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Singapore: RBC 2 review – Second Consultation

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The much anticipated second consultation on the proposed changes to the existing risk-based capital (RBC) framework, commonly dubbed as RBC 2, was announced by the Monetary Authority of Singapore (MAS) at the end of March 2014. This consultation paper sets out more specific proposals following the first consultation in June 2012 and takes into account the feedback received from the industry to that consultation as well as introducing some new proposals. As part of this announcement, the MAS has also released detailed technical specifications based on which insurers are expected to conduct the first quantitative impact study (QIS 1) to assess the impact of the proposals in the consultation paper.

The deadline for providing feedback and submitting the results for the QIS1 is 30 June 2014. The MAS intends to finalise the proposed changes to the RBC framework by the end of 2014 and implement the RBC 2 requirements (with the exception of certain general insurance risk requirements) from 1 January 2017. In the meantime, the MAS expects a third round of consultation on the RBC 2 proposals and a second quantitative impact study, also in 2014.

1. Risk free discount rate and matching adjustment

There are no significant changes to the valuation of assets and liabilities except for changes proposed to the risk free discount rate and the introduction of a matching adjustment. The MAS has proposed to phase out the long term risk free discount rate (LTRFDR) for SGD denominated liabilities of 30 years or greater over a period of five years. The five-year period has been chosen to reflect the time period that MAS expects the market for 30-year Singapore Government Securities (SGS) to become more liquid. For liabilities which have duration of less than 20 years, the SGS yield of the matching duration will be used. Those insurers who have implemented an effective cash flow hedge and are making use of the practice permitted under MAS 319 of discounting the liabilities using the SGS yield curve will be allowed to continue this practice during the transition period, at the end of which the RBC framework will have become aligned with the practice in MAS 319.

The MAS has proposed a matching adjustment to the risk free discount rate in place of an illiquidity premium adjustment which was proposed in the previous consultation. The matching adjustment requires ring fencing a portfolio of predictable liabilities and a matching portfolio of high quality bonds. The matching adjustment will equal the spread movement of the ring fenced assets that is not related to default or downgrade. The MAS will publish the spreads deemed to be in respect of default and downgrade.

2. Solvency intervention levels

In line with what was proposed in the first consultation, MAS has set out two triggers for supervisory intervention—prescribed capital requirement (PCR) and minimum capital requirement (MCR). The PCR refers to the total risk requirements which correspond to a value at risk of 99.5% confidence level over a one-year period, whereas the MCR refers to the value at risk of 90% confidence level over a one-year period. Both PCR and MCR will be applicable at both the company level and at an insurance fund level.

3. Components of required capital

The risk requirement will continue to be calibrated under the standardised approach using stresses as prescribed by the MAS. The key changes to the existing framework for the components of required capital include:

- **C1 risk requirement (insurance risk requirement**): An additional requirement called insurance catastrophe risk requirement (for both life and general business) will be included; C1 life insurance risk requirement will be split into various components and extended to also cover conversions of option risk requirement.

- **C2 risk requirement (market risk requirement)**: A new credit spread risk requirement and interest rate mismatch risk requirement will be introduced to replace the existing C2 debt requirement; the interest rate mismatch risk requirement will be based on stressing the assets and liabilities upwards and downwards using a same prescribed set of interest rates while an explicit C2 counterparty default risk module will be introduced to address the credit risk requirement. There is a significant increase in the proposed risk charge factor for equities from 16% under the new framework to 40% (for most equity classes).

- **C3 risk requirement (concentration risk requirement)**: No changes currently proposed.

- **C4 risk requirement (operational risk requirement)**: A new “C4 risk requirement” will be introduced to cover operational risk. The computation of this requirement is based on a simple formula prescribed by the MAS subject to a cap of 10% of the total risk requirements.

Diversification benefits: There will be an explicit allowance for diversification benefits within the C1 risk charge calculation for certain risks. In addition, the C1 and C2 risk requirements will be combined as a diversified sum. The C2 risk requirement will not benefit from a diversification adjustment as the MAS states it has already calibrated the various stress tests to make an allowance for diversification within these financial risks. There will also be a company level diversification offset in respect of the interest rate risk under C2 across the insurance funds (excluding the participating fund).

4. Available capital

The MAS has proposed various changes to the renaming and reclassification of capital in order to align the existing framework with that applying to banks.

5. Financial resources

The key change proposed to the financial resource calculation is the inclusion of a portion of the negative reserve component as a positive regulatory adjustment when determining the financial resources at the insurance fund level. The amount of negative reserves to be included in this adjustment will vary by the type of business—25% for investment linked and 50% for all business other than investment linked. The percentages will apply to the negative reserves after allowing for the RBC2 insurance shocks. The MAS has also indicated changes to reinsurance adjustment calculations as per the consultation paper entitled “Proposed framework for reinsurance management” issued in June 2010.

6. Use of internal model

While the MAS proposed to allow for the use of internal models in the first consultation paper, in view of the resources required and the likely time to grant approval for such models, the MAS has indicated that they will only allow for the use of internal models at a later stage, after the implementation of the standardised approach.

Observations/Implications

Valuation of liabilities

The removal of the LTRFDR may have two effects: (1) reduce volatility in the balance sheet for companies where assets and liabilities are well matched; (2) increase the volatility in the balance sheet for companies where assets are significantly shorter than liabilities due to limited supply of long term debt securities.

The matching adjustment mechanism has been introduced instead of the illiquidity premium to reduce basis risk and to track credit spread movements more accurately. However, this methodology is more complex to compute and as was the case with the illiquidity premium, it remains to be seen which product classes (besides annuities) will benefit from this treatment.

Solvency requirements

Certain risk charges under the proposed framework are significantly higher than under the existing framework, namely the equity risk charges and the morbidity risk charges. The new credit spread risk requirement is also expected to be higher than what is held for the debt specific risk requirement under the current regime.

On the other hand, there will be some offsetting impacts from the potentially lower mortality risk charges (removal of references to standard mortality tables) and the diversification benefits (albeit limited) proposed under the new regime. Also, positive financial resource adjustment for negative reserves could potentially be fairly significant for some companies.

The block of business likely to be adversely affected by the changes to the solvency requirements will be participating business with long dated liabilities and high equity investment as the combined effect of the removal of LTRFDR and the increase in equity risk charges could increase the guaranteed liabilities and C2 risk requirements quite substantially. However, this will be offset with the introduction of diversification factors.

Conclusions

Overall, the second consultation of the proposed revisions to the existing RBC framework is not vastly different to the existing RBC framework. In terms of implementation, we do not foresee any material issues except possibly the application of the matching adjustment but even that may potentially have limited applicability for most insurers. The overall financial impact of these proposals will become clearer after the results of the QIS 1 are released later this year.

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