirements that the FSC has imposed have been in the region of 200% of the Solvency I Premium or Claims basis calculation or 150% of the Minimum Guarantee Fund, whichever is the higher. For captive insurers we would consider the risk profile / potential Solvency II SCR, but would not anticipate a higher level than the existing Required Minimum Margin for most cases.

In addition to addressing this issue with newly licensed firms the FSC has also imposed additional minimum capital requirements on a number of existing insurers. This action has been taken when there has been an important trigger event, such as a firm being subject to a change of control, entering a new class or line of business or jurisdiction or being the subject of a FSC requirement to restore itself to a sound financial position. Existing legislation also permits the FSC to take such action where it is concerned that there may be a risk to policyholders. This might arise should the FSC form the view that management of the insurer is or may not have been acting in a sound and prudent manner. The FSC will continue to operate this approach with the intention of ensuring that all Gibraltar insurers, irrespective of when they were licenced, meet the same minimum capital standards and hold sufficient available assets at the start of each year to support the business that they intend to write during that year. As with new applicants the FSC may require an existing firm to produce a 'best endeavours' Solvency II SCR calculation, using current technical

specifications, to demonstrate that its capital base is appropriate for the risks to which it is exposed.

The FSC will take into account the same criteria in the event that insurers are required to obtain FSC approval for dividend payments.

Whilst the date for the implementation of capital requirements under Solvency II has not been determined, on 27 March 2013 the European Insurance and Occupational Pensions Authority ("EIOPA") published a number of consultation papers on "*Guidelines for the Preparation of Solvency II*" that it intends to issue in the autumn for implementation on 1 January 2014. Within two months of the Guidelines being issued national competent authorities ("NCAs"), such as the FSC, will be required to confirm their intention to comply with the Guideline or recommendation or submit the grounds for its decision not to comply. Although no decisions have been taken in relation to the Guidelines currently the subject of consultation the FSC is of the view that it is highly likely to confirm its intention to comply with the Guidelines.

2. *Reserving for technical provisions - Whether the firm has in place the necessary processes and policies to ensure that the appropriate level of reserves and provisions are maintained and that it is able to evaluate their adequacy and that they are maintained on an on-going basis.*

No discussion of capital adequacy of insurers would be complete without consideration of reserving issues. This is particularly true for general insurers with significant liability exposures, whether motor liability, general liability or any other liability class, but is also relevant for other lines of business where claims may crystallise a considerable period in the future.

The FSC has in place a Guidance Note on "*Systems of Control Over General Business Claims Provisions*". This sets out guidance as to FSC expectations of firms regarding systems of control over the recording and processing of notified claims incurred and the associated costs of handling claims and the setting of technical claims provisions.

The FSC also gave a presentation on the use of actuaries in non-life reserving at the Baker Tilly Insurance Conference in May 2012, for which slides are available in the Downloads section of the FSC website at:

<http://intranet/FSC2010/download/presentations/Baker%20Tilly%20Conference%20-%20Actuarial%20reports%20for%20Non-Life.pdf>

For several years the FSC has been placing increasing attention to reserving matters in its risk assessment of firms. For insurers with a significant liability insurance exposure, and for all motor insurers, the FSC would expect the firm to obtain an independent actuarial review of its technical provisions at least once per year if it does not have its own, in-house actuarial function. Where it does have such a function the FSC would also expect that the firm seeks independent validation of its internally produced information on a periodic basis.

Having obtained actuarial best estimates of required technical provisions the FSC expects the boards of firms to establish reserves that are considered, proportionate and prudent. In reaching decisions on reserving levels the FSC will expect to see clear evidence that firms have robust processes in place, that there is a clear risk appetite for setting reserve levels and that final decisions take account of the assumptions, uncertainties and risks implicit in the selection that the board has made. The board should demonstrate full understanding of those assumptions, uncertainties and risks implicit in the reserving choice, and be able to explain these, if challenged by the FSC

The FSC will view any decision of management to reserve at levels below the actuarial best estimate as a potential high risk factor, which may result in the FSC using supervisory tools available to it. The use of such tools might include requirements for additional information and analysis to be provided to the FSC,

imposing a higher capital requirement to reflect such a risk or requiring that the firm engages a specified person, being an actuary or accountant or other person with relevant professional skills, to produce a report for the firm which will be submitted to the FSC. Firms are reminded that the costs of engaging such a specified (skilled) person are the responsibility of the firm, not the FSC.

3. *Risk Management – Whether the firm has established a comprehensive risk management process that covers the setting of its risk policy/appetite, approval of risk limits, identification, measurement monitoring, control and management.*

You will be aware that the Solvency II Directive requires all firms to establish risk management, internal audit, internal control and actuarial functions. The recent EIOPA consultation paper on “The System of Governance” sets out a number of Guidelines for each of these areas. While the Guidelines apply to NCAs EIOPA expects NCAs to ensure that all insurers will comply with those of the Guidelines that are focussed on undertakings themselves. It thus follows that all insurers should ensure that their risk management framework is consistent with the approach set out in the Guidelines.

One Guideline with which certain firms will be expected to comply is that relating to “Forward Looking assessment of the undertaking’s own risks (based on the ORSA principles)”. EIOPA will require NCAs to ensure that undertakings representing at least 80% of the market share submit an ORSA to the FSC. Using current data the largest twelve Gibraltar insurers, those writing over £50m of premiums, would fall within this benchmark.

While conducting risk assessments the FSC has identified that many Gibraltar insurers have made good progress in developing their risk management frameworks. However, for most this remains very much “work-in-progress”. The FSC has seen very few examples of an assessment of key risks driving important business decisions. In addition, in many cases firms have not been able to demonstrate that they have formal policies and procedures to cover basic underwriting risks such as the types of risks that it will accept, how premium adequacy will be determined and how reinsurance and other risk mitigation techniques will be applied.

The FSC, and indeed EIOPA, accepts that building a robust risk management framework cannot be achieved overnight. However, we will expect firms to demonstrate that their own frameworks improve year-on-year and that they increasingly drive decision-making in the business.

4. *Corporate Governance - Whether the firm has established and implemented a corporate governance framework which provides for the sound and prudent management and oversight of the firm’s business and adequately recognises and protects the interests of its policyholders.*

The EIOPA consultation paper referred to in 3. above also sets out a number of Guidelines that directly relate to corporate governance. Again EIOPA expects NCAs to ensure that all insurers will comply with these guidelines.

The FSC has conducted a number of formal and informal investigations into whether the criteria of sound and prudent management has, would not or might not continue to be fulfilled by Gibraltar insurers. While many insurers have demonstrated on paper that they have adequate governance arrangements, with the Board, Subcommittees and members of each having suitable terms of reference, the implementation has not always followed the theory. In a number of cases there has been no evidence to show that the Board and subcommittees have operated in manner that is consistent with those terms of reference. Several examples have been found where subcommittees did little more than rubber-stamp decisions that had already been taken elsewhere. In some cases formal subcommittees have not even met.

The FSC expects that firms will be able to demonstrate that all important decisions have involved at least two persons and that important corporate-wide decisions are brought to the attention of the board and robustly considered.

In this letter I have made reference to the recently issued consultation papers on EIOPA Guidelines on the Preparation for Solvency II. I encourage all insurers to ensure that their firms benchmark their own organisations against these Guidelines at an early stage. Indeed I would encourage you to do so now. Although the Guidelines are still subject to consultation I recommend that you consider them to be close to final format. The current Consultation Papers may be found on the EIOPA website at:

<https://eiopa.europa.eu/consultations/consultation-papers/index.html>

Given the content of this letter and the importance that the FSC attaches to the four topics that I have mentioned I should be grateful if you would confirm that this letter has been considered by your Board.

Please feel free to provide me with any input that you consider relevant.

Yours faithfully

Michael B Oliver
Head of Insurance Supervision