# IMPLEMENTATION GUIDANCE ON ICAAP GUIDELINES

This document supplements the Guidelines on Internal Capital Adequacy Assessment Process (ICAAP) for Insurers[1] by clarifying the interpretation and rationale for key paragraphs of the ICAAP Guidelines and addressing anticipated issues likely to be faced by insurers in implementing ICAAP. It is not meant to introduce any requirements in addition to the ICAAP Guidelines. Rather, it is intended to provide non-exhaustive guidance to insurers on how to meet the requirements of the ICAAP Guidelines. In any case, insurers should exercise sound judgement in demonstrating compliance with the principles and standards contained in the ICAAP Guidelines. This document will be periodically updated to address new issues that emerge, or clarify existing guidance, where necessary.

[1] BNM/RH/GL/003-XX "Guidelines on Internal Capital Adequacy Assessment Process (ICAAP) for Insurers" (henceforth referred to as the ICAAP Guidelines).

## PART A OVERVIEW

1. The ICAAP Guidelines takes effect 1 September 2012. By this date, insurers are expected to have in place appropriate policies and procedures, supported by proper documentation and systems to enable effective on-going implementation of ICAAP. This implementation date takes into account the fact that insurers are already carrying out the various elements of the ICAAP as per the RBC Framework (RBCF) that has been in effect from 1 January 2009 but also recognises the fact that the ICAAP Guidelines outlines the Bank's expectations in greater detail. Hence, a period of 6 months is provided from the date of issuance for insurers to close any gaps in current practices against the expectations set out under the ICAAP Guidelines. The ICAAP Guidelines also seek to clarify the Bank's expectations with regard to the individual target capital levels (ITCL) and capital management plans of insurers, drawing from observations made during the Bank's supervisory reviews of insurer's practices. This in turn will contribute towards more effective engagements between the Bank and insurers under the supervisory review.

## PART B INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

2. Paragraph 7.1 of the ICAAP Guidelines requires insurers to have a process in place to assess the nature and extent of an insurer's risk profile and quality of risk management. Insurers may build on existing components of its risk management processes, specifically in areas pertaining to risk identification and measurement, and make enhancements where necessary. In particular, the assessments will need to be at an adequate level of detail to support identification of significant adverse scenarios that will be used in stress testing and determination of ITCL level.

3. Paragraph 7.1 of the ICAAP Guidelines also requires insurers to assess whether the RBC Framework adequately capture their own company specific risk profile and quality of risk management. Insurers will therefore need to assess if their risk profile is not adequately provided for under the RBC Framework. This may include a consideration of:

(a) Risks that are attributed to the specific nature of an insurer's business activities including the marketing of products with special features (e.g. investment-linked with capital guarantees or medical & health insurance with no lifetime limits) or

(b) Risks that are associated with a specialised target market (e.g. specialised risks under fire business) or

(c) Risks that are not explicitly captured under the RBCF such as:

i. Business-related risks

- Strategic risk, i.e. risk of losses resulting from strategic initiatives, e.g. merger and acquisitions, expansions, etc.
- Reputation risk, i.e. risk of loss of business volume after an event that damages the reputation of the insurance company.
- Business risk, i.e. risk arising from changes in the insurance company's businesses, including the risk that the insurance company may not be able to carry out its business plan and desired strategy, for example, earnings shortfall due to a fall in business volumes.

ii. Liquidity-related risks

- Asset liquidity risk, i.e. the exposure to loss in the event that insufficient liquid assets will be available, from among the assets supporting the policy obligations, to meet cash flow requirements of the policyholders obligations when they are due. Losses due to liquidity risk can occur when a company has to borrow unexpectedly or sell assets for an unanticipated low price, or due to the inability to dispose assets at the prevailing market price due to the lack of depth in the market.

iii. Catastrophe risk

- Risk of losses that potentially arise due to severe epidemic, natural catastrophe, terrorist attack, etc.

4. These risks should be factored into the ITCL, whether through stress tests or as a direct adjustment to the ITCL so that it captures the additional capital that should be held in excess of total capital required (TCR) under RBC. In most cases, a reasonable attempt at quantification of key risks is necessary, rather than just using

qualitative tools such as scorecards. This is so that the risk assessment can be used to support other components of the ICAAP, for example to guide the parameterisation of adverse scenarios for stress testing. The approach to quantification should reflect the complexity and significance of the risk category. For example, liquidity risks confined to a well defined block of investment-linked policies can be referenced to the funding cost for a credit line sufficient for adverse levels of withdrawals, whereas catastrophe risks may require detailed analysis of individual contracts across a range of policyholders and classes of business to identify any accumulation of exposures.

5. Paragraph 9.1 of the ICAAP Guidelines requires stress testing conducted under ICAAP to meet the standards of the Stress Testing Guidelines. In particular, key components highlighted in the Guidelines on Stress Testing that are relevant to stress testing under the ICAAP are:

(i) The stress test should be comprehensive enough to capture the business of the insurer;

(ii) Plausible adverse scenarios selected for stress testing should be events with a probability of occurrence that is not too remote and have a significant impact on the financial position[2];

(iii) Stress testing must cover sensitivities to single factors as well as scenarios of multiple risk factors, taking into account any second round effects; and

(iv) The magnitude of stress should be greater than the potential losses over one business or economic cycle.

Insurers will need to consider where they are in the business or economic cycle in deriving stress scenarios, although some degree of prudence will need to be applied if this results in a reduction of the severity of the stress.

6. Paragraph 9.1(ii) of the ICAAP Guidelines states that stress testing should be applied on the ITCL instead of the actual capital level when stress testing to determine the ITCL. This requires hypothetical financial positions to be used as base scenarios to be stressed and iteratively adjusted until a suitable level that meets the

[2] Please refer to Appendices 1 and 2 of the Guidelines on Stress Testing for examples

requirements of an ITCL is found, as stated in paragraph 8.1 of the ICAAP Guidelines. Care must be taken to ensure that the financial position for the base scenario tested is realistic, even though hypothetical, to ensure that the test is meaningful since this is the position on which the stress will be applied to derive the changes to the CAR. For example, an insurer with current CAR of 300% that wants to test a base scenario of 200% will need to adjust its actual balance sheet to arrive at a hypothetical balance sheet that has a CAR of 200%. Such a balance sheet might be arrived at if the level of retained profits is reduced through dividend payments or level of unearned premium is increased due to higher new business growth.

7. Paragraph 9.2 of the ICAAP Guidelines requires assumptions underlying the stress test to be realistic and consistent. Scenarios should reflect prudent assumptions of new business such that the projected rates of business growth or profitability are consistent with expectations under adverse scenarios. Planned business activities, such as expansion of business or mergers and acquisitions, should take into account operational costs and other risks arising from such activities.

8. Paragraph 9.3 of the ICAAP Guidelines addresses the process of generating and selecting adverse scenarios for stress testing. Insurers should use a wide range of tools for scenario planning e.g. Balanced Scorecard, Delphi methods, SWOT analyses and other types of stakeholder analyses. The scenarios selected should be the ones with the most significant impact on the insurer. For simulation methods, the scenarios will need to be selected with reference to a specified risk measure that is applied to the determination of ITCL, for example, a 10% probability of breaching supervisory target capital level over three-year horizon. It is also crucial to identify a range of potential scenarios with similar levels of severity but with different combinations of significant risk categories as they might necessitate different types of corrective actions under the CMP. Scenarios should cover events that result in sudden shock to the business as well as those that have a more lasting impact over the projection period. Where necessary, benchmark data from external sources such as reinsurers, brokers and industry databases may be used to validate or supplement internal data.

9. Paragraph 10.6(i) of the ICAAP Guidelines requires the CMP to specify thresholds for corrective actions. There should be at least one threshold above the supervisory target level of 130% and at the ITCL to ensure that corrective actions pre-empt any breaches of these levels. Other factors which are directly related to capital deterioration or are leading indicators of risk should be considered in addition to just using CAR levels as thresholds.

10. Paragraph 10.6(ii) of the ICAAP Guidelines requires the CMP to state specific corrective actions. Corrective actions may include reducing the level of inherent risk (for example, de-risking of the asset or liability portfolio) or increasing the capital available (for example, recapitalisation exercise or capital injection from shareholders). The actions must be realistic in the context of the adverse scenarios. For example, a capital transfer from a parent company might not be possible if the parent company's solvency is similarly impaired in the adverse scenario tested or prospects for recapitalisation through rights issues might be severely limited in a recession.

11. Paragraph 11.3 of the ICAAP Guidelines requires scheduled independent reviews. Comprehensive reviews every 3 years would be reasonable if there are no changes to the usual business/operating environment. This should be supplemented by additional reviews triggered by monitoring activities of the insurer. Insurers should update the Bank on a timely basis the outcome of any internal or external reviews conducted on ICAAP.

## PART C SUPERVISORY REVIEW AND EVALUATION

12. *Figure 1* is an illustration of the supervisory review process of ICAAP. The frequency and scope of the Bank's review of an insurer's ICAAP may vary for each insurer, depending on other information available to the Bank from its supervisory activities. Information gained from other areas of Risk-based Supervisory Framework (RBSF) will inform the Bank's expectations for and be considered in the Bank's assessment of an insurer's ICAAP. The approach used by the Bank in reviewing ICAAP will be similar to other reviews under RBSF, thus will consist of a combination of off-site and on-site reviews, in addition to regular discussions with board and senior management, and any external parties involved in an insurer's ICAAP.

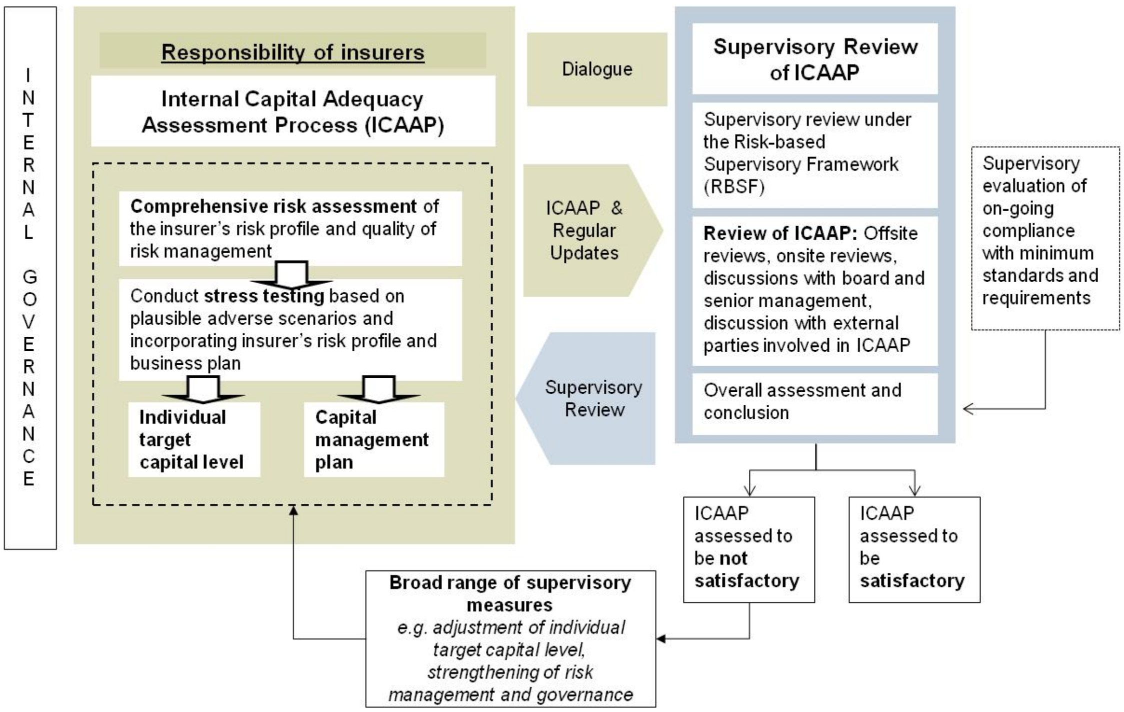


*Figure 1. Supervisory review process of ICAAP*

13. The adequacy of an insurer's ICAAP will be a key determinant in the Bank's assessment of whether an adjustment is required to the insurer's ITCL. The main criteria in assessing the adequacy of ICAAP are as follows:

(i) Adherence to the principles and standards laid out in the ICAAP Guidelines;

(ii) Adequacy of documentation as evidence to demonstrate that the insurer's ICAAP fulfils the requisite principles and standards; and

(iii) Degree of integration of components of the ICAAP with the insurer’s operations and business planning process.

The third criterion is important to ensure that the conclusions from the ICAAP are realistic and reliable, since a high degree of integration will ensure that the components of the ICAAP are current and robust. A high degree of integration will be evidenced by robust feedback loops between ICAAP and other activities such as business planning, investment management, capital allocation, reinsurance planning and setting risk tolerance limits.