Directives

of the Federal Office of Private Insurance FOPI

17/2006 – Directive on the Risk-Based Capital Requirement of Reinsurance Captives

Legal basis: Article 9 ISA

Decision of: 21 December 2006

Enter into force: on 21 December 2006

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Finance FDF
Federal Office of Private Insurance FOPI

Article 1 Scope

The present Directive shall apply to all reinsurance captives that are exempt from performing the Swiss Solvency Test (SST) in accordance with article 2, paragraph 1 of the Supervision Ordinance (SO).

Article 2 Determination of capital requirement

[1]The capital requirement of a reinsurance captive shall be determined on the basis of the technical risk, the market risk, and the credit risk.

[2]The capital requirement for assuming the technical risk shall be equal to the risk gap. The risk gap shall mean the difference between the contractually agreed maximum annual claims and the expected annual premiums (subtracting any commissions, fees, and other costs). If no maximum annual claims have been agreed or if they are unrealistically high, then the maximum annual claims may for instance be replaced by the claims expenditure resulting from an estimate of the 97.5% quantile of the claims rate. For so called "long-tail" lines of business, the adverse development risk must be taken into account. Also in this case, the one-year adverse loss development in accordance with the 97.5% quantile shall be used. Diversification effects between different classes of insurance may be taken into account.

[3]The capital requirement for assuming the market and credit risk shall be determined with the help of a factor model. The parameter table of the model is included in the Annex to this Directive.

[4]The capital components defined in paragraphs 1 to 3 shall be added together. An appropriate diversification effect may be deducted from the resulting sum. The amount of the diversification effect must be justified. The resulting value is the capital requirement determined in accordance with the **solvency requirements**.

[5]In the case of new undertakings, the own funds must furthermore be at least high enough so that a potential ‘under funding' under article 725, paragraph 1 of the Code of Obligations only has a 10% probability of occurring in the first year. The value calculated on this basis is the capital requirement determined in accordance with the **balance sheet requirements**.

Article 3 Covering the capital requirement

[1]If the capital requirement determined in accordance with the solvency requirements exceeds the maximum of the minimum capital and the required solvency margin I, then the supervisory authority may, upon a justified application, permit the difference to be covered by hybrid instruments with a term of at least 5 years. The hybrid instruments must meet the requirements set out in article 39, paragraph 1 SO.

[2]If the capital requirement determined in accordance with the balance sheet requirements exceeds the capital requirement determined in accordance with the solvency requirements, then the supervisory authority may, upon a justified application, permit the difference to be covered by hybrid instruments with a term of at least 5 years or by a guarantee of the owners of the reinsurance captive or third parties. A guarantee may only be considered if the guarantor has sufficient creditworthiness.

[3]If obligations from reinsurance contracts are due for which insufficient means are available, then the captive must be able to call on the guarantee under paragraph 2 immediately. The guarantee must be documented in writing and submitted to FOPI for verification. FOPI shall decide on approval of the guarantee case by case.

Article 4 Exceptions

If a reinsurance captive does not agree with the result of the procedure defined above, it shall have the option of conducting the SST. In this case, the undertaking must demonstrate that it has risk-bearing capital which at least reaches the target capital.

Reasoning

Under article 2, paragraph 1 SO, most reinsurance captives are exempt from the obligation to conduct the SST. The motivation for this article in the ordinance is the fact that the risk structure of a reinsurance captive, as a rule, is much simpler than that of other reinsurance undertakings. Even in the case of reinsurance captives, however, the principle still applies that the capital requirement is based on the risk of the undertaking. The present Directive serves to implement this principle. They are based on article 9 ISA, according to which the determination of the necessary solvency margin – in general terms, the target value of the own funds requirement under supervision law – must also take the risks into account to which the insurance undertaking is exposed.

The risk measure used in article 2, paragraph 2 of this Directive (97.5% quantile) was deliberately chosen less strictly than the risk measure of the SST (expected shortfall at the 1% level): In the case of captives, a higher probability of insolvency can be tolerated than in the case of reinsurance undertakings that assume the risks of third parties.

This Directive shall enter into force on 21 December 2006.

Federal Office of Private Insurance FOPI

Herbert Lüthy
Director

Annex to the FOPI Directive of 21 Dec 06

Factors for calculating the capital requirement for captives not subject to the SST	
<u>1. Market risk</u>	
a) Shares	**% of risk capital**
Europe & USA	25
Japan & others	30
b) Volatility risks	
Bond issues with terms of up to three years	2
Bond issues with terms of over three years	5
Real estate and land	35
<u>2. Credit risk</u>	
a) Default risk of bond issues	
Bond issues with rating >"A"	1
Bond issues with rating between "A" and "BBB"	5
Bond issues with rating < "BBB"	30
Other bond issues	to be determined
b) Reinsurance claims	
Claims relating to reinsurers with rating > "A"	2
Claims relating to reinsurers with rating between "A" and "BBB"	10
Claims relating to reinsurers with rating < "BBB"	60
Claims relating to reinsurers without rating	to be determined

3. Accumulation risk	
For accumulation risks relating to individual counterparties (shares, bonds, real estate, loans, etc.) that constitute more than 10% of the available risk-bearing capital (share capital + allowable components of equity capital), the risk capital according to the following factors must be calculated, in addition to the capital requirement for volatility and default risks. The sum of the capital requirement arising from default risks, volatility risks, and accumulation risks is limited to 100% of the relevant position.	
between 10 and 20	15
between 20 and 30	30
over 30	100