

# Regulatory Capital Requirements for Microinsurance in the Philippines

Report Prepared for GTZ

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## Executive Summary

As part of the Microinsurance Innovation Program for Social Security Project (MIPSS), a review was performed to identify changes in the existing requirements—specifically including those related to risk-based capital adequacy (RBC)—that will contribute to both the growth of the microinsurance market and the financial strength of microinsurance entities. This report presents the results of the review, which was performed by Michael Hafeman, an actuary and international consultant on financial sector regulation and supervision.

The review involved the gathering of information through the review of legislation and other documents, the analysis of financial data, and meetings with the Insurance Commission, industry representatives and the Core Coordinating Group for MIPSS. Preliminary findings were discussed with the Insurance Commission and the Core Coordinating Group.

Entities active in the microinsurance market include mutual benefit associations (MBAs), commercial insurers and cooperative insurers. Many microinsurance MBAs are very small operations. Differences between the microinsurance business and traditional insurance business can affect the risk profile of microinsurance entities. An analysis included in the report shows that, overall, microinsurance entities would seem to be subject to slightly higher risk than traditional insurers. However, unless evolving experience shows otherwise, the differences are probably not significant enough to warrant adjustments of the RBC risk weights.

The solvency regime is fairly comprehensive in nature, including controls on products and pricing, restrictions on the acceptability and valuation of assets, requirements on the valuation of liabilities, fixed capitalization requirements and risk-related solvency margin requirements. RBC requirements were introduced in 2006, along with increases in the fixed capitalization requirements, and are currently under review. Section 3 analyzes various aspects of the solvency regime and includes observations on issues, such as the complexity of fixed capitalization requirements, which might warrant revisions of the regime.

Section 4 sets out various objectives against which proposed changes to the solvency regime can be tested. For example, the solvency regime should strengthen solvency in a cost-justified manner, promote a level playing field, appropriately reflect differences in the risk profiles of various entities and be within the technical capacity of both the insurance entities and the Insurance Commission. Reference is also made to relevant international standards of practice.

The final section provides recommendations in respect of the solvency regime, with a particular focus on the fixed capitalization and RBC requirements. Some of the recommendations suggest further analysis before the details are established, and the

report describes the next steps that might be followed to finalize and implement the recommendations.

With respect to the solvency regime more generally, it is recommended that:

- Assets should be valued in accordance with IFRS, after which deductions can be made of assets that are not admitted for purposes of assessing solvency
- Liabilities should be valued using a gross premium method and currently-realistic assumptions;
- Until a gross premium valuation basis is in place, consideration should be given to requiring life insurers to test the sufficiency of their reserves in cases where the discount rate exceeds their current portfolio rate of return, and to establish additional reserves in respect of any deficiencies;
- Life insurers selling variable life insurance products that contain guarantees with respect to capital preservation or rates of return should be required to perform stochastic modelling and establish on-balance sheet reserves in support of these guarantees, and the RBC requirements should also recognize the need for additional capital in respect of such risks; and
- Solvency requirements for pre-need entities should be established on a basis consistent with those for insurers and MBAs.

Recommendations in respect of the fixed capitalization requirements include:

- Requirements should be based solely on the minimum amounts of capital and net worth needed to operate a viable entity of a particular type;
- Requirements should be simplified and should not be linked to RBC ratios or to the percentage of foreign ownership;
- The current fixed capitalization requirements for commercial insurers would seem to be sufficient;
- MBAs should be required to maintain not only a minimum guaranty fund but also a minimum members' equity;
- The ultimate fixed capitalization requirements of a MBA could be set at about 14.5 million pesos of members' equity, with a minimum guaranty fund of 50% of that, or 7.25 million pesos; and
- Any phase-in period for revised requirements should be of limited and fixed length, for example, three years.

With respect to the RBC requirements, it is recommended that:

- The RBC risk categories, risk weights and formulas for the various types of entities should be harmonized;
- Stress testing should be performed, to assess the ability of entities to meet RBC requirements in future years, even under adverse conditions; initially, it should be required as part of the capital planning of those entities subject to intervention;
- The RBC ratios of individual entities should be disclosed by the Insurance Commission; and
- The solvency regime should be simplified by amending the Insurance Code to replace the margin of solvency requirements with the RBC requirements (at the 50%, authorized control level).

Other recommendations include:

- There should be meaningful monetary penalties for the late filing of returns and for the filing of erroneous returns;
- Supervisory databases should be enhanced to facilitate easier analysis of insurance entities, including those engaged in microinsurance; and
- Steps should be taken to encourage the growth of nonlife microinsurance, such as reducing the taxation of nonlife insurance and allowing the establishment of MBAs devoted solely to underwriting nonlife microinsurance.

# 1. Introduction

## ***Background***

Microinsurance in the Philippines has been growing rapidly, and there is considerable scope for further evolution and growth. An appropriate regulatory framework can help to ensure that the microinsurance market grows in an orderly manner, through financially-sound and well-managed microinsurance entities that are able to meet their obligations to policyholders. The solvency regime, including regulatory capital requirements, is an essential part of the regulatory framework.

At the request of the Philippine government, GTZ has established the Microinsurance Innovation Program for Social Security Project (MIPSS). MIPSS includes several components: framing conditions for microinsurance; promoting microinsurance innovations; and enhancing social protection in case of illness. Under the first of these components, the project plan includes a review of the existing regulatory capital requirements. The purpose of such review is to identify changes in the existing requirements—specifically including those related to risk-based capital adequacy (RBC)—that will contribute to both the growth of the microinsurance market and the financial strength of microinsurance entities.

The review was performed by Michael Hafeman, an actuary and international consultant on financial sector regulation and supervision. It involved a mission in Manila, which took place September 17-25, 2009, and related work both before and after the mission. This report presents the results of the review.

## ***Approach***

It is impossible to achieve the purpose of the review without having a reasonably good understanding of the current situation. Accordingly, the approach taken to the review was designed to provide an understanding of the following:

- the traditional and microinsurance markets, in terms of providers, products, distribution channels and assets;
- the regulatory framework applied to traditional insurance companies and microinsurers, in terms of laws and regulations, RBC requirements, supervisory approach and supervisory resources;
- the practical constraints that might exist in applying RBC to microinsurers, such as their organizational capacities and the availability of data; and
- differences in the risk characteristics of microinsurance and microinsurance entities, as compared to the characteristics of more traditional insurance and insurers.

The steps taken to gain such an understanding included the following:

- reviewing *Making insurance markets work for the poor: microinsurance policy, regulation and supervision—Philippines case study*, January 12, 2009;

- reviewing the Philippines Insurance Code and the various Insurance Memorandum Circulars and Department Orders issued since 2006 related to capital adequacy and solvency;
- meetings with the Insurance Commissioner, Deputy Commissioner, and various senior staff of the Insurance Commission;
- meetings with representatives of the Life Insurance Association, Nonlife Insurance Association, Chamber of Mutual Benefit Associations, and RIMANSI;
- a meeting with the Core Coordinating Group for MIPSS; and
- meetings and informal discussions with management and staff of GTZ Philippines.

All persons who participated in the meetings were generous with their time and open with their comments, which were greatly appreciated.

Preliminary findings were presented in meetings with the Core Coordinating Group and the Insurance Commission. The feedback provided by the participants was invaluable in shaping the recommendations contained in this report.

Analyses were also performed of 2006-2008 financial data of the life and nonlife insurers and the mutual benefit associations (MBAs). The analyses assisted in understanding the financial strength of the entities, the effects of current requirements on them, and the possible effects of alternative requirements that might be considered. The assistance of the Insurance Commission in providing data in a timely manner was greatly appreciated.

The next two sections of the report relate to the current market and regulatory situations. They highlight findings of the information-gathering and analyses most relevant to the purpose of the review and present observations in respect of the findings.

The report then sets out objectives that might be considered when evaluating possible changes in the solvency regime. Some of these objectives relate to international standards, while others relate more specifically to the situation in the Philippines.

The final section of the report presents recommendations. The recommendations relate to the solvency regime as a whole, and more specifically to regulatory capital requirements and other related regulatory requirements and supervisory practices. Some recommendations have also been included on issues that, while not directly related to the solvency regime, could affect the growth and viability of microinsurance. Suggestions are also presented in respect of the further steps that might be taken to consult with stakeholders about the recommendations, finalize the changes, and implement them.

## 2. Current Market Situation

This section of the report focuses on aspects of the market situation that are particularly relevant to the purpose of the review. For a comprehensive description of the microinsurance market situation, reference should be made to the Philippines case study mentioned above.

Microinsurance products are defined<sup>1</sup> as policies under which the amount of premium computed on a daily basis does not exceed 10% of the current daily minimum wage for non-agricultural workers in Metro Manila. Based on the current minimum wage, the premium cannot exceed approximately 40 pesos per day, or 14,600 pesos per annum. In the case of life insurance, the maximum amount of life insurance coverage must also be not more than 500 times this daily minimum wage rate. This definition is consistent with the definition of industrial insurance in the Insurance Code.

The microinsurance market includes both formal and informal providers of coverage. Informal providers are entities that are not registered with and supervised by the Insurance Commission. They include *damayan* schemes, cooperatives and informal associations (such as the taxi drivers in a city). Formal providers include commercial insurers, cooperative insurers and mutual benefit associations (MBAs). Commercial insurers and cooperative insurers can be licensed as life insurers, nonlife insurers or composite insurers. However, MBAs are only permitted to underwrite life insurance products. All entities are permitted to underwrite personal accident products.

MBAs that provide only microinsurance policies and have at least 5,000 members are defined as microinsurance MBAs, which are subject to different guaranty fund requirements than other MBAs. Of the 21 MBAs currently operating, 7 are microinsurance MBAs that were formed explicitly for that purpose, 12 are more traditional employment-related or affinity-group MBAs that nevertheless meet the definition of a microinsurance MBA, and the other two are affinity-group MBAs that issue some larger policies that fall outside the definition of microinsurance products.

Many microinsurance MBAs are very small operations. For example, they might have a general manager, a bookkeeper and a few other staff. Premium collections are often handled through an affiliated microfinance institution, whose computer system might be adapted to handle insurance recordkeeping. Fast claims settlement is emphasized.

Most of the insurance underwritten by microinsurance MBAs is family coverage that provides both life insurance and personal accident benefits. Coverage typically terminates at age 65. Premiums are group-rated rather than age-related, and are not guaranteed. Although this is essentially term insurance coverage, a savings component is also involved. This arises from the requirement that a benefit be provided on surrender, after three or more years, which is not less than 50% of all premiums paid. Such a

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<sup>1</sup> Insurance Memorandum Circular 9-2006.

requirement does not exist with respect to insurance underwritten by an insurance company.

Although cooperatives are allowed to form insurers, only two have yet done so. Some cooperatives provide insurance on an informal basis and some offer insurance that is underwritten by commercial insurers.

Some commercial insurers are active in the microinsurance market. They most commonly underwrite group credit life, personal accident and supplemental motor vehicle insurance. Distribution is often through cooperatives, MBAs or rural banks. Agents are seldom involved in individual sales because the small commissions that would be generated are unattractive.

In the past, some life insurers had written industrial business. They no longer do so, reportedly because of concerns regarding the ability to maintain control over the premium collection process and the high cost of collection. Insurers voluntarily made industrial policies fully paid up, as the cost of doing so was more than made up for by the savings of collection costs.

The market also includes pre-need companies, which provide products that are in some respects similar to those offered by life insurers, except that they do not involve life contingencies. There are also health services providers in the market, some of which offer insurance-like arrangements. These entities are currently supervised by agencies other than the Insurance Commission.

Insurance products and insurance companies are subject to a variety of taxes, including premium tax (5% on life and personal accident insurance), value-added tax (12% of premiums on insurance underwritten by a nonlife insurer, including personal accident insurance), document stamp tax (0.25% of premiums on life and personal accident insurance and 12.5% of premiums on other nonlife insurance), certificate tax (15 pesos per certificate), local government taxes (typically about 1% of premiums), fire service tax (2% of fire and allied perils premiums), investment income tax (20% of investment income and capital gains), and corporate income tax. MBAs are exempt from premium tax and corporate income tax.

Based on the above, the tax burden appears to be both high and uneven. However, the income statements of the insurers show lower levels of taxation. For example, in 2008, the life insurance industry reported premium taxes of about 3% and total taxes of about 9% of premiums, with the corresponding numbers for the nonlife industry being 0% and 4%. Legislation is pending that would reduce the premium tax on life insurance, perhaps to 2%.

### ***Microinsurance Risk Analysis***

Differences between the microinsurance business and traditional insurance business can affect the risk profile of microinsurance entities. Some of the differences subject microinsurance entities to higher risk than traditional insurers, while some will tend to



reduce their risk. Industry representatives and Insurance Commission were asked to help identify and comment on the effects of such differences.

The following table contains an analysis of the most significant differences and their possible effects on the level of risk within various risk categories (to the extent that it might not already be captured in the RBC risk weights). Overall, microinsurance entities would seem to be subject to slightly higher risk than traditional insurers. However, unless evolving experience shows otherwise, the differences are probably not significant enough to warrant adjustments of the RBC risk weights.

**Table 2.1 Microinsurance Risk Analysis**

<b>Risk Category</b>	<b>Differences</b>	<b>Net Effects</b>
Credit risk: investments	Microinsurance MBAs might invest in deposits with related microfinance institutions.	Minimal, assuming the counterparty is a regulated bank.
Market risk: investments	None noted.	None.
Credit risk: other	Premium collection might be more difficult because of the irregularity of income and multiplicity of deductions. It might be easier because of the proximity of the policyholder to the entity.	Offsetting factors mean the net effect on the collectability of premiums is probably minimal.
Interest rate risk	Most microinsurance is term coverage, although MBAs must refund at least 50% of contributions upon termination after three or more years.	None.
Insurance risk: pricing	Pricing is done based on aggregate claims data and premiums are not age-rated. Historical utilization rates might be depressed by lack of awareness of benefit provisions. Expense provisions are limited to 20%.  However, premium rates are typically adjustable from year-to-year.	The first three factors create greater pricing risk, while the fourth factor helps to mitigate the risk. The net effect is probably slightly higher risk.

<b>Risk Category</b>	<b>Differences</b>	<b>Net Effects</b>
Insurance risk: underwriting	<p>Underwriting is usually limited. Low income policyholders are more affected by contagious diseases, fires and natural disasters. Microinsurance written through a MBA might be geographically concentrated.</p> <p>Policyholders might be known through relationships with a related microfinance entity. Policies are small in face amount.</p>	The first three factors create greater underwriting risk, while the last two would decrease the risk. The net effect is probably higher risk, which could be mitigated by reinsurance or geographic diversification.
Insurance risk: claims	<p>Small claims do not justify extensive review. Rapid settlement of claims is emphasized.</p> <p>Claimants might be known through geographic proximity.</p>	The first two factors create greater claims risk. The third factor should reduce the potential for claims fraud somewhat, although it might also increase the possibility of collusion. The net effect is probably slightly higher risk.
Liquidity risk	<p>Low income policyholders are more affected by contagious diseases, fires and natural disasters. Rapid settlement of claims is emphasized.</p> <p>Policies are small in face amount.</p>	The first two factors create greater liquidity risk, while the third reduces it. The net effect is probably minimal.
Operational risk: transactional	<p>Frequent transactions provide more chances for errors. Microinsurance is often written by smaller entities, which tend to have weaker internal controls. Systems might be adapted from those of a microfinance entity and not fully suited to insurance.</p> <p>Policies are small in face amount.</p>	The first three factors create greater risk of transactional error. The small amounts of the policies would help to limit the monetary exposure to an error. The net effect is probably slightly higher risk.
Operational risk: other	<p>Microinsurance is often written by smaller entities, whose managers might lack technical insurance expertise. MBAs might be formed around existing groups, which raises the possibility of commingling of operations and funds with those of informal insurance schemes.</p>	Other operational risk is probably slightly higher.

### 3. Current Regulatory Situation

The insurance sector is regulated and supervised by the Insurance Commission. The primary law is the Insurance Code, which was enacted in 1974. It has been supplemented over the years by various regulations, such as Insurance Memorandum Circulars and Department Orders.

A law is pending that would transfer responsibility for the supervision of pre-need companies from the Securities and Exchange Commission to the Insurance Commission. Approval is anticipated before the end of 2009.

#### ***Solvency Regime***

The solvency regime is fairly comprehensive in nature, including controls on products and pricing, restrictions on the acceptability and valuation of assets, requirements on the valuation of liabilities, fixed capitalization requirements, and risk-related solvency margin requirements. Significant changes were made in 2006, with the introduction of risk-based capital (RBC) requirements and increases in the fixed capitalization requirements. The RBC requirements include provision that they be reviewed after three years, and the review process is underway.

The sections below deal with various aspects of the capital adequacy requirements. Observations that can be made about the other components of the solvency regime, and its overall structure, include the following:

- Premium rates for some coverage types are set by the Insurance Commission or the nonlife industry association. Products and premium rates for other coverage types must be approved by the Insurance Commission. However, industry representatives report that deviation from approved premium rates is not uncommon;
- Microinsurance MBAs are required to submit viability analyses in support of new products. The Insurance Commission has specified some of the assumptions that must be used, including the maximum administrative expenses and investment yield, surrender rates, the minimum surrender benefit and a contribution to the guaranty fund. Based on a review of their financial statements, the operating expenses of many MBAs exceed the limit of 20% of contributions that can be reflected in the viability analysis, in which case the approved rates might be inadequate;
- Insurers prepare financial statements under both IFRS and regulatory accounting requirements, with the regulatory basis being used for capital adequacy purposes. Both bases value equities at market value, but regulatory accounting values bonds at amortized cost, while IFRS values them at market. Regulatory accounting also restricts the admissibility of certain assets;
- Life insurance liabilities are required to be valued using the net premium method, with a discount rate of no more than 6%. Any standard mortality table can be used. This basis is intended to be conservative. However, the net premium method does not make explicit allowance for either expenses or lapses, nor does it

- adapt to changing conditions. For example, the 6% discount rate used by most insurers might well exceed their current and prospective investment returns, which means their liabilities could be understated. Neither is the net premium method suitable for products that contain embedded options, such as variable life insurance with guarantees in respect of the rate of return; and
- Certain aspects of the solvency regime make it unduly complex overall. For example, the fixed capitalization requirements are complicated and, because the Insurance Code has not been updated, the margin of solvency requirement still applies even after the introduction of RBC requirements.

### **Fixed Capitalization Requirements**

Fixed capitalization requirements exist for each type of entity. The amounts differ depending on factors such as the type of entity, when it was formed and the level of foreign ownership. For commercial insurers, significant increases are being phased in over time, with the amounts applicable in a particular year depending on both the industry's and the insurer's success in meeting RBC Hurdle Rates, as discussed below. For a microinsurance MBA, the requirement begins at 5 million pesos and increases annually by 5% of its premiums.

The fixed capitalization requirements are summarized in the following table (all amounts in pesos):

**Table 3.1 Fixed Capitalization Requirements**

<b>Type of Entity</b>	<b>Current Requirement</b>	<b>Ultimate Requirement</b>
Microinsurance MBA <sup>2</sup>	5 million, increasing annually by 5% of premiums	12.5% of minimum paid up capital of a local insurer (62.5 million)
Existing MBA (non-MI)	12.5 million	12.5 million
New MBA (non-MI)	25% of minimum paid up capital of new local insurer (125 million)	25% of minimum paid up capital of new local insurer (125 million)
Existing Local Insurer <sup>3</sup>	150 million net worth; 75 million paid up capital	500 million net worth; 250 million paid up capital
Existing Foreign Insurer <sup>4</sup>	300 million net worth; 150 million paid up capital	1 billion net worth; 500 million paid up capital
New Insurer <sup>5</sup> (local or foreign)	1 billion net worth; 500 million paid up capital	1 billion net worth; 500 million paid up capital

<sup>2</sup> In the case of MBAs, the requirements are in respect of the minimum guaranty fund; there is no fixed minimum requirement in respect of net worth.

<sup>3</sup> Amounts apply to life insurers and nonlife insurers; each part of a composite insurer must meet the requirements independently.

<sup>4</sup> Applies to those 60% or more foreign ownership; lower requirements apply to those with less foreign ownership. However, the foreign insurers that were operating in the Philippines before the Insurance Code was enacted in 1994 were grandfathered as local insurers.

<sup>5</sup> Amounts are doubled for reinsurers.

<b>Type of Entity</b>	<b>Current Requirement</b>	<b>Ultimate Requirement</b>
Existing Cooperative Insurer <sup>6</sup>	75 million net worth; 37.5 million paid up capital	250 million net worth; 125 million paid up capital
New Cooperative Insurer	500 million net worth; 250 million paid up capital	500 million net worth; 250 million paid up capital

As noted above, the phase-in of fixed capitalization requirements for insurers depends on both the industry's and the insurer's success in meeting RBC Hurdle Rates. The phase-in period was originally scheduled to extend until 2010, but might be considerably longer. If the percentage of insurers that meet the RBC Hurdle Rate for the year (the Compliance Rate) is at least as high as the target Compliance Rate for the year, then the phase-in will generally be deferred by a year. However, the deferral does not apply to any particular insurer that fails to meet the RBC Hurdle Rate. The schedule of targets is set out in the following table:

**Table 3.2 RBC Targets**

<b>Basis of RBC Ratio</b>	<b>Review Year</b>	<b>Industry RBC Ratio Compliance Rate</b>	<b>RBC Hurdle Rate</b>
2006	2007	80%	150%
2007	2008	85%	175%
2008	2009	85%	200%
2009	2010	90%	200%
2010	2011	90%	250%

The targets were met in respect of the RBC ratios for 2006, but not for those of 2007.

Several observations can be made about the fixed capitalization requirements:

- Fixed capitalization requirements typically set the minimum amount of capital required to establish and operate an entity of the smallest size considered viable in a particular market. This could justify differences among the requirements for MBAs, commercial direct insurers and reinsurers, for example. However, the extremely large differences amongst various categories would be difficult to justify on this basis;
- Based on a review of 2007 results, many insurers that just met the minimum paid up capital requirement (and even some that fell short of it) had RBC ratios that were well above the RBC Hurdle Rate. This might indicate that the ultimate fixed capitalization requirements are unnecessarily high;
- It is not unusual for increased capital requirements to be phased-in over a period of time. However, such phase-in periods are typically fixed in advance and unrelated to either the industry's or an entity's RBC ratios. The system used in the Philippines is very complex and the results somewhat unpredictable, which makes capital planning difficult. Furthermore, it is not obvious why the phase-in is linked to RBC ratios at all;

<sup>6</sup> Amounts are one-half of those for local commercial insurers.

- Compliance by a MBA with the minimum guaranty fund requirements does not necessarily mean that the MBA is solvent; it might at the same time have negative Members' Equity;
- The gradual build-up of the minimum guaranty fund is a useful mechanism to enable small microinsurance MBAs to begin operating. However, if 5 million pesos is not enough to establish and operate a MBA then, at least in the short run, the MBA and its members will be subject to a heightened risk of failure; and
- Many existing MBAs were not established with the explicit purpose of operating as microinsurance entities, but nonetheless meet the requirements to qualify as microinsurance MBAs. The Insurance Commission thus treats them as microinsurance MBAs, which means that they must increase their minimum guaranty fund by 5% of premiums each year until it reaches 12.5% of the minimum paid up capital of a local insurer (ultimately, 62.5 million pesos)—far higher than the 12.5 million pesos requirement that they might have expected would apply.

### ***RBC Formulas***

Risk-based capital (RBC) requirements have been established for both insurers and MBAs. Required capital is calculated by applying factors to various risk parameters and adding the results within major categories of risks. The results for the various categories are not simply added together, but are combined with one another using formulas that are designed to recognize the interrelationships of the risk categories.

The risk categories used for life insurers and MBAs are as follows:

- C1 asset default risk;
- C2 insurance pricing risk;
- C3 interest rate risk; and
- C4 general business risk.

The RBC requirement is given by the formula:

$$RBC\ Requirement\ Life = \sqrt{(C1 + C3)^2 + C2^2} + C4$$

The risk categories used for nonlife insurers are as follows:

- R1 fixed income securities;
- R2 equity securities;
- R3 credit risk;
- R4 loss reserves; and
- R5 net written premiums.

The RBC requirement is given by the formula:

$$RBC\ Requirement\ Nonlife = \sqrt{R1^2 + R2^2 + (0.5 * R3)^2 + (0.5 * R3 + R4)^2} + R5^2$$

Several observations can be made about the RBC risk weights and formulas:

- No distinctions are made between microinsurance and other insurance, or between microinsurance MBAs and other MBAs;
- The risk parameters and risk weights for all risk categories are the same for life insurers and MBAs, except that the MBA requirements make no provision for derivatives and off-balance sheet items in C1 or variable life insurance in C4 (although MBAs are not legally prohibited from operating in these areas);
- The risk parameters and risk weights within risk categories R1, R2 and R3 for nonlife insurers are almost entirely covered by and consistent with those within risk category C1 for life insurers and MBAs;
- Insurance risk is captured in categories C2, R4 and R5, but the risk parameters and risk weights differ—in some cases significantly—between life and nonlife, for example, in respect of types of business that can be written by both (such as health);
- Nonlife insurance risk categories R4 and R5 include adjustments for rapid growth, which can indicate increased risk, but there is no rapid-growth adjustment for life insurers;
- Interest rate risk category C3 has no counterpart for nonlife, which is appropriate considering the short-term nature of nonlife business;
- General business risk category C4 has no counterpart for nonlife;
- Although there is a small provision in category C4 for the general business risk associated with variable life insurance assets, there is no provision in the RBC requirements in respect of the performance and capital guarantees that have been incorporated in some insurers' products;
- Based on both a limited comparison of the risk weights with those used in other jurisdictions and the comments of industry representatives, it appears that some of the risk weights might be higher than appropriate (for example, the 25% of premiums risk weight in R5); and
- Even where risk parameters and risk weights are consistent, differences in categorization and the manner in which the categories are combined within the formulas mean that the RBC required of a life insurer or MBA will differ from that required of a nonlife insurer (for example, in respect of an identical portfolio of assets or personal accident business).

### ***RBC Ratio Requirements***

The RBC ratio of a life or nonlife insurer (including a cooperative insurer) is calculated as Networth divided by the RBC requirement, where Networth is defined as:

- “the company’s paid-up capital, contributed and contingency surplus and unassigned surplus. Revaluation and fluctuation reserve accounts shall form part of networth only to the extent authorized by the Insurance Commissioner.”

The RBC ratio of a MBA is calculated as Members’ Equity divided by the RBC requirement, where Members’ Equity is defined as:

- “Admitted Assets minus All Liabilities inclusive of Actuarial Reserves and other obligations under the policies and membership certificates.”



Various levels of regulatory intervention are applied based on the RBC ratio, as follows:

**Table 3.3 Regulatory Intervention Levels**

<b>RBC Ratio = Y</b>	<b>Event</b>	<b>Description of Action</b>
$100\% \leq Y < 125\%$	Trend Test	Linear extrapolation if next year's ratio < 100%. If so, move to Company Action Event.
$75\% \leq Y < 100\%$	Company Action	Submit RBC plan and financial projections. Company implements the plan.
$50\% \leq Y < 75\%$	Regulatory Action	IC authorized to examine company and issue Corrective Orders.
$35\% \leq Y < 50\%$	Authorized Control	IC authorized to take control of the company.
$Y < 35\%$	Mandatory Control	IC required to take control of the company.

Several observations can be made about the RBC ratio requirements and intervention levels:

- The definitions of Networth and Members' Equity are consistent with one another;
- Regulatory intervention—even with respect to the trend test—is triggered at considerably lower RBC ratios than those set as RBC Hurdle Rates under the fixed capitalization requirements;
- The Insurance Commission is authorized to examine a company only if its RBC ratio falls below 75%, which is a significant restriction of supervisory powers;
- Other than the simple trend test, the RBC ratio requirements do not involve any forward-looking assessment, such as stress testing; and
- There is no requirement that insurers and MBAs disclose their RBC ratios, although such disclosure is not prohibited.

### ***Margin of Solvency Requirements***

The Insurance Code, which was enacted in 1974, requires that insurers maintain a minimum margin of solvency. The margin of solvency is defined as the excess of the value of admitted assets, exclusive of paid-up capital, over the amount of liabilities, unearned premium and reinsurance reserves.

The minimum margin of solvency for a life insurer is two per mille of non-term insurance in force at the end of the preceding year. The minimum margin of solvency for a nonlife insurer is ten percent of net premium written during the preceding year. In either case, the minimum margin of solvency must not be less than 500 thousand pesos.

An insurer that fails to meet the minimum margin of solvency can be required to make good the deficiency within 15 days. Failure to meet the minimum margin of solvency constitutes sufficient grounds for declaring an insurer insolvent.



Several observations can be made about the margin of solvency requirements:

- The margin of solvency requirements, being based on a measure of the risks assumed by an insurer, are similar in concept to the RBC requirements;
- Being based on only one risk parameter for each type of insurer, they are a much cruder measure of solvency than that provided by the RBC requirements;
- Depending on the mix of a life insurer's business, the margin of solvency requirements might be almost meaningless (for example, if a life insurer writes only term life insurance and personal accident insurance, its minimum margin of solvency would be only 500 thousand pesos);
- Based on both inspection of the formulas and comments from industry representatives, it is unlikely that an insurer could exceed the regulatory intervention levels of RBC while at the same time failing to meet the margin of solvency requirements; and
- The Insurance Code does not require MBAs to maintain a minimum margin of solvency, but the Insurance Commission is considering a measure for its internal assessments of MBA solvency calculated as one per mille of insurance in force net of reserves, but not less than the minimum guaranty fund.

### ***Supervision of Solvency***

The Insurance Commission supervises solvency through both offsite analysis and onsite inspections. Much of the offsite analysis is based on returns filed by the insurers and MBAs. The returns include (among other things) income statements, balance sheets, RBC calculations and statistical information about the business they have written. Onsite inspections assist in validating the information contained in the returns and assessing the controls in place at the entities.

Annual financial returns must be filed by April 30 of the following year. Some returns are subject to late filing penalties, but there are no penalties for filing erroneous returns.

The Insurance Commission is organized on a functional basis, and several departments might be involved in reviewing the returns, assessing the solvency of an entity and taking necessary corrective action. A new organization structure is currently under consideration, which would remain functional at the highest level but consolidate the financial examination work within sector-specific units.

The assessment process can extend into the fourth quarter of the following year. It often results in adjustments to the financial information, most commonly in respect of the assets that are considered admissible. In the course of this review, the Insurance Commission provided selected financial and statistical information on insurers and MBAs. Based on both a review of this information and comments of the Insurance Commission, adjustments can sometimes be quite large, usually make the financial position of the entity look less favourable than initially reported and tend to be more frequent among the smaller entities.

The following observations are offered on the supervision of solvency:

- The new organization structure being considered by the Insurance Commission should assist in strengthening sectoral expertise, for example, regarding microinsurance;
- The annual solvency assessment process extends for a very long time, at least in part because of the filing of erroneous returns by many insurers and MBAs; and
- Analysis showed that some of the information provided by the Insurance Commission was internally inconsistent. Also, in some cases conflicting information was provided by different departments.

## 4. Objectives

The most fundamental objective of any solvency regime—and the capital adequacy requirements that are a key component of it—is to reduce the risk that insurance entities will be unable to meet their current or future financial obligations to policyholders and other beneficiaries. However, it is impossible to eliminate that risk completely. In fact, attempts to do so could result in an onerous solvency regime, which compromises the ability of insurance entities to meet legitimate market needs in a sound and profitable manner.

Therefore, in addition to this fundamental objective, it is useful to establish some other objectives against which proposed changes to the solvency regime can be tested. They might include the following, some of which focus specifically on microinsurance:

- The solvency regime should strengthen the solvency position of the market and the individual insurance entities;
- The benefits of the solvency regime should outweigh its associated costs;
- The solvency regime should promote a level playing field and discourage regulatory arbitrage;
- The requirements should be customized, where appropriate, to reflect differences between the risks facing microinsurance entities and those facing other insurance entities;
- The solvency regime should be commensurate with the technical capacity of the insurance entities, including microinsurance entities;
- The solvency regime should be consistent with the existing regulatory framework; and
- The solvency regime should be commensurate with the technical capacity of the Insurance Commission.

Also, as a member of the IAIS, the Insurance Commission strives to conform to international standards of practice. One such standard is the *Standard on the Structure of Regulatory Capital Requirements*, adopted by the IAIS in October 2008. The table below sets out the various items in the standard and describes the current situation in the Philippines with respect to each item.

**Table 4.1 IAIS Standard on the Structure of Regulatory Capital Requirements**

<b>Item in the IAIS Standard</b>	<b>Current Situation in the Philippines</b>
1. A total balance sheet approach should be used in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources and to ensure that risks are appropriately recognised.	The Philippines' solvency regime does not explicitly take a total balance sheet approach. Interdependence is recognized to some extent through the covariance adjustments (square root) in the RBC formulas and in the C3 component of the life requirements.

<b>Item in the IAIS Standard</b>	<b>Current Situation in the Philippines</b>
2. Regulatory capital requirements should be established at a level such that the amount of capital that an insurer is required to hold should be sufficient to ensure that, in adversity, an insurer's obligations to policyholders will continue to be met as they fall due.	The regulatory capital requirements are intended to be sufficient, although they are not tied to a specific level of certainty.
3. The solvency regime should include a range of solvency control levels which trigger different degrees of intervention by the supervisor with an appropriate degree of urgency.	The RBC requirements include various regulatory intervention levels, which are triggered by the RBC ratio of an entity.
4. The solvency regime should ensure coherence between the solvency control levels established and the associated corrective action that may be at the disposal of the insurer and/or the supervisor. Corrective action may include options to reduce the risks being taken by the insurer as well as to raise more capital.	Corrective actions become progressively more severe as the solvency level declines. Insurers are required to develop plans, which might include a combination of reducing the risks being taken and raising more capital.
5. The regulatory capital requirements in a solvency regime should establish a solvency control level which defines the level above which the supervisor would not require action to increase the capital resources held or reduce the risks undertaken by the insurer. This is referred to as the Prescribed Capital Requirement (PCR).	The 125% RBC level might be considered to be the PCR. However, this is complicated by the existence of higher hurdle rates for RBC. The fixed capitalization requirement can vary depending on both the industry's experience in achieving the hurdle rate and the entity's level of RBC versus the hurdle rate.
6. The PCR should be defined such that assets will exceed technical provisions and other liabilities with a specified level of safety over a defined time horizon.	The PCR has not been defined in terms of a specified level of safety over a defined time horizon.
7. The regulatory capital requirements in a solvency regime should establish a solvency control level which defines the supervisory intervention point at which the supervisor would invoke its strongest actions, if further capital is not made available. This is referred to as the Minimum Capital Requirement (MCR).	Within the Philippines' solvency regime, the Authorized Control Level could be considered to be the MCR. However, action can also be taken against life and nonlife insurers that do not the minimum solvency margins defined in the Insurance Code for life and nonlife insurers.

<b>Item in the IAIS Standard</b>	<b>Current Situation in the Philippines</b>
8. The solvency regime should establish a minimum bound on the MCR below which no insurer is regarded to be viable to operate effectively.	Both the Mandatory Control Level defined in the RBC requirements and the minimum solvency margins defined in the Insurance Code establish minimum bounds below which insurers will not be allowed to operate.
9. The solvency regime should be open and transparent as to the regulatory capital requirements that apply. It should be explicit about the objectives of the regulatory capital requirements and the bases on which they are determined.	The fixed capitalization requirements seem to be trying to meet multiple objectives, none of which has been stated explicitly. A minimum solvency margin for MBAs is being used internally by the Insurance Commission, but has not been published.
10. In determining regulatory capital requirements, the solvency regime should allow a set of standardised and, if appropriate, other approved more tailored approaches such as the use of (partial or full) internal models.	The requirements are based entirely on standardized approaches and do not involve the use of internal models.
11. The solvency regime should be explicit as to where risks are addressed, whether solely in technical provisions, solely in regulatory capital requirements or if split between the two, the extent to which the risks are addressed in each. The regime should also be explicit as to how risks and their aggregation are reflected in regulatory capital requirements.	The solvency regime is not explicit as to where risks are addressed. Aggregation is dealt with to some extent through the correlation adjustments (square root) in the RBC formulas.
12. The supervisor should set out appropriate target criteria for the calculation of regulatory capital requirements, which should underlie the calibration of a standardised approach.	Target criteria have not been established.
13. Where the supervisory regime allows the use of approved more tailored approaches such as internal models for the purpose of determining regulatory capital requirements, the target criteria should also be used by those approaches for that purpose to ensure broad consistency among all insurers within the regime.	This is not applicable under the current solvency regime.

<b>Item in the IAIS Standard</b>	<b>Current Situation in the Philippines</b>
14. The solvency regime should be designed so that any variations to the regulatory capital requirement imposed by the supervisor are made within a transparent framework, are proportionate according to the target criteria and are only expected to be required in limited circumstances.	This is not applicable under the current solvency regime.
15. The solvency regime should be supported by appropriate public disclosure and additional confidential reporting to the supervisor.	Public disclosure of solvency positions is not required.

Other IAIS documents of particular relevance to the establishment of a solvency regime include the following:

- *Insurance Core Principles*, October 2003, ICPs 18-23;
- *Principles on Capital Adequacy and Solvency*, January 2002;
- *Guidance Paper on the Structure of Regulatory Capital Requirements*, October 2008;
- *Summary of IAIS Positions on the Valuation of Technical Provisions*, October 2007; and
- *Guidance Paper on Stress Testing by Insurers*, October 2003.

## 5. Recommendations

This section provides recommendations in respect of the solvency regime, with a particular focus on the fixed capitalization and RBC requirements. They seek to satisfy the objectives described in the previous section; in some cases, specific comments are made about how a recommendation might do so.

Some of the recommendations suggest further analysis before the details, such as amounts and risk weights, are established. The Insurance Commission has already initiated the three-year review called for under the RBC requirements. It is recommended that the analyses be performed in conjunction with the RBC review process.

### ***Solvency Regime***

Assets should be valued in accordance with IFRS, after which deductions can be made of assets that are not admitted for purposes of assessing solvency. This will simplify the financial reporting process and, hopefully, reduce the number of reporting errors.

Long-term life insurance liabilities should be valued using a gross premium method. These and other insurance liabilities should be valued using currently-realistic assumptions, for example, with respect to claims, expenses and interest rates. This will provide a better valuation of liabilities, on a basis consistent with the valuation of assets.

Some life insurers are already using gross premium valuation for internal reporting purposes. A transition period will probably be required to enable others to implement this methodology. For entities underwriting only short-term products, such as most microinsurance MBAs and nonlife insurers, the move to valuation using more realistic assumptions should not be particularly difficult to accomplish.

Until a gross premium valuation basis is in place, consideration should be given to requiring life insurers to test the sufficiency of their reserves in cases where the discount rate exceeds their current portfolio rate of return, and to establish additional reserves in respect of any deficiencies. This will reduce the risk that liabilities are understated.

Life insurers selling variable life insurance products that contain guarantees with respect to capital preservation or rates of return should be required to perform stochastic modelling and establish on-balance sheet reserves in support of these guarantees. The RBC requirements should also recognize the need for additional capital in respect of such risks.

Solvency requirements for pre-need entities should be established on a basis consistent with those for insurers and MBAs. This will promote a level playing field.

### ***Fixed Capitalization Requirements***

Fixed capitalization requirements should be based solely on the minimum amounts of capital and net worth needed to operate a viable entity of a particular type. This will

prevent entry to the market by entities that are too small and financially weak to be likely to operate effectively, while encouraging the formation of entities—including those focused on the microinsurance market—that would have sufficient size and resources to be viable. Fixed capitalization requirements should ordinarily be a constraint only on the smallest entities of a particular type; RBC requirements would typically assume much more importance as entities increase in size.

Consistent with the above, fixed capitalization requirements would be simplified. In particular, they would no longer be linked to RBC ratios or to the percentage of foreign ownership. This will provide greater certainty to the entities, enabling them to conduct more effective capital planning. It will also remove an impediment to the entry of foreign insurers, including those interested in participating in the microinsurance market.

When establishing the minimums, the capital positions, profitability and operating capabilities of existing smaller entities should be considered. Those that are able to meet the RBC hurdle rate, produce consistent profits, keep operating expense ratios close to industry averages and ordinarily meet regulatory requirements will provide an indication of the minimum size of a viable entity. The net worth required by such an entity to meet the RBC hurdle rate would then serve to guide the establishment of the fixed capitalization requirements. Benchmarking against the fixed capitalization requirements of other jurisdictions in the region (especially those that have updated their requirements in recent years) should also be done.

The 2007 financial positions of the life and nonlife insurers were analyzed. The life insurers that failed to meet the RBC hurdle rate were fairly evenly distributed by size (in terms of premiums), while the nonlife insurers that failed to meet the RBC hurdle rate were more likely to be large insurers. The difference between net worth and paid up capital—an indication of historical profitability—was also examined. For both the life and nonlife sectors, the mid-sized insurers were the weakest under this measure. Based on this limited analysis, the current fixed capitalization requirements for commercial insurers would seem to be sufficient.

The fixed capitalization requirements for MBAs relate only to the minimum guaranty fund. Although the guaranty fund would be called upon in case of insolvency, it is not available to absorb risks on a going-concern basis. Therefore, it is recommended that the fixed capitalization requirements for MBAs include not only the minimum guaranty fund but also minimum members' equity. The same relationship that exists between the paid up capital and net worth requirements for insurers could be applied; in other words, the minimum members' equity would be two times the minimum guaranty fund.

The small expense margins available within microinsurance products will probably be a major determinant of the fixed capitalization requirements of a MBA. This would also drive the determination of the minimum number of members required to support a viable MBA. For example, using the typical annual premium of 600 pesos per member and an



assumed operating expense level of 20%<sup>7</sup> of premiums, an expense margin of 120 pesos per member per annum would be available. Very few of the existing MBAs have total operating expenses of less than 3 million pesos, which would require at least 25,000 members. A simplified calculation can be done to estimate the RBC requirement that would apply to such an entity, for example:

- Premiums of 25,000 x 600 = 15,000,000
- Liabilities of 2 x premiums = 30,000,000
- Assets of 1.4 x liabilities = 42,000,000
- C1 requirement of 0.10 x assets = 4,200,000
- C2 requirement of 0.25 x premiums = 3,750,000
- C3 requirement of 0
- C4 requirement of 0.005 x premiums plus 0.0025 x assets = 180,000
- RBC requirement, using current formula = 5,810,000
- 175% of RBC requirement (2007 hurdle rate) = 10,168,000
- 250% of RBC requirement (ultimate hurdle rate) = 14,526,000

Based on the above analysis, the ultimate fixed capitalization requirements of a MBA could be set at about 14.5 million pesos of members' equity, with a minimum guaranty fund of 50% of that, or 7.25 million pesos.

If the revised fixed capitalization requirements significantly exceed current requirements, a phase-in period would be appropriate. It is recommended that the period be of limited and fixed length, for example, three years. This will provide a known planning horizon for the entities, while not unduly compromising policyholder safety by allowing entities to operate with insufficient capital for an extended period of time.

### ***RBC Requirements***

The RBC risk categories, risk weights and formulas should be harmonized. This will provide for consistent treatment of insurance products and their associated risks, regardless of the type of entity that underwrites them.

For example, the following risk categories might be established:

- X1 Credit risk
- X2 Market risk
- X3 Underwriting risk
- X4 Operational risk

Category X1 would largely correspond to current categories C1, R1, R2 and R3. Category X2 would correspond to current category C3 and the foreign exchange component of C1. Category X3 would correspond to current categories C2, R4 and R5, while category X4 would correspond to current category C4.

The following RBC formula might be considered:

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<sup>7</sup> This is the maximum under the Insurance Commission guidelines and approximately the arithmetic average operating expense level of MBAs formed specifically to operate as microinsurers.

$$RBC \text{ Requirement} = \sqrt{X1^2 + X2^2 + X3^2 + X4^2}$$

The existing risk parameters and risk weights could be assigned to the new categories and the risk weights harmonized with one another, where necessary. The RBC requirements and ratios could then be calculated for all or a representative sample of the entities and the results compared to those under the existing regime. Risk weights or the formula could be adjusted if the results appear unreasonably high or low. The risk weights and the results might also be benchmarked by applying the RBC requirements of other jurisdictions in the region, such as Singapore and Indonesia, to a sample of entities. If some of the insurers are calculating economic capital for management purposes, or RBC requirements under the solvency regime applicable to a foreign parent, the results of such calculations could also provide useful input to the calibration process.

Based on the analysis presented earlier in the report, it is not recommended that the risk weights applicable specifically to microinsurance differ from those applicable to other insurance. However, consideration should be given to adjusting the capital required in respect of operational risk to take account of the size and rate of growth of an entity. The risk weight might be higher for smaller entities, to recognize the less formal controls that often exist compared to those in larger entities. The risk weight might also be higher for entities that are growing rapidly, much like the adjustments in categories R4 and R5, to recognize the operational difficulties that often accompany rapid growth.

The regulatory intervention levels generally seem reasonable and appropriate. However, it is recommended that the Insurance Commission be authorized to examine an entity at a much higher RBC ratio than the 75% currently specified, for example, at a RBC ratio of 125% or lower. This will facilitate earlier intervention, thereby increasing the likelihood that a weak entity can be returned to health. This could be particularly important for smaller entities that lack management depth, such as many MBAs.

Stress testing should be performed, to assess the ability of entities to meet RBC requirements in future years, even under adverse conditions. International best practice is to require the actuary of each entity to perform stress tests at least annually. The primary benefit of such a requirement is to assist those responsible for running an entity to better manage its risks, but the results are usually also reported to the supervisory authority. Although all life insurers and MBAs are required to have actuaries and some might already be doing stress testing, it would be appropriate to provide at least a few years' notice before imposing a general requirement. In the meantime, it is recommended that stress testing be required as part of the capital planning of those entities subject to intervention because of low RBC ratios.

The Insurance Code should be amended, if necessary, to permit the disclosure of the RBC ratios of individual entities by the Insurance Commission. After a reasonable period of notice, such as three years, the Insurance Commission should disclose RBC ratios along with the other financial information that it already discloses. This will provide useful

information to policyholders and investors, allowing market discipline to contribute to the maintenance of adequate levels of capital.

As already noted, the margin of solvency requirements largely, in theory, became redundant with the implementation of RBC requirements. Therefore, it is recommended that the solvency regime be simplified by amending the Insurance Code to replace the margin of solvency requirements with the RBC requirements (at the 50%, authorized control level).

However, before doing so, it is recommended that an analysis be performed of the financial situations of entities whose RBC ratios exceed 125%, but which nevertheless fail to meet the margin of solvency requirements. Based on the results of this analysis, it might be necessary to modify the RBC requirements to ensure that they are adequately identifying entities whose solvency is at risk.

### ***Other Issues***

Penalties are imposed for the late filing of certain regulatory returns. However, the Insurance Commission has indicated that late filing is not uncommon and that financial information is often revised, in some cases significantly, as a result of their review.

It is recommended that regulations provide for meaningful monetary penalties for the late filing of returns and for the filing of erroneous returns. Experience elsewhere has shown that this can produce significant improvements in the timeliness and quality of information available to the supervisory authority.

It is recommended that supervisory databases be enhanced to facilitate easier analysis of insurance entities, including those engaged in microinsurance. Data should be validated upon receipt and the most up-to-date and correct data should be retained in the database and used for analysis. Various ratios should be calculated for each entity and compared both from year-to-year and against the ratios of peer groups of entities. Normal ranges should be established for each ratio, with results outside those ranges triggering further investigation.

For example, in the course of this review, the following ratios were calculated for the MBAs<sup>8</sup>:

- Guaranty fund to liabilities
- Equity to liabilities
- Net investment income to assets
- Net income to assets
- Underwriting income to equity
- Net income to equity
- Underwriting expense to underwriting income
- Net investment income to underwriting income
- Operating expense to underwriting income

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<sup>8</sup> A spreadsheet with the results of the analysis will be provided separately to the Insurance Commission.

- Other income to underwriting income
- Net income to underwriting income
- Assets per certificate
- Underwriting income per certificate
- Operating expense per certificate
- Amount of insurance per certificate
- Underwriting income per 1,000 pesos of insurance.

It is recommended that steps be taken to encourage the growth of nonlife microinsurance. This might include reducing the taxation of nonlife insurance, to make formal insurance more attractive relative to informal insurance. It might also include allowing the establishment of MBAs devoted solely to underwriting nonlife microinsurance.

### ***Next Steps***

It is recommended that the following steps be taken to deal with the recommendations contained in this report:

- The Core Coordinating Group for MIPSS reviews the report and reaches agreement in principle on major recommendations, including any modifications considered necessary;
- The Insurance Commission performs a detailed review and further analysis in relation to the technical aspects of the recommendations;
- The Insurance Commission and Ministry make policy decisions regarding the recommendations to be adopted, subject to stakeholder consultation;
- All relevant stakeholders are consulted;
- Further analysis is performed and the policy proposals are revised, as necessary;
- Regulations are drafted to implement the finalized policy;
- Other implementation-related activities are performed, such as revising reporting forms, training of supervisory staff and informing the entities; and
- Depending on the extent of the changes that are made, transition periods—or testing the new regime over a year-end—might be appropriate.

As previously mentioned, these steps should be integrated with the review of RBC requirements that is already underway.