MILLIMAN BRIEFING NOTE

Changes to the IoM Corporate Governance Code for Insurers

Proposals relate to recovery planning for all insurers as well as additions for Class 12 (captives)

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In December 2019 the Isle of Man Financial Services Authority published a consultation on proposed changes to the Corporate Governance Code for Insurers[1]. The majority of the changes relate to exclusions in respect of Class 12 (captive) insurers. However, requirements relating to recovery scenario planning have also been introduced for all insurers.

The Isle of Man Corporate Governance Code ("CGC") was updated significantly in 2019. This was to support the Financial Services Authority's (the "Authority") plans to develop a framework for the Island's insurance market which is appropriately consistent with the International Association of Insurance Supervisors Insurance Core Principles ("ICP"). The 2019 revision was aimed at commercial insurers, i.e. non-captives, and introduced, amongst other things, requirements for Enterprise Risk Management (""ERM") Frameworks and Own Risk and Solvency Assessments ("ORSA").

The Authority is now consulting on a further revision to the CGC to implement enhanced requirements for non-commercial insurers. They have also taken the opportunity to update the CGC for ICP 16 covering recovery planning. The timetable for implementation of the latest CGC is 1 July 2020, to coincide with the implementation of new Valuation and Solvency Regulations to cover non-life insurers and captives.

All Insurers

The new CGC contains two significant proposed changes that apply to all insurers in the Isle of Man, whether captive or commercial.

1. Board Composition

Previously, insurers could combine the roles of chair and chief executive in one individual, subject to certain requirements around internal controls and regular review of the arrangement.

This version prohibits such a combination, and was previously indicated by the Authority in 2018 that it would be brought in.

2. Recovery Plans

The new CGC introduces a number of requirements related to considering how an insurer would recover from severely adverse circumstances, including "hypothetical insolvency". In particular, it requires insurers and boards to:

- Regularly (and at least annually) evaluate and review their risks, options and intentions under recovery scenarios.
- Ensure the insurer has a properly considered approach for possible recovery scenarios.

3. ERM Framework

The new CGC also contains a number of detailed changes to the ERM requirements to reflect ICPs 8 and 16. The revised CGC does not change the general approach firms should take to establishing and maintaining an appropriate ERM framework, but it is more explicit about the regulator's expectations, specifically:

- The definition of the risk management system as one of the significant systems of governance, requiring establishment and maintenance of adequate documentation, and meaningful engagement in its governance from the Board.
- The requirement for an annual review of capital adequacy and liquidity policies and compliance with them.
- How the insurer formally operates within its risk management system.
- Including financial management as well as risk management within the ORSA process.
- The relationship between the insurer's risk profile & appetite, economic capital needs, capital & liquidity adequacy, regulatory capital requirement, and its risk monitoring processes.
- A focus within the ERM framework on those risks that are "reasonably foreseeable, relevant and material", along with a consideration of their interdependency and quantification.
- The requirement for a risk appetite statement by the board and its relationship to the risk management policy.
- Detailed requirements for considering underwriting risk, linking it to the risk appetite and its interaction with reinsurance strategy and product pricing.
- Linking investment risk to the risk appetite.

As an immediate first step, insurers should consider updating their CGC compliance checklists to ensure they have appropriately considered and documented these changes. This will assist in the completion of the annual Director's Certificate on Corporate Governance. Over time, it is likely

that the Authority will engage in thematic reviews of corporate governance to ensure appropriate standards of compliance are being observed by insurers.

Recovery Planning

The addition of recovery planning requirements to the IoM CGC is in line with international developments in this space. The European Insurance and Occupational Pensions Authority ("EIOPA") has stated its proposal to introduce recovery planning requirements across all EU insurers both in its 2017 Opinion on Recovery and Resolution Frameworks[2] and as part of its recent 2020 Solvency II review consultation paper.

The International Association of Insurance Supervisors ("IAIS") has also published detailed guidance for insurers regarding recovery planning. In addition, the Financial Stability Board ("FSB") has been very active[3] in the area of recovery planning for a number of years through its involvement with large or systemically important insurers, in particular.

According to the FSB, a recovery plan "identifies options to restore financial strength and viability when the firm comes under severe stress." This appears to be in line with the IoM proposed changes to the CGC regarding recovery planning.

As part of Milliman's work in this area, we have identified a number of key issues in creating and maintaining robust recovery plans. An important consideration in recovery and resolution planning is the governance arrangements that need to be put in place when drafting and maintaining plans. Processes need to be in place to ensure:

- Timely escalation of issues through the use of indicators and triggers.
- Approvals from the Board and supervisors must be factored into the recovery plan.
- Clearly defined responsibilities to support the recovery planning process should be outlined.

In order to develop recovery plans, companies should investigate a span of options that would be available to them in the event of financial difficulty by examining a range of adverse scenarios and coming up with a shortlist from these options.

There are many factors that companies should consider when deciding on the most appropriate course of action that would be taken in a recovery situation, as illustrated in Figure 1 below. Companies should analyse the options available to them if they get into financial difficulty, and weigh up the benefits and drawbacks of each.

As solutions will inevitably need to be tailored to the exact circumstances giving rise to an adverse financial situation, recovery plans containing a well-developed set of principles can prove invaluable in enabling an effective and coordinated response to be implemented within as short a timeframe as possible.

Consideration	Question
Liquidity or Solvency	Will this strategy improve the company's liquidity or solvency position, and by how much?
Time	Will the company have time to implement this strategy and for its benefits to materialise?
Availability	Will the strategy always be available to the company i.e. are there third parties willing to facilitate it in all scenarios?
Cost	Can the company afford the cost of this strategy and is it the most cost-efficient approach?
Complexity, Ease of Implementation & Ongoing Maintenance	Has the company access to the necessary skills, expertise and resources in order to implement this strategy and carry out any ongoing maintenance required in terms of its complexity and ease of implementation?
Credibility and feasibility	How achievable are the timelines? Is there any past experience? Are there potential risks and impediments to implementation, including adverse second-order impacts and longer-term risks to the sustainability of the company's business model?

Figure 1: Recovery Considerations

Recovery Strategies

In exploring the toolkit available to re/insurers should they encounter financial difficulty, Figure 2 below groups a non-exhaustive list of example recovery strategies into broad segments based on whether they serve primarily to improve liquidity, to raise capital, to de-risk the balance sheet or to restructure the company/group.

Improve Liquidity	Raise Capital
• VIF monetisation • Insurance-linked securities • Investment portfolio rebalancing • Product structure • Other options	• Equity and debt • Contingent capital • Group finance • Off-balance sheet

De-Risk	Restructure
• Reinsurance	• Portfolio transfer
• Capital Markets	• Closure
• Investment Strategy	• Group restructure
• Change of business plan	• Other options

Figure 2: Recovery Strategies

Numerous examples of recovery options as well as colourful case studies are outlined in a Milliman research paper on this topic[4].

Recovery options can range from relatively quick and less complex actions – such as optimisation of investment strategy or counterparty exposures in order to reduce capital requirements, revision of the business plan or requesting a capital injection from another Group entity – to more complex and time-consuming actions. The sections below summarise some of these more complex options which may nonetheless be viable options particularly in more extreme scenarios where more straightforward options are either not available or not sufficient in order to restore the financial position.

Improve Liquidity

One example of a method of improving liquidity for insurers is through the use of a value in force (VIF) monetisation arrangement. The primary benefit of VIF monetisation is typically the uplift to the company's liquidity position arising from the receipt of an upfront commission from a reinsurer or another third party in return for an illiquid asset representing capitalised future expected profits. Depending on the regulatory regime, the capital position may also improve if the deal contains an element of risk transfer or if the value of future profits was not already included on the balance sheet.

Recovery plans would need to acknowledge the challenges and any barriers to implementing a VIF monetisation, such as the time and effort required, reduction in ongoing profitability and reliance on securing a counterparty in order to complete the transaction.

Raising Capital

There are several ways of raising capital, such as via the issue of subordinated debt. Subordinated debt can be used to improve a company's capital position as, in the event of liquidation, the company will not repay the lenders of subordinated debt until all other liabilities and secured creditors have been paid.

However there are a number of considerations to take account of before issuing such an instrument, such as the cost of the interest payments relative to the benefit of this form of capital in comparison to tier 2 capital. It may also be more challenging to secure an investor for this debt if the company waits until it is in recovery to implement such an option, which can adversely affect credibility of this option in the recovery plan.

De-Risking

By reducing the risks that it assumes, a re/insurer can reduce its capital requirements, thereby boosting its solvency coverage position. There are a number of capital management tools which can achieve this, such as reinsurance structures, capital markets solutions and investment strategies.

From a reinsurance perspective, in territories where risk-based solvency regimes exist, a treaty could be structured in such a way that the re/insurer is protected against the occurrence of an adverse event that is linked to the risk-based stresses used to derive its capital requirements. Such cover could be relatively cheap given the low likelihood of the event occurring.

However, companies will need to ensure that there is a reasonable level of risk transfer associated with any reinsurance arrangements in order to avoid regulatory challenge regarding such arrangements.

Restructuring

By changing the structure of insurance companies or groups, capital and liquidity can be raised or alternatively capital requirements can be reduced through the disposal of capital intensive business or by achieving capital efficiencies through increased diversification benefits.

Groups could set up branch structures whereby subsidiaries are grouped under a single head office so as to maximise diversification benefits.

Another option for groups would be to dispose of certain entities or lines of business for strategic reasons. Large-scale restructuring has taken place in a number of global insurers, incorporating several different strategies, including M&A deals. The funds generated by these activities can help restore the Group's solvency position and/or enable an orderly run-off depending on the situation.

Resolution

Sometimes, however, recovery plans are not enough. The FSB refers to resolution as the situation in which a firm "is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so."

Under the EIOPA proposals for a recovery and resolution regime in the EU, the regulator would be expected to prepare the (pre-emptive) resolution plans, noting that resolution is not mentioned in the IoM CGC consultation draft. Whilst many resolution strategies may be pursued by regulatory authorities rather than by re/insurers themselves, it is certainly useful for companies to be familiar with the types of actions which may be considered by regulators.

As there is currently no resolution regime in place in the EU, failures are generally subject to normal insolvency rules. However, the resolutions of insurance companies in Japan between 1997 and 2001 could provide a precedent for national regulators developing their own resolution regimes. For example, such resolutions included measures such as establishment of a new, restructured entity which could attract new investors, provision of finance from an industry insurance fund and write-down of certain policyholder benefits. These demonstrated the additional value that can be preserved through an effective resolution regime.

There can be a fine line between recovery and resolution. Extreme measures such as closing the company to new business or changing the corporate or ownership structure such that the company survives, albeit in a different form, probably lie somewhere between recovery and resolution.

Captive Insurers

From 2016 to 2018, the Authority engaged in detailed consultation with the captive insurance industry regarding the application of a proportionate and appropriate risk-based solvency framework for non-life insurers, which include captive and other specialist insurers. The Authority also consulted on an appropriate definition for captive insurers as a class of business.

The changes to the CGC in this consultation draft in respect of captives and other non-life insurers are as follows.

Fair Treatment of Policyholders

Captives are exempt from these requirements in relation to their dealings with related parties or with insurers in respect of which they provide reinsurance.

Actuarial Function

Non-life insurers or reinsurers may apply to the Authority to vary the requirements for an actuarial function and the Authority may vary the requirements. In the consultation document, the Authority highlighted the example of an insurer in a sustained stable run-off as being less likely to require repeated actuarial input.

The full Actuarial Function requirements do not apply to captive insurers, however they must have, or have access to, an effective actuarial function covering, at least, technical provisions, pricing, and compliance with related statutory and regulatory requirements.

In light of this change, captive Boards should consider whether they require a “live” actuarial function for the types of risks that they cover. The Authority will not require captives to have, for example, an active retainer arrangement with an actuarial service provider. However, the Authority has highlighted actuarial advice as an important example of the external expertise that Boards must have the powers and resources to obtain if required by the characteristics of their written lines of business.

Own Risk and Solvency Assessment

Captives may avail of a significantly simplified template for reporting the ORSA results to the Authority, see Figure 3 below. However they must still hold a full ORSA report covering the ORSA results, conclusions and additional information as set out in paragraph 9 of Schedule 2 of the proposed CGC.

Name of insurer
Categories within class 12 by which the insurer qualifies as class 12
The reason why the ORSA was carried out (if the reason was due to a material change or changes in the insurer’s circumstances then an explanation of that/those change(s) must be included)
The date the ORSA was completed
Who carried out the ORSA work
Who/what body provided ultimate approval of the ORSA
A summary of the insurer’s immediate and (if different) longer term business goals
A brief description of the reasonably foreseeable relevant and material categories of risks facing the insurer
The insurer’s risk appetite statement and key sub limits structure.
What is the insurer’s own capital adequacy policy in respect of— • normal business conditions; and • abnormal business conditions?
Given the outcome of the insurer’s ORSA, what sources of funding will be required to comply with the insurer’s own capital policy over the insurer’s forecast time horizon?
What are the insurer’s considered and realistic options in the event of the insurer needing to recapitalise for any reason?

Figure 3: Summary ORSA Submission

Captives may also apply a number of exemptions to the full ORSA requirements. Many of these are concerned with the standard requirement to consider the difference between an insurer’s own risks/risk profile and own economic capital needs, and the standard model’s risks and capital requirements respectively.

The new CGC reflects the nature of captive business time horizons, specifically where captives write business from related parties and depend on their group or parent for business. In these cases, the captive may apply a minimum forecast time horizon in excess of 1 year (reduced from 3 years).

As captives may not have an actuarial function, the requirement to obtain input to the ORSA from the function is waived.

Internal Audit

Captives do not require an annual report from the internal audit function to the Board.

Furthermore, the new CGC clarifies that internal audit work for all insurers can be scheduled over more than one year. However, the Board still has the responsibility to determine an appropriate schedule for internal audit work, including any ad-hoc work required to respond to changes in systems of governance, for example.

Finally, the new CGC recognises that conflicts of interest may arise where internal audit resources of a captive's insurance manager carries out the function, and requires any conflict to be effectively managed.

Commentary

The new CGC provides a number of valuable proportionate simplifications of the regulatory framework for captives and should help the Island's captive industry promote itself as a well-regulated but more sympathetic jurisdiction for captive business than a full Solvency II territory.

How can Milliman Help?

For all insurers, Milliman can assist you with all aspects of your recovery and resolution planning projects, including advice on:

- Choosing recovery strategies that are appropriate to your business.
- Methodology for effectively developing recovery plans.
- Modelling the impact of different recovery strategies.
- Design and implementation of risk management frameworks.
- Expert review and benchmarking of recovery plans.

For captive insurers, Milliman can assist you with all actuarial aspects of your programme, including advice on:

- Outsourcing of the Actuarial Function.
- Advice on specific provisions, pricing or regulatory compliance issues as they arise.
- Methodology and production of ORSAs and ORSA reports.

For further information, please contact your usual Milliman consultant or those below.

[1] https://consult.gov.im/financial-services-authority/cp19-10-t11-corporate-governance-code-of-practice/consult_view/
[2] https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf
[3] FSB Key Attributes of Effective Resolution Regimes Paper: https://www.fsb.org/wp-content/uploads/r_141015.pdf
[4] http://ie.milliman.com/insight/2016/Recovery-and-Resolution-Plans-Dealing-with-financial-distress/

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