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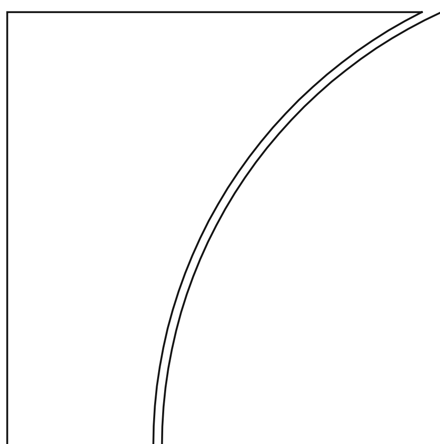

Proportionality in the application of insurance solvency requirements

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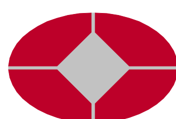

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Proportionality in the application of insurance solvency requirements[1]

Executive summary

Insurance supervisory authorities have been modernising their supervisory and regulatory regimes since the 1990s. As solvency regimes become more risk-based, the complexity of the requirements have increased significantly. Today, some solvency regimes have developed into rather complex frameworks. This is not unreasonable from a prudential point of view, given that such complexity is necessary in order to determine as accurately as possible the amount of capital insurers need to hold to withstand unexpected losses under stress circumstances.

Yet complex regulations are not optimal for all insurers. Smaller or less complex firms may find that the regulatory costs put them at a competitive disadvantage to larger or more complex insurers. Regulatory regimes should be agnostic as to the types of insurer or their business models in order to be fair to all market players. Diversity in the insurance market will ultimately benefit consumers in terms of choice as well as price competitiveness. This is how proportionate regulation can help.

The concept of proportionality is often confused with risk-based regulation and risk-based supervision. In general terms, proportionality involves taking measures that go only as far as necessary to achieve their aims. From a regulatory standpoint, proportionality means subjecting smaller or less complex insurers to simplified requirements that achieve prudential objectives, namely protection of policyholders' interests and maintaining financial stability, without being unduly burdensome.

This paper outlines various regulatory approaches to proportionate solvency regulation. It is based on a survey of 16 insurance authorities, of which eight have adopted a proportionate approach, allowing certain insurers to apply simplified regulatory requirements. Jurisdictions that do not follow such an approach typically consider that their risk-sensitive solvency frameworks are sufficient to achieve the aims of proportionate rules.

In most of the surveyed jurisdictions, the risk profile of insurers is the main criterion that insurance regulators typically use to identify insurers that are eligible for simplified solvency requirements. The other commonly used criteria are the size of an insurer and the complexity of its business model. In certain countries, specific types of insurer such as micro-insurers, mutual insurers and funeral benefit insurers are subjected to separate, simplified solvency requirements.

In practice, there is a wide range of ways in which solvency requirements can be simplified. For example, an alternative and simpler formula can be used to calculate regulatory capital requirements for certain risks; or certain types of insurer can be partially exempted from supervisory reporting. Typically, regulators would only allow the application of proportionate regulation if the outcome is at least as prudent as the standard approach. Jurisdictions that allow proportionate capital resource requirements typically use the same criteria as for regulatory capital requirements in identifying eligible insurers. Most regulators that allow proportionate supervisory reporting also allow proportionate public disclosure requirements.

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Importantly, a proportionate regime should be consistent with key prudential policy objectives. In particular, proportionate regulation should not be misunderstood to mean relaxing rules at the expense of compromising the safety and soundness of insurance firms. In fact, regulators may consider accompanying the simplification of some regulatory requirements with additional stringency (eg in terms of capital adequacy requirements). Moreover, a sound regulatory framework should provide insurance regulators with the necessary flexibility to apply the full set of standard rules to eligible insurers even if they meet the criteria for simplified rules. There are sound prudential reasons to do so if the insurance authority regards those insurers as posing higher risks to policyholders than their peers.

A proportionate framework should also aim at preserving a level playing field. Proportionality may help mitigate competitive distortions arising from excessive regulatory burdens on small and less sophisticated firms. However, the concept of proportionality should not be used to justify overprotection of certain firms from legitimate competitive forces.

To develop a sound proportionate solvency framework, insurance regulators need to consider several critical issues. These include the extent to which simplified regulatory requirements may weaken incentives for insurers to manage their business properly, the trade-off between simplification and risk sensitivity and the absolute minimum level of complexity that may be needed to achieve prudential objectives. In addition, insurers should not be able to cherry-pick between standard and proportionate requirements.

Section 1 – Introduction

1. **In insurance regulation, the concept of proportionality is embedded in the Insurance Core Principles (ICPs), which are the international standards on insurance supervision set by the International Association of Insurance Supervisors (IAIS).** By implication, jurisdictions that implement the ICPs in their regulatory frameworks are similarly expected to apply the principle of proportionality. In the introduction of the ICPs, it is stated that:

"The ICPs establish the minimum requirements for effective insurance supervision and are expected to be implemented and applied in a proportionate manner. Therefore, proportionality underlies all the ICPs. Supervisors have the flexibility to tailor their implementation of supervisory requirements and their application of insurance supervision to achieve the outcomes stipulated in the Principle Statements and Standards."

2. **Insurance regulators typically adopt a proportionate approach to solvency requirements to fulfil mandates beyond their core prudential responsibilities.** Such mandates include regulating conduct of business to ensure fair treatment of policyholders, facilitating financial inclusion, developing the local insurance industry or promoting the country as a financial centre. More recently, certain jurisdictions have intensified efforts to promote financial innovation including "insurtech" and one of the ways to achieve this aim is by subjecting entities involved in this area to simplified rules.

3. **There is currently no internationally agreed definition of proportionality in the context of insurance regulation.** This has led to jurisdictions interpreting this concept differently. In legal terms, proportionality means that measures should be suitable and not go beyond what is necessary to achieve their aims. Transposing this into the context of insurance regulation, proportionality is generally understood as imposing requirements on insurers that achieve prudential objectives, namely protection of policyholders' interests and maintaining financial stability, without being unnecessarily onerous.

4. **Setting unduly lax regulations in pursuit of proportionality may result in adverse consequences for policyholders if an insurer fails.** The challenge for insurance regulators[2] is to find the right balance in setting rules that are just sufficient to achieve prudential aims.

5. **The primary aim of this paper is to outline the different approaches to proportionate solvency regulation.** It describes the different aspects of a proportionate approach to solvency regulation and the rationale of a small number of jurisdictions that do not take such an approach. Where proportionate regulation is adopted, the paper describes how the rules are tailored to different types of insurer. The scope is intentionally limited to solvency regulation, covering technical provisions, regulatory capital requirements, regulatory capital resources, supervisory reporting and public disclosure. Although proportionate regulation is usually discussed in the context of financial inclusion, the concept of proportionality can be applied in all aspects of insurance regulation.

6. **The paper is based on a survey of 16 insurance authorities[3] covering a diverse set of insurance markets.** A key challenge in any discussion on proportionality is the potential confusion with the concept of risk-based regulation and supervision. We examine this issue further in Section 2, which starts by describing the conceptual difference between proportionate regulation, risk-based regulation, supervisory intensity and risk-based supervision. For each of the major components of a solvency regime (technical provisions, regulatory capital requirements, regulatory capital resources, supervisory reporting and public disclosure), the paper then describes the different criteria that jurisdictions use to determine insurers that are eligible for simplified regulation. The paper also provides specific examples of such proportionate requirements.

Section 2 – The concept of proportionality

7. **The ICPs[4] describe the concept of proportionality in the context of implementation and application.** According to the ICPs:

- from the perspective of implementation, proportionality "allows the ICPs to be translated into a jurisdiction's supervisory framework in a manner appropriate to its legal structure, market conditions and consumers".
- from the perspective of application, proportionality "allows the supervisor to increase or decrease the intensity of supervision according to the risks inherent to insurers, and the risks posed by insurers to policyholders, the insurance sector or the financial system as a whole. A proportionate application involves using a variety of supervisory techniques and practices which are tailored to the insurer to achieve the outcomes of the ICPs. Such techniques and practices should not go beyond what is necessary in order to achieve their purpose. Risk-based supervision is a related concept but distinct from proportionality; it means more supervisory activities and resources are allocated to insurers, lines of business or market practices that pose the greatest risk to policyholders, the insurance sector, or the financial system as a whole".

[2] Although the terms "insurance regulator" and "insurance supervisor" are often used interchangeably, this paper makes a distinction. "Insurance regulator" refers to authorities with powers to set rules for insurers. "Insurance supervisor" refers to authorities that undertake the monitoring of insurers, for example through on-site inspections and off-site monitoring. In most jurisdictions, these functions are undertaken by the same authority.

[3] The survey covered insurance authorities in Australia, Brazil, Canada, France, Japan, Mexico, Morocco, the Netherlands, Peru, the Philippines, Singapore, South Africa, Sweden, Switzerland, the United Kingdom and the United States.

[4] See International Association of Insurance Supervisors (2017b).

8. **This paper focuses on the application of proportionality in regulation.** While it is understandable that the ICPs define proportionality in the context of supervision, this paper takes a different view. It is well understood that risk-based supervision means allocating supervisory resources based on the riskiness of insurers. Such a supervisory approach can be regarded as proportionate in the sense of deploying supervisory resources or intensity in a way that is commensurate with the risk profiles of insurers. However, this concept needs to be differentiated from proportionality in regulation, which is concerned with simplifying requirements to minimise regulatory cost or burden while still meeting prudential objectives. It is possible to apply more intense supervisory scrutiny to an insurer that is subjected to simplified regulatory requirements. To illustrate this point, a small insurer with a simple business model may be eligible to apply simplified solvency calculations under a proportionate regulatory regime. However, it may attract greater supervisory attention if its risk profile gives rise to more concern than a larger insurer that is subjected to the full set of regulatory requirements but has a lower risk profile.

9. **It is possible that an insurance authority may decide to deliberately link the two concepts – proportionate regulation and risk-based supervision.** For example, the insurance authorities in the Netherlands, Singapore and Switzerland classify insurers according to their size and complexity as part of their risk-based supervisory assessment process. Insurers within the same category are subject to a specific level of supervisory intensity and the corresponding proportionate regulatory requirements. In the United States, the state insurance regulators consider the outcomes of risk-based supervision and proportionate regulation to be similar and therefore do not distinguish between the two.

10. **To focus the discussion on proportionality, it is important to acknowledge the differences between the concept of proportionality and risk-based regulation.**[5] In this paper, proportionality refers to regulators classifying insurers based on a predefined set of criteria and imposing differentiated regulatory requirements on different classes of insurers. Proportionate regulation should be appropriate to the specific circumstances of an insurer without being unnecessarily onerous. By contrast, risk-based regulation is commonly understood to mean imposing requirements that vary according to insurers' risk profile.

11. **Proportionality means applying less complex requirements to insurers that meet certain criteria.** However, this does not necessarily mean less stringent regulatory outcomes. In fact, less complex requirements could very well result in more conservative outcomes, for example higher capital requirements. By definition, proportionate regulatory treatment can, in certain cases, coincide with the outcomes of risk-based regulation. An insurer that is less complex with lower risk exposure may qualify for proportionate regulatory treatment and also be subjected to lower regulatory capital requirements. However, the two concepts are not the same. The difference between proportionality and risk-based regulation is best illustrated by considering the different ways in which they might be combined (see Table 1). At one extreme, regulation can be risk-sensitive but not proportionate. Under such an approach, the rules result in higher capital requirements for insurers with higher risk exposures but apply equally to all insurers. At the other extreme (which is unlikely to exist in reality), regulation can be proportionate but not risk-sensitive. In such a framework, the calculation method is simpler for smaller, less complex insurers but the capital requirements are set conservatively so that they do not need to vary according to insurers' risk exposures.

Combinations of risk-based and proportionate regulation — Table 1

		Proportionate regulation	
		Yes	No
Risk-based regulation	Yes	Ideal situation	Probably most common approach
	No	Unlikely to exist in practice	Least ideal situation

[5] Risk-based regulation is distinct from risk-based supervision. Risk-based regulation means prescribing risk-sensitive regulatory requirements for insurers, for example capital requirements that increase with the risk profile of an insurer. On the other hand, risk-based supervision refers to a supervisory approach that deploys resources according to the perceived risks of insurers.

12. **Proportionality and risk sensitivity are complementary concepts.** Typically, the more risk-sensitive a particular regulatory requirement, the more complex it is likely to become. For solvency regulation to become more risk-sensitive, it is usually the case that more parameters are needed, for example, when specifying formulae for the calculation of regulatory capital requirements in order to better capture the different risk drivers. Applying a proportionate approach could prevent the imposition of an unnecessary regulatory burden on insurers while requiring insurers to hold sufficient capital for their risk exposures, thus reconciling two regulatory objectives.

Section 3 – Rationale for proportionate regulation and its forms

13. **In general, jurisdictions apply simplified regulation to avoid placing a disproportionate burden[6] on insurers relative to their risk profiles and or imposing excessive compliance costs on certain eligible insurers.** A study by the Netherlands Bank showed that compliance costs for smaller domestic insurers are high relative to their size. The study also found that there is always a minimum in terms of indirect compliance costs regardless of an insurer's size, which weighs relatively more heavily on smaller insurers. Other reasons for imposing less complex regulatory requirements include:

- to promote diversity of insurers in the market, for example niche insurers that specialise in a particular line of business;
- to promote development of the insurance market by facilitating entry of new insurers or new business models;
- to better focus regulatory attention and resources where most needed to address the risks of insurers; and
- to facilitate financial innovation and financial inclusion.

14. **Insurance regulators may prescribe specific simplified rules for particular types of insurer with a narrow business focus.** As an example, in Singapore, certain types of insurer such as marine mutual insurers[7] and captives[8] are eligible for a simplified solvency regime as they only insure the risks of their own members or related corporations, and do not pose risks to systemic stability. The simplified solvency regime is explained in Box 1.

Box 1

Example of simplified solvency regime for marine mutuals and captives in Singapore

In Singapore, marine mutual and captive insurers are exempted from the general risk-based capital adequacy requirements that apply to all other insurers. Instead, such insurers are eligible for simplified solvency regimes as stipulated in the insurance legislation that is specific to each of those types of insurer.

Capital requirements

Insurers other than marine mutual and captive insurers are required to calculate regulatory capital requirements for pre-defined risk categories, including insurance risks, market risks, credit risks, (interest rate sensitivity and currency exposure) mismatch risks and concentration risks. Within each of these risk categories, there are more granular subcategories for which there are specific calculations that insurers need to undertake. For example,

[6] See Annex 1 for the rationale for proportionate solvency requirements in selected jurisdictions.

[7] Mutual insurers are typically set up by voluntary groups of natural or legal persons to meet the needs of their members. The distinguishing feature of mutual insurers is that they do not have shareholders.

[8] A captive insurer is an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the main purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities.

the insurance risks category is further split into life and non-life insurance risks. Within the non-life insurance risks category, there are two components: the premium liability risk requirement and the claims liability risk requirement. Within each of these components, there is further granularity defined in terms of business lines and the volatility categories. For example, marine cargo risk exposure is classified under the "medium" volatility category while marine hull risk exposure is considered a "high" volatility category. For each of these risk exposures, the capital requirement is calculated by applying a prescribed risk factor to the liability value. Effectively, a non-life insurer will first need to calculate its technical provisions (claims liabilities and unexpired risk reserves) for each risk exposure before it can calculate the capital requirements.

For marine mutual and captive insurers, the capital requirement calculation is simplified by not requiring such insurers to split their risk exposure at such a granular level, that is, by cargo or hull business. In addition, there is no separate capital requirement calculation for premium or claims liability. Instead, the capital requirement for marine mutual insurers is the higher of SGD 400,000; 20% of net premiums written in the preceding year; or 20% of claims liabilities at the end of the preceding year.

Capital resource requirements

Insurers, other than marine mutual and captive insurers, need to determine their capital resources at two levels, for each insurance fund and for the insurer as a whole. To determine the capital resources at the insurer level, an insurer needs to categorise each capital instrument into one of two different tiers (that reflect the quality of the instrument) based on a prescribed set of criteria and ensure that the limits imposed on the lower quality tier are not exceeded. Insurers also need to make deductions for certain balance sheet items that are not recognised as capital resources.

For marine mutual and captive insurers, the determination of capital resource requirements is simplified. Such insurers need not determine the different tiers of capital. Instead, the capital resources are effectively shareholders' equity and surplus less contingent liabilities of the insurer.

15. **A few jurisdictions do not explicitly prescribe proportionate solvency requirements, mainly on grounds that existing requirements already reflect the relative scale, complexity and risks of insurers.** This is the case in Brazil, Canada, Mexico and Peru. One jurisdiction viewed this approach as avoiding an unlevel playing field and competitive distortion in the insurance market. Certain regulators may take the view that there is less need to specify a separate set of simplified rules if there are no specific types of insurer, such as captive insurers or micro-insurers that warrant such special treatment in their jurisdictions. Some may take the view that there are natural drivers of proportionality within a risk-based solvency regime and these are already sufficient. For example, a small insurer that underwrites simple types of insurance contract and has a simple investment portfolio would take less time and effort than a larger, more complex insurer to complete its supervisory reporting. Hence, there is little need to formally prescribe a proportionate approach to the application of the relevant requirements.

16. **In most jurisdictions, proportionality is a general concept in insurance regulation.** In France, the Netherlands, South Africa, Sweden and Switzerland, there is a general principle in the relevant insurance legislation, or in the mandate of the insurance regulator, that embeds the principle of proportionality in the solvency requirements. In Switzerland, proportionality is an overarching principle taking into account the nature, scale and complexity of the insurer. On this basis, the Swiss Financial Market Supervisory Authority (FINMA) takes into account the various business activities and risks incurred by the supervised persons and entities; as well as the international minimum standards.

17. **Jurisdictions that adopt a proportionate approach to solvency regulation usually define how the requirements should be applied.** Nevertheless, insurance regulators in most of these jurisdictions have the discretion to adapt the regulation and tailor it to individual insurers on a case-by-case basis. In general, proportionate regulation can apply:

- automatically to insurers that meet certain pre-defined criteria.
- upon prior approval by the insurance regulator for insurers that meet certain pre-defined criteria.
- upon request by an insurer based on its risk profile.

Where the application of proportionate regulation is not standardised based on a pre-defined set of criteria, it is important that the process is subject to proper internal due process within a regulatory authority so that a level playing field is maintained across the insurance industry.

18. **At one extreme, certain insurers that pose very little risk to prudential objectives may be completely exempted from prudential supervision**. Box 2 describes the proportionate solvency framework in the Netherlands, including the criteria for certain insurers to be exempted from prudential supervision.

Box 2

Example of proportionate solvency framework in the Netherlands

There are three categories of insurance solvency requirements in the Netherlands:

- Solvency II.
- basic regime.
- exemption from prudential regulation and supervision.

Solvency II

In general, insurers that meet the following criteria are subject to Solvency II, the insurance solvency framework in the European Union (EU):

- gross premium income of more than EUR 5 million; and/or
- technical provisions of more than EUR 25 million; and/or
- reinsurance activities are non-negligible; and/or
- activities abroad are non-negligible.

Basic regime

Insurers that are not within the scope of Solvency II can be subjected to the basic regime if they fulfil all the following conditions:

- gross premium income does not exceed EUR 5 million;
- technical provisions do not exceed EUR 25 million;
- if the insurer is part of an insurance group, the group's total technical provisions do not exceed EUR 25 million; and
- reinsurance activities do not exceed EUR 500,000 in gross premium income, EUR 2.5 million in technical provisions or 10% of total gross premium income or technical provisions.

In addition, for non-life insurers to qualify for the basic regime, they must not underwrite any of the following business segments:

- motor vehicle liability;
- road transport liability;
- aircraft liability;
- liability for ships;
- general liability;
- credit risks; and
- suretyship.

It should be noted that a basic regime authorisation does not provide an EU passport for offering insurance products in other member states.

Exemption from prudential regulation and supervision

Non-life insurers and funeral insurers that are not within the scope of Solvency II nor the basic regime may be exempted from prudential regulation and supervision if they fulfil all the following conditions:

- gross premium income does not exceed EUR 2 million;
- technical provisions do not exceed EUR 10 million;
- if the insurer is part of an insurance group, the group's total technical provisions do not exceed EUR 25 million and no other group companies fall under the scope of the Solvency II regime;
- reinsurance activities do not exceed EUR 500,000 in gross premium income, EUR 2.5 million in technical provisions or 10% of total gross premium income or technical provisions; and
- the insurer does not undertake any other activities, except trading activities arising from its non-life or funeral expenses and benefits-in-kind insurance business and activities in the context of its life or non-life reinsurance business.

In addition, for non-life insurers, they should not offer cover in excess of EUR 12,500 per beneficiary per potential claim and they do not provide war insurance cover. For funeral expense and benefits-in-kind insurers, they should not offer cover in excess of EUR 12,500 per death.

19. **In certain circumstances, supervisors can apply the full solvency requirements even though the insurers meet the prescribed criteria for proportionate rules**. In the Netherlands and Singapore, the regulator may apply the full, non-proportionate regulatory requirements even though an insurer fulfils all the criteria for proportionality. This might be the case for insurers with a higher risk profile than other eligible insurers. Features that may heighten an insurer's risk profile include interconnectedness with other insurers and financial market players, lack of substitutability of the underwritten insurance products, and interconnectedness within an insurance group. In Switzerland, the status of an insurer's eligibility for proportionate treatment can be revoked by the insurance supervisor if the insurer breaches regulatory requirements.

Section 4 – Proportionate regulatory approaches

20. **This section describes the criteria used to identify eligible insurers and the forms of simplification for each component of solvency requirements.** The five components are regulatory capital requirements, regulatory capital resources, technical provisions, supervisory reporting and public disclosure.

Regulatory capital requirements

21. **The guidance under ICP 17 Capital Adequacy provides that regulators should adopt approaches to determine regulatory capital requirements that take account of the nature and materiality of risks faced by insurers and, to the extent practicable, reflect the nature, scale and complexity of risks of the particular insurer.** In general terms, regulatory capital requirements can take two forms – a standardised approach whereby all insurers calculate their regulatory capital requirements based on a formula prescribed by the insurance regulator; or an internal model approach whereby an insurer uses its own internal model, subject to regulatory approval, to calculate its regulatory capital requirements. In practice, some regulatory regimes adopt a mixture of both approaches depending on the risk categories. Regardless of the approach adopted by a particular jurisdiction, the intention behind the ICP is for regulators to put in place regulatory capital requirements that are not overly burdensome for insurers to calculate. More specifically, ICP 17 guidance states that standardised approaches should be appropriate to the nature, scale and complexity of the risks that insurers face and should include approaches that are feasible in practice for insurers of all types including small and medium-sized insurers

and captives, taking into account the technical capacity that insurers need to manage their businesses effectively.

22. **The main criteria[9] that regulators use to identify insurers that are eligible for simplified regulatory capital requirements are the nature of their risk profiles, complexity of business, size of the insurer and type of policyholder.** To a lesser extent and in a smaller number of jurisdictions, the legal form of an insurer and its limited geographic reach are also factors. Examples of such legal forms include mutual and captive insurers in Singapore and Mexico, given that such insurers are deemed to pose less risk to prudential objectives than other more typical forms of insurer. In Japan, simplified capital requirements are applied to insurers that underwrite only short-term insurance policies with sums insured that do not exceed a predefined threshold. Both of these factors limit the risk exposure of policyholders, which justifies a proportionate approach for such insurers. Most insurers are required to calculate the capital requirements for personal accident, automobile, hull, cargo and other insurance classes separately. However, the proportionate approach reduces the complexity of the calculation for insurers that underwrite only short-term policies with small sums insured by permitting the capital requirements for different classes to be determined on a combined basis.

23. **There is interplay between the various criteria that regulators use to identify insurers eligible for proportionate regulatory treatment.** The more common criteria of nature of risk, complexity and size can manifest themselves through the insurer's specific legal form. Similarly, the geographic reach and type of policyholder can, to a certain extent, influence the complexity of an insurer's business and the nature of its risk. Effectively, the criteria should not be regarded as being mutually exclusive.

24. **In the case of standardised regulatory capital requirements, proportionality takes the form mainly of modifications to the standard formula or the use of other simpler formulae by eligible insurers.** In the Netherlands, for insurers that are not within the scope of Solvency II, proportionality takes the form of exemption from certain capital requirements or the application of a different set of capital requirements, for example different formulae for certain risk categories. Box 3 provides an example of proportionate regulatory capital requirement for longevity risk under Solvency II.

Box 3

Example of proportionate regulatory capital requirement under Solvency II – longevity risk

Solvency II, the insurance solvency framework in the EU, is underpinned by the principle of proportionality. The relevant legislation stipulates that the requirements "should not be too burdensome for small and medium-sized insurance undertakings. One of the tools by which to achieve that objective is the proper application of the proportionality principle. That principle should apply both to the requirements imposed on the insurance and reinsurance undertakings and to the exercise of supervisory powers".

Certain EU countries issue specific guidance to their insurers to supplement the Solvency II application of proportionality. One jurisdiction prescribes simplified regulatory capital requirements in the form of a partial or full exemption, simplification of the standard formula, an alternative calculation method and insurer-specific parameters.

The capital requirement for longevity risk under Solvency II provides a concrete example of how regulatory capital requirements can be simplified. The standard approach is for an insurer to calculate the change in the value of its capital resources assuming an instantaneous permanent decrease of 20% in the mortality rates used to calculate its technical provisions. In practice, this requires the insurer to revalue its technical provisions using this set of "stressed" mortality rates. A simpler approach avoids a complete revaluation and instead involves a straightforward formula defined as a function of the 20% factor, the best estimate, the expected average mortality rate and the modified duration in years of payment to beneficiaries. The simplified approach is only allowed provided that two conditions are met:

[9] See Annex 2 for the criteria used in selected jurisdictions to determine insurers that are eligible for simplified solvency requirements.

- the simplification is proportionate to the nature, scale and complexity of the risks of the insurer; and
- the standard calculation is an undue burden for the insurer.

25. **Usually, regulators would expect the results calculated using a simpler approach not to be materially different to those of the general (non-proportionate) requirements.** For example, in France, insurers can be exempted from calculating diversification benefit within a risk category if the resulting capital requirement is at least as prudent as the standard approach. In Switzerland, simplifications to the Swiss Solvency Test (SST) and the right to disregard immaterial information are only allowed if the relative impact on the SST ratio[10] is less than 10%, and the insurer does not move between the supervisory intervention thresholds.

26. **Jurisdictions that apply a different set of capital requirements typically define eligibility by type of insurer.** This is the case in the Netherlands, Singapore, South Africa, Sweden and the United Kingdom. In South Africa, micro-insurers are subject to a simpler formula calculation and lower capital requirements, while captive insurers are treated as ring-fenced funds and are consequently subject to simplified solvency rules. Box 4 describes further the approach for micro-insurers in South Africa.

Box 4

Example of proportionate regulatory capital requirements for micro-insurers in South Africa

The general capital requirements that apply to all insurers, other than micro-insurers and captive insurers, in South Africa involve the calculation of two solvency control levels.

- Minimum Capital Requirement (MCR), which is the absolute minimum level of capital resources that the insurance authority considers necessary to protect policyholders. The MCR is calculated using a formula consisting of variables that measure the scale of an insurer's business. To undertake this calculation, an insurer needs to consider each product type separately, and apply a prescribed factor to a component of technical provisions. An example of the calculation is 2.9% of the current estimate for non-participating policies. In addition, the MCR needs to be within 25% and 45% of the Solvency Capital Requirement and not less than a prescribed absolute minimum amount.
- Solvency Capital Requirement (SCR), which is the level of capital resources to ensure the value of assets will exceed technical provisions and other liabilities at a 99.5% level of certainty over a one-year time horizon. The SCR calculation mainly involves applying a stress scenario for each risk category and determining the impact on the capital resources. There are three main risk categories: market risk, underwriting risk and operational risk. Within each of these categories, there are subcategories, for example, within market risk, there are seven subcategories such as interest rate risk, equity risk etc.

Micro-insurers in South Africa are exempted from calculating the SCR. Instead, they need to calculate only a simplified version of the MCR, which is 15% of net written premium for 12 months preceding the current or previous reporting date, whichever is higher. The absolute minimum amount is fixed at ZAR 4 million. Unlike other insurers, micro-insurers need not calculate the technical provision (or derivations of it) of each product type to calculate the MCR.

[10] The SST ratio is measured as available capital over required capital.

27. **A complete exemption of insurers from regulatory capital requirements is not common in practice.** In only one of the surveyed jurisdictions with a proportionate regulatory approach on solvency requirements can certain insurers be entirely exempted from regulatory capital requirements. In Singapore and the United Kingdom, certain insurers[11] can be partially exempted from regulatory capital requirements.

Regulatory capital resource requirements

28. **The application of proportionality to regulatory capital resource requirements is not an obvious concept.** Regulatory capital resource requirements do not usually involve complex calculations and therefore, it is less clear what a simplification of rules means in this context. Capital resources are financial instruments or capital elements (eg retained earnings) that an insurer maintains to absorb losses. The efforts needed to meet regulatory capital resource requirements depend on how the requirements are structured. In general, capital resource requirements may comprise some or all of the following elements:

- classification of financial instruments and capital elements into different tiers according to their loss-absorbing quality;
- specification of minimum and/or maximum limits for each tier;
- assessment of quality of individual financial instruments or capital elements against a set of principles-based criteria;[12] and
- adjustment of certain types of financial instrument or capital element (eg allowing only a proportion of the value to be recognised as regulatory capital resources).

29. **Jurisdictions that allow proportionate capital resource requirements typically identify eligible insurers using the same criteria as those used for regulatory capital requirements.** The most common criteria are the nature of an insurer's risk profile, its size and the complexity of its business model. An insurer's legal form and the type of policyholders it underwrites are also used, but to a lesser extent. In practice, smaller and less complex insurers typically hold a narrower range of capital instruments and they tend to be the more familiar types, such as common equity. Therefore, it is less demanding for such insurers to demonstrate the quality of their capital resources to supervisors.

Technical provision requirements

30. **There is currently a variety of regulatory approaches to setting technical provision requirements.** In some jurisdictions, regulators adopt the local accounting standard, possibly with some minor modifications, as the basis for calculating technical provisions for the purpose of regulatory solvency assessments. In other jurisdictions, regulators specify a basis for valuation that can be significantly different from accounting standards. To the extent that accounting standards are used for regulatory solvency purposes, the concept of materiality that underpins accounting standards in general could achieve the same result as proportionality. Under this concept, an accounting standard can be ignored if the impact on accounting results is insignificant and does not mislead users of the financial statements.

31. **Most jurisdictions that allow simplified technical provision requirements do not use accounting standards as the basis.** Insurers in these jurisdictions may apply simpler valuation approaches

[11] In Singapore's case, the offshore insurance fund (OIF) of reinsurance branches is exempted from risk-based capital while the Singapore insurance fund is not. The Monetary Authority of Singapore recognises that imposing capital for OIF business of reinsurance branches could impede the ability of these reinsurers to move capital swiftly to meet large and unexpected claims. Moreover, licensed reinsurers in Singapore typically come under robust group-wide supervision by their home regulator.

[12] The criteria are loss-absorbing capacity and availability, level of subordination, permanence and absence of encumbrances or mandatory servicing costs.

if they meet certain criteria relating to the nature of their risk profiles, their size and complexity of business model. To a lesser extent, some jurisdictions such as the Netherlands also consider the type of policyholder. In South Africa, a specific type of insurer, that is micro-insurers, is subjected to simplified technical provision requirements.

32. **Proportionate regulation on technical provisions can take the form of a simplified formula for the valuation.** This approach is taken, for example, in South Africa. In Europe, insurers that are eligible for proportionate regulatory capital requirements are also permitted to apply less burdensome calculations of technical provisions.

33. **Interestingly, not all jurisdictions that allow a proportionate approach for regulatory capital requirements also allow similar treatment for the valuation of technical provisions.** This is the case in Singapore and Switzerland. This is notwithstanding the close interlinkages between technical provisions and regulatory capital requirements as both represent amounts that an insurer needs to hold. Box 5 provides an example of proportionate technical provision requirements under Solvency II.

Box 5

Proportionate technical provision requirements under Solvency II

Under Solvency II, insurers are required to use methods to calculate technical provisions that are proportionate to the nature, scale and complexity of the risks underlying their insurance obligations. In determining whether a method of calculating technical provisions is proportionate, insurers are expected to carry out an assessment that includes the following.

- An assessment of the nature, scale and complexity of the risks underlying their insurance obligations. This assessment should include all risks that affect the amount, timing or value of cash in- and out-flows required to settle insurance obligations over their lifetime.
- An evaluation in qualitative or quantitative terms of the error introduced in the results of the method due to any deviation between the following:
    i. the assumptions underlying the method in relation to the risks; and
    ii. the results of the ""nature, scale and complexity of risks" assessment.

A method is considered to be disproportionate to the nature, scale and complexity of the risks if the error leads to a misstatement of technical provisions or their components that could influence the decision-making or judgment of the intended user of the information, unless one of the following conditions are met:

- no other method with a smaller error is available and the method is not likely to result in an underestimation of the amount of technical provisions; and
- the method leads to an amount of technical provisions of the insurer that is higher than the amount that would result from using a proportionate method and the method does not lead to an underestimation of the risk inherent in the insurance obligations to which it is applied.

The legislation allows specific simplifications. For example, in the calculation of the risk margin component of the technical provision, insurers may use methods that approximate the projected amount of future Solvency Capital Requirement instead of undertaking full projections.

Guidelines issued by the European Insurance and Occupational Pensions Authority (EIOPA) further supplement the proportionate application of the Solvency II technical provision requirements. For instance, the guidelines call for insurers to document cases where the use of a method that introduces material error is unavoidable and to consider the implications for the reliability of the calculation and their overall solvency positions. Insurers should also require the actuarial function to ensure that the process to validate the technical provisions is proportionate, considering the significance of the impact, both in isolation and in combination, of assumptions, approximations and methodologies on the value of the technical provisions. The technical specifications published by EIOPA provide more specific and granular guidance. For example, a simple formula is provided for the calculation of the best estimate of reported insurance claims, along with the criteria for when such simplification can be allowed.

Supervisory reporting requirements

34. **ICP 9 Supervisory Review and Reporting requires regulators to periodically review their supervisory reporting requirements to ascertain that they still serve the intended objectives and to identify any gaps.** In practice, if deemed appropriate, regulators may decide to adjust the requirements for certain insurers based on their nature, scale and complexity.

35. **The main criteria for determining insurers that are eligible for less onerous supervisory reporting requirements are their size, the nature of their risk profiles and business complexity.** Other criteria that are used by regulators in practice are the type of policyholder that an insurer underwrites and, to a lesser extent, its geographical reach. The UK regulator identifies eligible insurers as those that have low potential impact on policyholders and financial stability. Such insurers may submit semiannual (instead of quarterly) reporting on selected balance sheet data. Insurers in the United Kingdom can also be exempted from supervisory reporting entirely if they can demonstrate that the reporting is unduly burdensome and would not achieve the intended regulatory purpose of the rule.

36. **Proportionate supervisory reporting requirements usually take the form of less frequent reporting and exemption from filing certain reports.** In practice, examples of such proportionate requirements include:

- allowing less complex insurers to submit supervisory reports once every three years instead of annually (Netherlands);
- requiring less detailed reporting (South Africa);
- modifying the reporting requirements for non-life insurers that are in run-off or, in other words, not taking on any new business (Australia);
- permitting insurers below a certain size to submit quarterly reporting of only a part of regulatory capital requirements (Sweden); and
- exempting certain smaller insurers from regional supervisory requirements altogether and subjecting them to less extensive quantitative and qualitative reporting at the national level (the Netherlands).

37. **Although some insurance regulators have the power to vary reporting requirements on a case-by-case basis, this is not done routinely.** This is to preserve a level playing field and promote comparability of results across the different insurers operating in the jurisdiction.

38. **Several surveyed authorities require supervisory reporting on own risk and solvency assessment (ORSA) to be proportionate to the size, business mix and complexity of an insurer.** ORSA is essentially an insurer's own view of its risk position and capital needs. In Switzerland, the smallest and least risky insurers, as assessed by the supervisor, and reinsurance captives are exempted from ORSA reporting to the supervisor although they must still conduct the ORSA process. In Singapore, all insurers except marine mutuals and captive insurers[13] need to perform ORSA annually. However, smaller and less risky insurers are only required to submit the ORSA report to the regulator once every three years.

[13] This is because marine mutuals and captive insurers do not pose systemic risk as they insure only the risks of their own members or related corporations.

Public disclosure requirements

39. **ICP 20 Public Disclosure acknowledges that it is important that regulators consider the nature, scale and complexity of insurers when applying public disclosure requirements.** As an example, the ICP calls for regulators to consider materiality when specifying disclosure of asset classes. Excessively granular disclosure may incur unnecessary costs for insurers. On the other hand, over-aggregation may conceal important information from market participants. A balance needs to be struck by regulators in determining the level of disclosure that appropriately meets prudential objectives without compliance becoming overly burdensome for insurers.

40. **Most regulators that allow proportionate supervisory reporting also allow proportionate public disclosure requirements.** Some jurisdictions do not see a need for proportionate public disclosure requirements because in their view, by definition, smaller and less complex insurers would need to disclose less extensive information.

41. **While criteria of "nature, scale and complexity" are frequently used for the determination of eligible insurers for proportionate quantitative solvency requirements, the primary determinants for proportionate public disclosure requirements are the legal form of an insurer and the types of its policyholders.** To a lesser extent, regulators might consider an insurer's risk profile, size, and complexity as factors.

42. **Proportionate public disclosure requirements can take the form of full or partial exemption from the disclosure requirements or shorter reporting periods for certain disclosure items.** This is the case in Singapore and Switzerland. In Japan, smaller, less complex insurers are allowed to disclose operating performance indicators for the past three years instead of five. In the United Kingdom, an insurer may be partially exempted from public disclosure requirements if the disclosure would give its competitors unfair advantage or if it is bound by secrecy or confidentiality requirements.

Section 5 – Concluding remarks

43. **It is important to acknowledge the differences between proportionate regulation, risk-based regulation and risk-based supervision.** Although these concepts are interrelated, their objectives are different. Clearly distinguishing these concepts can help policymakers decide an appropriate solvency regulatory framework for insurers in their jurisdiction. A regulatory framework, whether risk-based or not, could in principle be underpinned by the principle of proportionality.

44. **Proportionate regulation can benefit not only insurers but also policyholders if the reduced regulatory cost is passed on to them through lower premium rates.** Reducing the complexity of regulatory requirements for smaller, less complex insurers can lower the barrier to market entry, thus increasing diversity of insurers and competition among them. This could provide a wider choice of insurance products to consumers, potentially at more competitive rates.

45. **Proportionate regulatory approaches should not threaten the prudential objectives of protecting policyholder interests and maintaining a sound and stable insurance market, nor should they tilt the playing field within the insurance industry.** There is a limit to how far regulations can be simplified. Care should be taken to avoid oversimplifying rules, which may result in unintended consequences, such as the underregulation of insurers whose likelihood and impact of failure may be significant despite their smaller size or less complex business model.

46. **Simplified regulatory requirements should not be taken to mean less stringent rules.** In other words, subjecting smaller, less complex insurers to simpler rules does not imply less protection for the policyholders of those insurers as compared with the policyholders of larger, more complex firms.

47. **Proportionality regimes should aim to maintain a level playing field for different types of insurer.** Regulators should be careful not to give unwarranted preferential treatment to certain groups of insurers in order to protect them from legitimate competitive forces. A proportionate approach to regulation should still maintain fair competition among insurers.

48. **In adopting a proportionate approach to solvency requirements, regulators may need to take into account some high-level considerations**:

- Regulatory requirements are usually designed to provide incentives for insurers to act in a certain way. By simplifying such requirements, some of the incentives may be weakened.
- It can be challenging to determine the right level of simplification. The trade-off for simplification is usually less risk sensitivity or less supervisory information. As such, there could be a limit on the extent of simplification that is desirable.
- The regulatory framework should avoid insurers cherry-picking between the standard and proportionate requirements. Some jurisdictions tackle this issue by requiring the regulatory outcomes of a proportionate requirement to be at least as onerous as the standard approach.
- For certain components of solvency requirements, there are absolute minimum levels of rule complexity in order to achieve the intended prudential objectives.
- Clear criteria to identify insurers that are eligible for poportionate solvency requirements are important to provide regulatory certainty and consistency.

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Annex 1 – Rationale for adopting proportionate insurance solvency requirements

The table below shows the reasons why insurance regulators in selected jurisdictions allow certain eligible insurers to apply simplified solvency requirements.

Table 2

Rationale	FR	NL	SG	SA	SE	CH	UK
To avoid imposing a disproportionate burden/compliance costs on insurers relative to their risk profiles	✓	✓	✓	✓	✓	✓	✓
To promote diversity in the insurance market	✓			✓	✓	✓	✓
To facilitate entry of new insurers				✓	✓		✓
To facilitate financial inclusion				✓			

FR = France, NL = Netherlands, SG = Singapore, SA = South Africa, SE = Sweden, CH = Switzerland, UK = United Kingdom

Annex 2 – Criteria to determine insurers that are eligible for proportionate solvency requirements

The tables below show the criteria used in the surveyed jurisdictions to identify insurers that are eligible for simplified solvency requirements.

Regulatory capital requirements — Table 3

Jurisdiction	Risk profile	Size/scale	Complexity	Type of policyholder	Legal form	Geographic reach
France	✓	✓	✓			
Netherlands	✓	✓	✓			✓
Singapore	✓			✓	✓	
South Africa	✓	✓	✓	✓		
Sweden	✓	✓	✓	✓		
Switzerland	✓	✓	✓	✓		
United Kingdom	✓	✓	✓			

Regulatory capital resource requirements — Table 4

Jurisdiction	Risk profile	Size/scale	Complexity	Type of policyholder	Legal form
Netherlands	✓	✓	✓		✓
Singapore	✓			✓	✓
Sweden	✓	✓	✓	✓	
Switzerland	✓	✓	✓	✓	

Technical provision requirements — Table 5

Jurisdiction	Risk profile	Size/scale	Complexity
France	✓	✓	✓
Netherlands	✓	✓	✓
South Africa	✓		✓
Sweden	✓	✓	✓
United Kingdom	✓	✓	✓

Supervisory reporting requirements

Table 6

Jurisdiction	Risk profile	Size/scale	Complexity	Type of policyholder	Geographic reach
Australia			✓		
France	✓	✓	✓		
Japan		✓	✓		
Netherlands	✓	✓	✓		✓
Singapore	✓	✓	✓	✓	
South Africa				✓	
Sweden	✓	✓	✓		
Switzerland	✓	✓	✓	✓	
United Kingdom	✓	✓	✓		

Public disclosure requirements

Table 7

Jurisdiction	Risk profile	Size/scale	Complexity	Type of policyholder	Legal form
Singapore	✓		✓	✓	✓
South Africa				✓	✓
Sweden		✓			✓
Switzerland		✓		✓	