CONSULTATION PAPER

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Proposed Modifications to Regulatory Requirements for Trade Credit & Political Risk Insurance Business

MAS

Monetary Authority of Singapore

PROPOSED MODIFICATIONS TO REGULATORY REQUIREMENTS FOR TRADE CREDIT & POLITICAL RISK INSURANCE BUSINESS

PREFACE

1.1 Trade credit insurance protects against the risk of non-payment of buyers and importers, while political risk insurance protects against losses from operations as a result of adverse political developments. To date, both trade credit and political risk insurance remain specialised businesses that are largely written by a few specialist insurance companies in Singapore.

1.2 The Risk-Based Capital ("RBC") framework for insurers which was implemented on 1 January 2005 prescribes specific capital requirements that insurance companies have to maintain in respect of trade credit and political risk insurance (TCP) businesses. Recognising the specialised nature of such businesses, MAS recently conducted a further review of the existing regulatory requirements in order to better capture the underlying risks of conducting such businesses.

1.3 This consultation paper sets out the issues considered by MAS under the review. In the course of the review, references were also made to the regulatory requirements imposed on TCP business in other jurisdictions. The review proposes revisions to the C1 (insurance risk) requirements for TCP business as well as the amount and nature of contingency reserves which insurance companies have to establish in respect of this business line.

1.4 MAS invites interested parties to submit their views and comments on the proposed revisions outlined in this consultation paper. Electronic submission is encouraged. Written comments should be submitted to:

Insurance Supervision Department
Monetary Authority of Singapore

10 Shenton Way
MAS Building
Singapore 079117
Fax : (65) 6-229 9694
Email : tcpr_ins06@mas.gov.sg

All comments should be submitted to MAS by 1 December 2006.

1.5 Please note that all submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

TABLE OF CONTENTS

		Page
PREFACE		1
1	**Requirement for Contingency Reserves**	
1.1	Issues for Consideration	4
1.2	Proposed Revisions	5
2	**C1 (Insurance Risk) Requirements for TCP Business**	
2.1	Issues for consideration - Onshore & Offshore Insurance Business	6
2.2	Proposed Revisions	7
2.3	Issues for consideration - Impact of Contingency Reserves	7
2.4	Proposed Revisions	8
3	**Implementation of the Proposed Revisions**	8

1 REQUIREMENT FOR CONTINGENCY RESERVES

1.1 Issues for Consideration

1.1.1 Contingency reserves are reserves set aside by insurance companies to cover catastrophic losses or sharp volatility in loss experience. They are commonly set aside for classes of business where the frequency of losses is low, but should a loss occur, the severity is likely to be high. In the case of TCP business, contingency reserves are necessary to buffer potential surges in loss experience caused by widespread default on accounts receivables arising from cyclical economic downturns or adverse political developments.

1.1.2 Under existing MAS requirements, insurance companies are specifically required to establish contingency reserves in respect of each insurance fund where TCP business is written. These requirements state that the amount to be transferred to contingency reserves in respect of each insurance fund at the end of each accounting period is the higher of:

i. 12% of the net premiums written during the year; or
ii. 50% of the underwriting profit earned during the year in respect of such insurance.

The existing requirements also state that such annual transfers to the contingency reserves shall continue until the reserves reach 400% of the highest amount of net written premiums in respect of such insurance in the current and previous two years. When the net claims paid in any year exceed the net premium income for that year, the insurer is permitted to draw down on its contingency reserves an amount equal to the difference between the two items.

1.1.3 Under the current requirements, an insurance company writing TCP business is permitted to draw down on its contingency reserves only when actual

claims paid exceed net premium income in the year. The insurer is not permitted to draw down on contingency reserves based on premiums earned and claims incurred, although these provides a more accurate indication of the actual experience of the business line.

1.1.4 In addition, MAS also recognises that insurance companies which write TCP business may have in place actuarial valuation systems with parameters built-in to specifically reflect the contingent risk of widespread claims arising from a cyclical economic downturn or adverse political event. Consequently, such insurance companies already have their own 'contingency' reserves established in the course of their actuarial reserving processes. Presently, MAS' requirement that all insurance companies should establish *separate* statutory contingency reserves using the formula described in paragraph 1.1.2 above does not recognise that such contingency reserves may have already been provided for by the insurance companies.

Proposed Revisions

1.1.5 To address the issues highlighted above, MAS proposes that:

a) Transfers out of contingency reserves will be permitted when net claims *incurred* exceed the net premiums *earned* for that particular year. The amount that can be transferred out should not exceed the difference between the two items; and

b) Where an insurance company has established contingency reserves in the course of its actuarial reserving process, such contingency reserves can be counted towards meeting the statutory contingency reserve requirement imposed by MAS, provided that:

(i) The amount of such contingency reserves is established over and on top of case reserves and reserves for incurred but not reported claims (IBNR); and

(ii) Where the amount of such contingency reserves is below that stipulated by the statutory requirement, the insurance company is required to top up with additional contingency reserves to make up the difference between the two items.

2 C1 (INSURANCE RISK) REQUIREMENTS FOR TCP BUSINESS

2.1 Issues for Consideration – Onshore and Offshore Insurance Business

2.1.1 The C1 requirements in respect of TCP business are set out in the Insurance (Valuation & Capital) Regulations 2004. Specifically, Table 5 of the Sixth Schedule in the Regulations sets out volatility categories for TCP business written from the Singapore Insurance Fund (SIF) and Offshore Insurance Fund (OIF) respectively. TCP business written from the SIF is presently assigned a "Medium" volatility category while that written from the OIF is assigned a "High" volatility category. Such volatility categories translate into the following C1 risk factors for TCP business:

Table 1: C1 Risk Factors for TCP Business

TCP Risk Factors	SIF	OIF
Premium Liability	130%	136%
Claim Liability	125%	130%

2.2 The distinction between the risk factors for TCP business written from the SIF and OIF was originally derived from statistical analyses performed on the loss experiences of insurance companies in Singapore over a period of time. Following our recent review, it was noted that the difference in results derived for the SIF and OIF in the original analyses had been largely due to the classification adopted for the raw data, rather than a real difference in the actual loss

experiences between the SIF and OIF portfolios. Also, given the international nature of the underlying trade export business, there is no strong basis to presume that TCP risks assumed from offshore insureds are inherently more risky than those assumed from local insureds because both could be transacting business with similar counterparties. Essentially, the insurance TCP risk factors should capture the business risk of the underlying trade export transaction itself, and should not be affected by whether the insured is located in Singapore or overseas.

2.2 Proposed Revisions

2.2.1 Following from the above, MAS proposes that the volatility category for OIF business be revised from "High" to "Medium" in alignment with the SIF. This means that the C1 (insurance risk) factors for SIF and OIF business in respect of TCP business would now be as follows:

Table 2: Revised C1 Risk Factors for TCP Business

TCP Risk Factors	SIF	OIF
Premium Liability	130%	130% (from 136%)
Claim Liability	125%	125% (from 130%)

2.2.2 The alignment of the volatility category between SIF and OIF business would also bring the C1 (insurance risk) factors for TCP business in Singapore down to a level that is more comparable with that imposed by regulatory authorities in other jurisdictions.

2.3 Issues for Consideration – Impact of Contingency Reserves

2.3.1 Presently, insurance companies writing TCP business are required to establish both contingency reserves as well as specific C1 (insurance risk) requirements. As mentioned earlier, contingency reserves for TCP business are established to buffer against catastrophic losses or sharp volatility in loss experience brought about by cyclical downturns in the economy. To this end,

contingency reserves bear certain characteristics of capital resources and share the same function as C1 (insurance risk) requirements under the RBC framework.

2.3.2 MAS is mindful that the regulatory requirements imposed on insurance companies operating in Singapore should not be unduly burdensome in terms of compliance costs, provided that prudential considerations are not compromised. Given that contingency reserves serve the same function as capital resources to a certain extent, MAS is prepared to allow contingency reserves to be recognised as capital to a limited extent for compliance with regulatory capital requirements.

2.4 Proposed Revisions

2.4.1 Following from the above, MAS proposes that up to 50% of the C1 (insurance risk) requirements to be maintained by insurers in respect of a particular insurance fund can be met using no more than 50% of the contingency reserves set aside in that fund. The following table provides a detailed illustration on how this may be applied.

Table 3: Illustration on the Offsetting of C1 Requirements Using Contingency Reserves

	Insurance Risk Requirement (C1) **[a]**	Contingency Reserves (CR) **[b]**	Amount of CR permitted to offset C1 **[c] = 50% x [b]**	Net Amount of C1 **[d] = [a] – [c]**
SIF business	S$1,000,000	S$600,000	S$300,000	*S$700,000
OIF business	S$1,200,000	S$1,400,000	S$700,000	**S$600,000

** Full amount of 50% of CR that may go toward offsetting C1*
***Amount of CR that may go toward offsetting C1 capped at 50% of C1 = S$600,000*

3 IMPLEMENTATION OF THE PROPOSED REVISIONS

3.1 MAS will assess the views and comments received from interested parties in determining the final revisions to the existing regulatory requirements for TCP business. The final revisions will be incorporated as amendments to the Insurance (Valuation & Capital) Regulations 2004.

Monetary Authority of Singapore