CONSULTATION PAPER NO.134

PROPOSED SOLVENCY REGIME FOR CAPTIVE INSURERS

5 NOVEMBER 2020

PREFACE

Why are we issuing this Consultation Paper?

1. This Consultation Paper (CP) seeks public comment on the Dubai Financial Services Authority's (DFSA's) proposals to make amendments to the current solvency regime applicable to Captive Insurers in order to provide more proportionate regulation for this sector.

Who should read this CP?

2. These proposals will be of interest to Insurers, Insurance Intermediaries, Insurance Managers, foreign Insurers conducting insurance activities in or from the Dubai International Financial Centre (DIFC), applicants for licences as Insurers, Insurance Intermediaries or Insurance Managers, as well as to other industry participants, including the users of the services offered by persons referred to above.

Terminology

3. Defined terms have the initial letter of the word capitalised, or of each word in a phrase. Definitions are set out in the Glossary Module (GLO) of the DFSA Rulebook. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

4. Please send any comments using the online response form. You will need to identify the organisation you represent when providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish your comments to remain confidential, you must expressly request so at the time of making comments, and give your reasons for so requesting. The deadline for providing comments on this consultation is **4 January 2021**.

5. Following the public consultation, we will proceed to make the relevant changes to the DFSA Rulebook as appropriate to reflect points raised in the consultation. You should not act on the proposals until the relevant changes are made. We will issue a notice on our website when this happens.

Structure of this CP

Part I:	Background
Part II:	Proposals for a new solvency regime
Part III:	Additional and consequential issues
Appendix 1:	Draft amendments to PIN Module
Appendix 2:	Draft amendments to GLO Module
Annex 1:	Questions in this Consultation Paper

Part I: Background

Objective of this CP

6. Since the introduction of the DFSA solvency regime for the insurance sector in 2003, the market in the DIFC has grown significantly, becoming home to a heterogeneous population of (re)insurance firms, including captive insurers ("captives"), insurance intermediaries and managers.

7. Despite having a radically different risk profile in comparison to commercial (re)insurance firms, captives in the DIFC have traditionally been subject to an equal solvency regime set out in the Prudential – Insurance Business Module (PIN) of the DFSA Rulebook.

8. The solvency regime in PIN, which was initially developed based on a credit rating model used by rating agencies, introduced qualification criteria for capital resources and Minimum Capital Requirement (MCR) calculated as a sum of various risk components.

9. The regime has met its policy objective well for commercial (re)insurance firms, but its application to DIFC captives has resulted in many waivers and modifications in order to apply the regime more appropriately. It has become evident that the current solvency regime needs an update in order to recognise the limited nature, scale and complexity of the captive insurance model.

Captive insurance model

10. Captive insurance is a form of self-insurance for organisations seeking effective and flexible solutions to manage risk. A parent entity of a captive is usually a large corporation exposed to risks that are difficult to insure in the most cost-effective manner.

11. However, lower insurance premiums are not the only advantage of running a captive. Captives can provide greater flexibility in insuring hard-to-place risks, capturing underwriting profits, gaining direct access to cross-border reinsurance markets, optimising risk retention strategies, and obtaining (where relevant) tax benefits.

12. There are approximately 7000 captives globally, most of them established by parent entities from North America and Caribbean (54%), Europe (11%), Asia (12%), and Middle East and Africa (18%).[1] More than 90% of Fortune 500 companies have captive vehicles, while the market is seeing increasing interest from mid-sized firms due to relatively low entry barriers.[2]

Captive insurers in the DIFC and the region

13. The DFSA is the regulator of several captives operating in and from the DIFC. With the hardening of international insurance markets, there is a tendency for large businesses to self-insure via captives by employing risk retention strategies. This global sentiment has resonated in the DIFC as well, where the DFSA's role includes providing an effective regulatory platform for insurance operations.

14. As for the region, the number of captives owned by Middle Eastern parent entities has increased by 33% over the last 5 years,[3] while parent entities from the region are leading

[1] Aon (2019), Global Risk Management Survey
[2] Chubb (2018), Emerging Global Challenges for Captives
[3] Marsh (2019), The Captive Landscape

globally in their intent (8% of respondents) to establish a captive.[4]

Current capital requirements for DIFC captives

15. Captives are defined as DIFC Incorporated Insurers, categorised as Class 1, Class 2 and Class 3, depending on the extent of their permission to underwrite third-party business.[5] Captives must at all times meet a MCR, which is equal to or higher than the amounts as follows:[6]

Class 1 (USD 150,000) “pure” captive	Licensed to effect or carry out Contracts of Insurance only in respect of risks related to or arising out of the business or operations of the Group, including only contracts of reinsurance.
Class 2 (USD 250,000) “diversified” captive	Licensed to obtain at least 80% of its Gross Written Premium in any year from Contracts of Insurance in respect of risks related to or arising out of the business or operations of the Group, including only contracts of reinsurance.
Class 3 (USD 1,000,000) “mutual” captive	Licensed to effect or carry out Contracts of Insurance only in respect of risks related to or arising out of the business or operations of persons who engage in similar, related or common: (i) businesses; (ii) activities; (iii) trade; (iv) services; (v) operations, including only contracts of reinsurance; and are owned by such persons or by a Body Corporate of which all such persons are members.

16. MCR is a risk-based measure, which is dependent on the types, volumes and other characteristics of the captive operation, leading to a sum of the following risk components:[7]

DRC	Default risk component
IVRC	Investment volatility risk component
OARC	Off-balance sheet asset risk component
OLRC	Off-balance sheet liability risk component
CRC	Concentration risk component
SFAC	Size factor adjustment component
URC	Underwriting risk component
RRC	Reserving risk component
LIRC	Long-term insurance risk component

4 Aon (2019), Global Risk Management Survey
5 GLO Module
6 PIN Rule A4.2.3
7 PIN Rule A4.2.1

AMRC	Asset management risk component

Need for proportionate application of the solvency regime

17. The question addressed by the DFSA in this CP is whether the existing solvency regime, which has been in place since 2003, remains fit for purpose for captive insurers.

18. The DFSA has come to realise that the solvency regime is not fully appropriate for captives and needs to be commensurate to the nature, scale and complexity of the captive insurance model. Disproportionate application of the solvency regime is not purely a theoretical discussion. As of today, the DFSA has granted numerous waivers and modifications to authorised captives in order to apply the regime appropriately.

19. As recommended by the Financial Stability Institute (FSI),[8] jurisdictions implementing the Insurance Core Principles (ICP) of the International Association of Insurance Supervisors (IAIS) in their framework are expected to apply proportionality, where the criteria for identifying insurers subject to a simplified solvency regime are the size, risk profile, complexity of business, and policyholder types. Moreover, in applying proportionality, the IAIS[9] encourages insurance supervisors to recognise that regulatory risk inherent in a captive may vary substantially, which should inform the required level of supervisory scrutiny.

20. Captives do not pose the same level of risk to markets as commercial (re)insurance firms do. The objective is to insure the risks of the parent entity, with no third-party policyholders usually involved. The entire risk is allocated among entities within a closed and related ecosystem, where the parent entity is exposed to a deductible (unless also insured), while the captive takes on risk retention (the remaining risk is reinsured). Where a captive decreases its “purity” by incorporating third-party business into its business model, the applicable capital requirements become higher to provide better protection for potential policyholders other than the parent entity.

Overview of the proposals

21. In line with the DFSA’s risk-based regulatory approach, the proposals in this CP are designed to make the solvency regime for captives more proportionate to their business models and risk profiles.

22. The key aspects of the proposals are:

    a. amending definition of Class 2 Captive Insurer – Proposal 1;

    b. simplifying MCR calculation for Class 1 Captive Insurer – Proposal 2;

    c. simplifying MCR calculation for Class 2 and Class 3 Captive Insurer – Proposal 3;

    d. revising URC calculation methodology – Proposal 4;

    e. revising RRC calculation methodology – Proposal 5;

    f. clarifying regulatory treatment of intra-group loans – Proposal 6;

    g. clarifying DRC and IVRC treatment of Money Market Funds – Proposal 7; and

    h. amending submission rules for actuarial reports – Proposal 8.

[8] FSI (2018), Proportionality in the Application of Insurance Solvency Requirements
[9] IAIS (2015), Application Paper on the Regulation and Supervision of Captive Insurers

Part II: Proposals for a new solvency regime

Principles underlying our proposals

23. When designing our proposals, we sought to:

   a. limit regulatory disruption by introducing minimal changes to the structure and contents of the DFSA Rulebook in a way that achieves the desired proportionality in the application of prudential requirements;

   b. align our proposals with the concepts of the 2015 IAIS Application Paper,[10] as the primary source of official guidance on regulation and supervision of captives;

   c. adhere to best practices observed in domiciles with long-standing captive insurance sectors;[11] and

   d. consider the impact of our proposals on capital requirements of DIFC captives and on the current status of their waivers and modifications.

Proposal 1 – Amending definition of Class 2 Captive Insurer

24. Under the current regime, a captive wishing to include non-Group business into its insurance model is limited to the choice of seeking a licence for either a Class 2 or Class 3 Captive Insurer. In the case of the former, premiums written to third parties outside of the Group must be capped at 20% of the captive's Gross Written Premium. In the case of the latter, third parties must be in the same business (industry, sector, etc.) as the Group and hold ownership in the captive either through common membership of an association or by direct equity stake.

25. The current classification of captives does not allow sufficient flexibility to allow market entry of captives whose insurance arrangements may include a higher percentage of business with third parties that are outside of the Group but share similar risks and/or have common economic interests arising by way of business from their commercial activities with the Group (e.g. joint venture partners, vendors, clients, employees).

26. To provide greater flexibility, we consider that it is appropriate to:

   a. require that a Class 2 Captive Insurer writes at least 51% of its Gross Written Premium to the Group, being permitted to use its remaining capacity to underwrite business for third parties, which are engaged by way of business in a commercial activity with the Group;

   b. define the scope of third parties who are to be treated as engaged by way of business in a commercial activity with the Group, for whom the captive is permitted to underwrite Contracts of Insurance;

   c. require that a Class 2 Captive Insurer meets a MCR of at least USD 500,000, unless a higher amount of up to USD 1,000,000 is set by the DFSA depending on factors relating to the nature, size and complexity of the applicant, including:

      i. percentage of gross premiums written to third parties vis-à-vis gross premiums written to the Group;

      ii. coverage provided for various risk types (e.g. short-tail, long-tail, life) under

[10] IAIS (2015), Application Paper on the Regulation and Supervision of Captive Insurers
[11] Including but not limited to Bermuda, Guernsey, The Isle of Man, Singapore, Vermont.

insurance contracts underwritten for the Group or third parties;

iii. categories of persons insured and policyholders (e.g. clients, businesses, investors) under the insurance contracts underwritten; and

iv. financial and non-financial risks arising from the nature, size and complexity of the Group, which may affect the activities of the captive.

27. With regard to paragraph 26a, we are not creating a new licence for a captive insurance model that has not yet emerged, but rather extending the current permission to underwrite third-party business (effectively, up to 49% of Gross Written Premium) and clarifying the scope of business which may be insured in order to cater to the need for a more flexible model, but with appropriate requirements for authorisation and ongoing supervision.

28. With regard to paragraph 26b, benchmark analysis suggests that captive models with greater flexibility are being permitted for authorisation in peer domiciles. There are international examples of how various domiciles are engineering the entry of emerging captive insurance models; Bermuda has the most explicit definition of a domicile captive with permission to write from 20% to 50% of its premiums to third-parties.

29. With regard to paragraph 26c, a Class 2 Captive Insurer as redefined would take the middle ground between Class 1 and Class 3 Captive Insurers in terms of regulatory risk. Therefore, the MCR needs also to be in that range, but with a regulatory discretion for setting a higher amount where there is evidence of greater risk.

30. In light of the above discussion, we propose to amend the definition of Class 2 Captive Insurer as set out in paragraph 26.

See draft PIN Rule A4.2.3-A4.2.4 at Appendix 1 and GLO at Appendix 2

Question 1:

Do you agree with our proposal to extend the permission for Class 2 Captive Insurer to effectively write up to 49% of its premiums to third parties? Please comment.

Question 2:

Do you agree with our proposal to define the scope of third parties in the definition of Class 2 Captive Insurer? Please comment.

Question 3:

Do you agree with our proposal to set MCR at USD 500,000 (unless a higher amount is set by the DFSA) for Class 2 Captive Insurer? Please comment.

Proposal 2 – Simplifying MCR calculation for Class 1 Captive Insurer

31. A Class 1 Captive Insurer, or a “pure” captive, is the most basic business model, representing 2/3 of all captives globally. A pure captive poses lower regulatory risk since it underwrites related-party business only, with no third-party policyholders involved. Hence, it would be an undesired policy outcome to make pure captives subject to the same MCR calculation as commercial (re)insurance firms.

32. To address the above, we propose to apply a *de minimis* approach to the calculation of MCR for Class 1 Captive Insurers, where the simplified MCR becomes the higher of:

a. underwriting risk component (URC); and

b. reserving risk component (RRC).

33. Our proposals would result in the following policy outcomes:

a. Class 1 Captive Insurers will no longer be required to meet the following components of MCR: DRC, IVRC, OARC, OLRC, CRC, SFAC, LIRC, AMRC;

b. instead of meeting the combined URC and RRC as part of the overall MCR, Class 1 Captive Insurers will be asked to satisfy the higher of the two components; and

c. the percentage factors prescribed to each insurance Class of Business will remain unchanged when calculating URC and RRC.

34. With regard to paragraph 33a, benchmark analysis suggests that pure captives in peer domiciles are generally subject to the simplified two-factor model capital requirement. Moreover, due to simple investment strategies on the asset side, captives would not be exposed to a number of these risk components. Most importantly, size factor adjustment component (SFAC), which is meant to provide capital relief to Insurers with large balance sheets due to assumed diversification benefits, is by definition punitive for captives. Our data analysis suggests that SFAC is a significant contributor (around 30%) to MCR, posing unnecessary pressure on capital resources for a captive.

35. With regard to paragraph 33b, data analysis[12] suggests that URC or RRC is usually the main driver for MCR. Moreover, according to the correlation matrices used in regulatory frameworks of peer domiciles,[13] URC and RRC have a correlation of only 25% for captives (as opposed to 50% for commercial (re)insurance firms), which may suggest that only one of these risks will prevail at a given time. Based on this, we propose using "higher of" URC and RRC for the solvency test of a Class 1 Captive Insurer.

36. With regard to paragraph 33c, we note that the percentage factors used for MCR calculation date back to 2003. Although there has been episodic evidence of moving towards lower percentage factors across other domiciles, we propose to leave the existing percentages unchanged, pending a future holistic review of the insurance solvency regime, in light of emerging international convergence towards best practices.

See draft PIN Rule A4.2.1 and A6.2.2 at Appendix 1

Question 4:
Do you agree with our proposal that MCR for Class 1 Captive Insurer be calculated as the higher of URC and RRC? Please comment.

Proposal 3 – Simplifying MCR calculation for Class 2 and Class 3 Captive Insurer

37. Class 2 and Class 3 Captive Insurers, or "diversified" and "mutual" captives, respectively, pose higher regulatory risk since they have permission to underwrite non-Group business.

38. Nevertheless, as opposed to commercial (re)insurance firms, the strategic focus of the captive is not around third-party policyholders in the general market, especially in the case of DIFC captives, which are more likely to underwrite wholesale business by indirect ceding through fronting agents. Hence, it is an undesired policy outcome to

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12 Financials of the following captives were used as a proxy for the captive industry practice: AEGIS, NEIL, OCIL, OIL, VALIANT, as well as financials and business plans of captives authorised in the DIFC.

13 Risk correlation matrices are used for calculating insurance capital requirements, net of risk diversification effects, as per the regulatory standardised approach commonly used in peer domiciles.

make diversified and mutual captives subject to the same MCR calculation as commercial (re)insurance firms.

39. Based on the principle of proportionality in regulation, we propose to apply a risk-oriented approach to the calculation of MCR for Class 2 and Class 3 Captive Insurers, where the simplified MCR becomes the sum of:

    a. underwriting risk component (URC);

    b. reserving risk component (RRC);

    c. default risk component (DRC); and

    d. investment volatility risk component (IVRC).

40. These proposals would result in the following policy outcomes:

    a. Class 2 and Class 3 Captive Insurers are no longer required to meet the following components of MCR: OARC, OLRC, CRC, SFAC, LIRC, AMRC; and

    b. Class 2 and Class 3 Captive Insurers shall continue to meet the combined URC and RRC as part of the overall MCR.

41. With regard to paragraph 40a, the IAIS[14] recommends that, due to various factors in play (e.g. permission to underwrite third-party business), diversified and mutual captives may pose risks similar to those of commercial (re)insurance firms and, to that extent, similar regulatory requirements can be applied.

42. Moreover, pursuant to the consequential outcome of ICP17,[15] the IAIS adds that regulators are required to address material categories of risks within technical provisions and regulatory capital requirements for captives, including, at a minimum, the following sources of risk: underwriting risk, credit risk, market risk, and operational risk. With the exception of operational risk, all these material risk types have their equivalent definitions and proxy calculation methodologies in our solvency regime. Hence, our proposal is that Class 2 and Class 3 Captive Insurers be required to meet the risk components of URC, RRC, DRC and IVRC.

43. Idiosyncratic operational risk should be minimal for DIFC captives as they write wholesale risk, where the number of polices issued and claims received are unlikely voluminous to cause operational strain. Key operational functions (i.e. administration, arrangement, accounting, reporting) are outsourced to regulated Insurance Managers, which are subject to supervisory risk assessments, requiring robust systems and controls against operational risk.[16]

44. With regard to paragraph 40b, and as already discussed as part of Proposal 2, the correlation between URC and RRC for commercial (re)insurance firms is considered to be 50%, which may suggest that both risks tend to materialise in tandem to a significant degree. Based on this, we propose using "sum of" URC and RRC for the solvency test of captives other than Class 1 Captive Insurer.

See draft PIN Rule A4.2.1 and A6.2.2 at Appendix 1

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[14] IAIS (2015). Application Paper on the Regulation and Supervision of Captive Insurers

[15] ICP17 is one of the Insurance Core Principles that provides guidance on capital adequacy and solvency.

[16] Perhaps with similar assumptions, The Isle of Man, as a benchmark domicile in this case, has exempted all captives from operational risk requirements; Man Insurance (Non-Long-Term Business Valuation and Solvency) Regulations 2020.

Question 5:
Do you agree with our proposal that MCR for captives other than Class 1 Captive Insurer be calculated as the sum of URC, RRC, DRC, IVRC? Please comment.

Proposal 4 – Revising URC calculation methodology

45. URC is currently calculated using the higher of Net Written Premiums during the reference period and 50% of Gross Written Premiums during the same period.[17] However, for a captive, which may act as a pass-through vehicle for risk, Net Written Premiums will almost always be lower than 50% of Gross Written Premiums, effectively allowing for no (or partial) recognition of netting benefits from premiums paid. This results in an undesired policy outcome for captives – lower risk by definition, but higher capital charge.

46. We propose to calculate URC as the sum of individual results obtained by multiplying Net Written Premiums during the reference period, for each insurance Class of Business, by the prescribed percentage factors in PIN.

47. Benchmark analysis[18] suggests that URC is generally calculated on net basis, allowing for recognition of netting benefits from premiums paid by the captive when signing reinsurance. URC calculation on a net basis will remove the undesired policy outcome and restore the principle of risk-based regulation in this regard. In particular, larger net premiums shall (linearly) require higher capital requirements, since – besides a size indicator – large net premiums may suggest retention of greater risk within the captive.

See draft PIN Rule A4.10.6 and Guidance to A4.10 at Appendix 1

Question 6:
Do you agree with our proposal to calculate URC on net basis, allowing for recognition of netting benefits from premiums paid by the captive when obtaining reinsurance? Please comment.

Proposal 5 – Revising RRC calculation methodology

48. RRC is currently calculated using the higher of Gross Outstanding Claims, less the amount of reinsurance and other recoveries expected to be received in respect of that liability, and 50% of Gross Outstanding Claims provision.[19] However, net claims provision would rarely be large enough to eclipse 50% of gross provisions, effectively allowing for no (or partial) recognition of netting benefits from reinsurance obtained. This presents an undue regulatory burden for the captive model.

49. To address this issue, we propose to calculate RRC as the sum of individual results obtained by multiplying Gross Outstanding Claims, less the amount of reinsurance and other recoveries expected to be received in respect of that liability, for each insurance Class of Business, by the prescribed percentage factors in PIN.

50. Benchmark analysis suggests that RRC is generally calculated on net basis, allowing for recognition of netting benefits from insurance obtained by the captive. RRC calculation on a net basis will remove the undesired policy outcome and restore the

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17 PIN Rule A4.10.6
18 E.g. Bermuda, Guernsey, The Isle of Man, Singapore
19 PIN Rule A4.11.4

principle of risk-based regulation in this regard.

See draft PIN Rule A4.11.4 at Appendix 1

Question 7:
Do you agree with our proposal to calculate RRC on net basis, allowing for recognition of netting benefits from reinsurance obtained by the captive? Please comment.

Proposal 6 – Clarifying regulatory treatment of intra-group loans

51. In hard insurance markets, risk retention will become an integral part of the captive insurance business strategy. In these circumstances, any excess cash from net premiums is either invested in financial instruments and/or loaned back to the parent.

52. Despite intra-group loans being an integral part of cash management for captives, no clear instructions are provided in PIN when it comes to the recognition of intra-group loans, as well as to their treatment for the purpose of DRC and IVRC calculation.

53. The DFSA has provided individual waivers and modification to captives with regard to intra-group loans in the past, but these legacy requirements have not been clearly defined and included in PIN.

54. Our proposal to clarify the treatment of intra-group loans would result in the following policy outcomes:

    a. intra-group loans that meet the following criteria would qualify for preferential treatment, equivalent to a rated bond, for the purpose of DRC calculation:

        i. the borrower has a credit rating;

        ii. the loan maturity is limited to 12 months with no automatic prolongation;

        iii. the loan is provided at market terms and conditions;

        iv. the loan is subject to a contractual obligation to be repaid at the first call by the Captive Insurer; and

        v. the DFSA has been notified before granting the loan (no prior permission required);

    unqualified intra-group loans would be treated as "other loans", unless covered by guarantees or collateral to qualify as a "secured loan";[20] and

    b. intra-group loans, regardless of qualification criteria, would receive a treatment equivalent to bonds for the purpose of IVRC calculation.

55. With regard to paragraph 54a, benchmark analysis suggests diverse examples of how regulators view intra-group loans for captives. Practices range from requiring prior regulatory approval, scrutinising borrower financial soundness, to placing hard limits on loans relative to solvency margins.[21] However, stricter requirements for intra-group loans are usually used as a supervisory tool in domiciles with large populations of captives,

[20] PIN Rule A4.4.1, where "secured loans" attract a capital charge of 2% (14% when impaired), and a more punitive charge of 50% applies to "other loans".

[21] The Isle of Man, Bermuda and Vermont practice prior regulatory approval for intra-group loans combined with additional limitations on borrower credit worthiness and/or loan amounts; Guernsey has refrained from requiring prior regulatory approval for intra-group loans, as previously practiced. In practice, supervisory scrutiny usually leads to regulatory approval of intra-group lending, as long as transactions are on market terms and conditions.

where regulators do not possess enough resources for relationship-based supervision.

56. Worth noting that intra-group loans for a captive are usually a capital management instrument, where excess resources are loaned back for better investment strategies. There is limited risk to third-party policyholders, whose interests could be jeopardised because of intra-group transactions by the captive.

57. We believe that intra-group loans provided on market terms and conditions to a Parent or Group with a credit rating should attract a lower capital charge than is currently prescribed.[22] Going forward, qualifying intra-group loans would be viewed as bonds for the purpose of DRC calculation, subject to percentage factors depending on the borrower's credit rating.

58. With regard to paragraph 54b, intra-group loans, in the same way to any other interest-rate-sensitive assets, shall be subject to IVRC,[23] where a corresponding capital charge applies depending on the maturity of the transaction.[24]

See draft PIN Rule A4.4.8 and A4.5.3 at Appendix 1

Question 8:

Do you agree with our proposal that intra-group loans that meet qualification criteria be given preferential treatment for the purpose of DRC calculation? Please comment.

Question 9:

Do you agree with our proposal that intra-group loans be treated as bonds for the purpose of IVRC calculation and receive a capital charge based on their maturity? Please comment.

Proposal 7 – Clarifying DRC and IVRC treatment of Money Market Funds

59. DIFC captives have used Money Market Funds as part of their investment strategies, despite no clear instructions are provided in PIN when it comes to the treatment of these instruments for the purpose of DRC and IVRC calculation.

60. The DFSA has issued individual waivers and modification with regard to Money Market Funds in the past, but these legacy issues have not been embedded into PIN.

61. We propose that investments in Money Market Funds with a credit rating be treated as rated bonds for the purpose of DRC calculation. In parallel to that, investments in Money Market Funds will receive a treatment, equivalent to bonds, for the purpose of IVRC calculation.

62. Treatment of Money Market Funds for the purpose of DRC and IVRC calculation is a specific issue that was raised through our supervisory engagement with DIFC captives. In this regard, the existing framework in PIN, with our proposals, allows for determining the capital charge based on credit ratings under the DRC framework and using maturity as the driver for capital charge under IVRC.

[22] Notwithstanding the existing waivers and modifications provided to DIFC captives.
[23] Intra-group loans are subject to cost accounting rather than fair valuation, and so subject to "interest rate risk in the banking book" rather than "market risk", to be technically correct, although captured within the same IVRC framework as part of the insurance solvency regime.
[24] PIN Rule A4.5.1

See draft PIN Rule A4.4.9 and A4.5.4 at Appendix 1

Question 10:

Do you agree with our proposal to treat investments in rated Money Market Funds as rated bonds for the purpose of DRC calculation, with a capital charge based on credit ratings? Please comment.

Question 11:

Do you agree with our proposal that investments in Money Market Funds be treated as bonds for the purpose of IVRC calculation, with a capital charge based on maturity? Please comment.

Proposal 8 – Amending submission rules for actuarial reports

63. DIFC captives are required to produce and submit actuarial reports to the DFSA on an annual basis. However, given the limited extent to which captives are permitted to underwrite third-party business, and the fact that a captive model assumes actuarial scrutiny from fronting and reinsurance arrangements, the cost of producing actuarial reports on an annual basis for regulatory purposes outweighs associated benefits.

64. Across the board application of this requirement to captives and commercial re(insurance) firms alike imposes an extra burden on captives, which warrants change.

65. We propose that captives undertaking General Insurance Business not be required to produce actuarial reports for regulatory purposes, unless specifically asked by the DFSA. Captives underwriting Long-Term Insurance Business will continue to produce and submit actuarial reports to the DFSA on an annual basis.

66. We note that captives are generally using fronting and reinsurance arrangements as part of their business model, especially when it comes to low-frequency high-value claims, where loss adjusters are involved in setting reserves, and added scrutiny is exercised by reinsurers. Under such conditions, which are typical of DIFC captives, producing actuarial reports only when required by the DFSA will meet our policy objective. The DFSA may ask for actuarial reporting as part of its supervisory function or when exercising its wider supervisory powers. Benchmark analysis generally suggests no actuarial reporting for General Insurance Business.[25]

67. Long-Term Insurance Business requires actuarial scrutiny, which shall be made available to the regulator and other information users. Benchmark analysis[26] suggests that there is international consensus on requiring annual (sometimes even semi-annual) actuarial reporting to the regulator in this sector.

See draft PIN Rule 7.2.3 at Appendix 1

Question 12:

Do you agree with our proposals that Captive Insurers undertaking General Insurance Business be exempt from actuarial reporting requirement? Please comment.

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25 Once-in-three years reporting frequency is practiced in a limited number of domiciles that have a large population of captives.

26 E.g. Bermuda, Guernsey, Singapore

Part III: Additional and consequential issues

68. We do not think that any transitional arrangements are needed as the proposals in this paper provide greater flexibility than the current requirements, particularly capital, that apply to captives. However, we would like to hear from the industry if there are any practical difficulties that arise from these proposals, or any matters that are not identified in these proposals, which the DFSA ought to consider.

69. Should these proposals be implemented, we will make necessary adjustment to our online forms for regulatory reporting. Bearing in mind that such reporting changes could require systems changes by Captive Insurers in order to generate the relevant information, we would allow a suitable period of time before requiring reporting in an amended format.

Annex 1: Questions in this Consultation Paper

Question 1:

Do you agree with our proposal to extend the permission for Class 2 Captive Insurer to effectively write up to 49% of its premiums to third parties? Please comment.

Question 2:

Do you agree with our proposal to define the scope of third parties in the definition of Class 2 Captive Insurer? Please comment.

Question 3:

Do you agree with our proposal to set MCR at USD 500,000 (unless a higher amount is set by the DFSA) for Class 2 Captive Insurer? Please comment.

Question 4:

Do you agree with our proposal that MCR for Class 1 Captive Insurer be calculated as the higher of URC and RRC? Please comment.

Question 5:

Do you agree with our proposal that MCR for captives other than Class 1 Captive Insurer be calculated as the sum of URC, RRC, DRC, IVRC? Please comment.

Question 6:

Do you agree with our proposal to calculate URC on net basis, allowing for recognition of netting benefits from premiums paid by the captive when obtaining reinsurance? Please comment.

Question 7:

Do you agree with our proposal to calculate RRC on net basis, allowing for recognition of netting benefits from reinsurance obtained by the captive? Please comment.

Question 8:

Do you agree with our proposal that intra-group loans that meet qualification criteria be given preferential treatment for the purpose of DRC calculation? Please comment.

Question 9:

Do you agree with our proposal that intra-group loans be treated as bonds for the purpose of IVRC calculation and receive a capital charge based on their maturity? Please comment.

Question 10:

Do you agree with our proposal to treat investments in rated Money Market Funds as rated bonds for the purpose of DRC calculation, with a capital charge based on credit ratings? Please comment.

Question 11:

Do you agree with our proposal that investments in Money Market Funds be treated as bonds for the purpose of IVRC calculation, with a capital charge based on maturity? Please comment.

Question 12:

Do you agree with our proposals that Captive Insurers undertaking General Insurance Business be exempt from actuarial reporting requirement? Please comment.