THE RELEVANCE OF MINIMUM CAPITAL REQUIREMENT (MCR) INCREASES UNDER EFFECTIVE RISK-BASED SUPERVISION AND CORPORATE GOVERNANCE

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INTRODUCTION

- Welcome to an emotive topic – no matter how you slash it!
- Rest assured that the presenter is not an expert in any sense of the world; just a fellow-traveller raising issues that will elicit debate leading, hopefully, to appropriate action to move our industry forward.
- "Contradiction should not awaken passion; it should awaken attention."Thomas Fuller

FIRST PRINCIPLES

- Capital is crucial to a primary insurer because it is required to fund working capital including day-to-day operating costs, and the development /growth of the business.
- The **Regulator** will require adequate capital to be in place before insurance policies can be written.
- **Insureds** will want comfort from the existence of a solid capital base that claims will be met in the future.
- **Credit rating agencies** and investment analysts will also look at the level of capital in their assessments of the organisation.

THE NEEDS FOR THE EFFECTIVE MANAGEMENT OF INSURANCE CAP.

- An insurer's capital is core to its existence. It defines how much business it can write; it indicates strength and ability to withstand 'shocks' and is a key measure used by both regulators and other external analysts to assess the company.
- There is always continuous tension between financial analysts (representing investors) and rating agencies regarding how much capital to keep. To get a high rating requires a large amount of excess capital, while financial analysts would like excess capital to be got rid of as soon as possible

THE PROBLEMS OF TOO MUCH OR TOO LITTLE CAPITAL

- **Excess capital has an opportunity cost** – what investors will gain elsewhere with the funds. Therefore unless management can clearly demonstrate what they plan to do with the excess capital to generate a return on that capital greater than investors can gain themselves, independently, then that capital should be returned to investors.
- **Too little capital will restrict the volume of business that can be retained** by the company so either less business is written, or more reinsurance is required to maintain a net retention consistent with the capital base. Too little capital will restrict the growth and profitability of an insurer.

WHAT IS 'ENOUGH' AND WHAT IS 'EXCESS'

- All capital modeling uses estimates, assumptions and judgements on what will happen in the future, but the only thing we can be sure of is that things are going to change in ways we cannot fully predict, particularly in insurance.
- This is why the credit rating agencies like to see a significant surplus of capital over that deemed the minimum necessary to run the business to allow for the inherently uncertain future.
- The tighter that capital is managed the greater the risk that unforeseen events will damage the ability of the company to grow and prosper in a changing marketplace and environment.

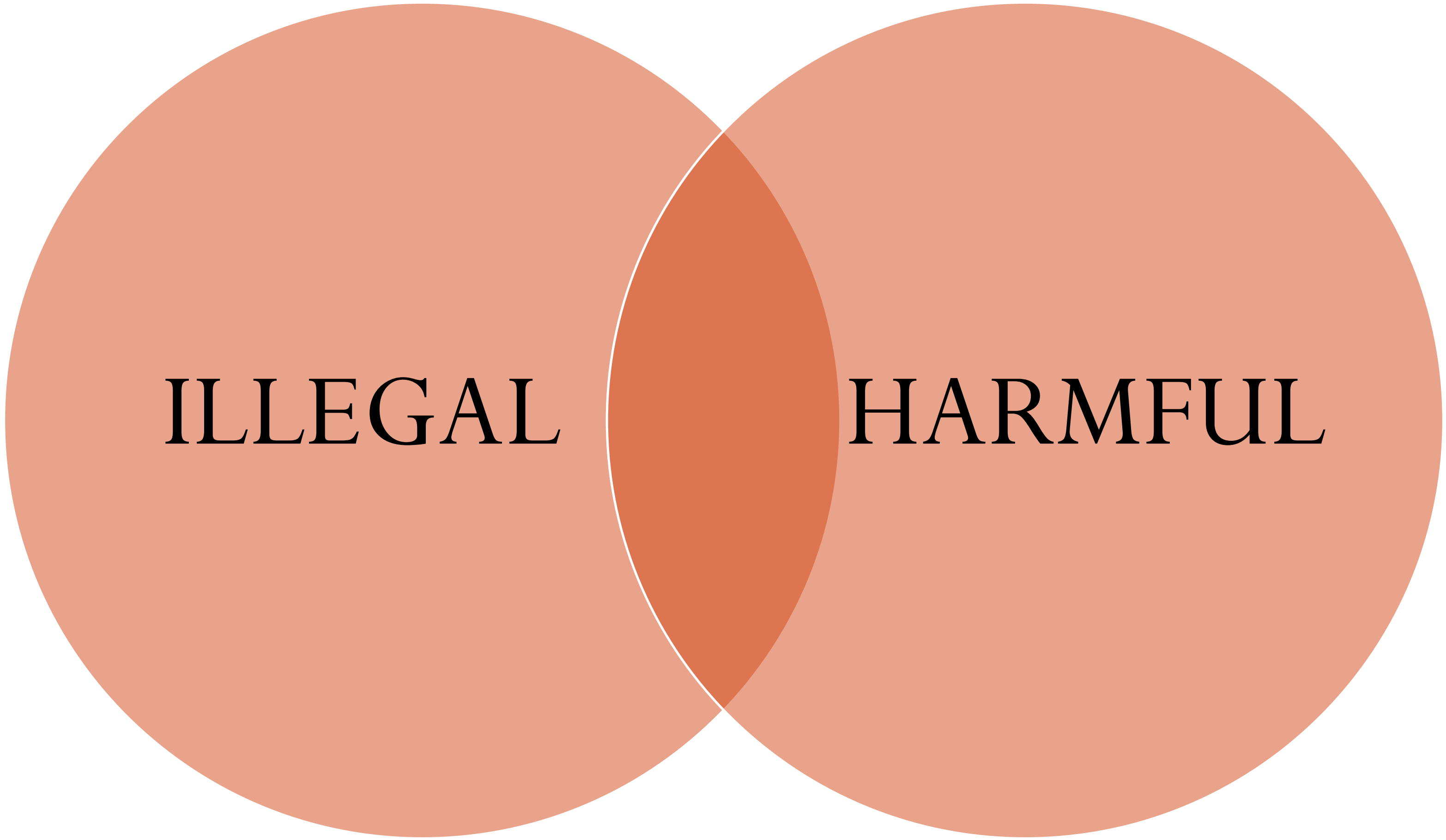
MINIMUM CAPITAL

- "To maintain a stable market of insurance companies that are in business for many years, and not put at risk by one-off events such as bad weather, a set of large claims or investment value fluctuations, insurance regulators specify minimum capital requirements for a company to be authorised to transact insurance." Ian Bates & Derek Atkins
- The rule of thumb was a range of 15% - 20% of net premiums written. In practice, most reputable insurers operate at substantially higher levels than this – typically 40% of net premiums written or greater to provide resilience to external shocks and events.

RISK BASED SUPERVISION

- Compared to a Compliance based approach that focuses on the financial situation of the supervised entities, RBS is a dynamic process where the emphasis is on understanding and anticipating the possible risks the supervised entity will be facing when executing its business plan, thus going beyond its current financial situation.
- RBS focuses on those risks that hamper the delivery of public value rather than expending resources on ensuring compliance to laws where no real harm is being done.
- Malcolm Sparrow, the Harvard Academic, has described this as a shift from a focus on illegality into a more agile approach aimed at minimizing harm

THE CRAFT OF REGULATION



RISK BASED CAPITAL FRAMEWORK

- Risk Based Capital (RBC) is defined as the amount of capital required by a company to protect itself against adverse movements in its risk profile
- Implementation of RBC would present an opportunity for insurers to manage their risks and capital efficiently.
- Where a RBC framework is in operation the issue of minimum capital requirement is not overridden, but it is a ‘secondary’ consideration.

SOLVENCY II – A COMPARATOR

- Solvency II is administered on a three pillar system
- Pillar 1: Quantification of capital requirements
  - Solvency capital requirement (SCR) – a risk based capital requirement that can be determined either through a formula or via the company's internal model
  - Minimum Capital Requirement (MCR) – the minimum solvency requirement where a breach would trigger ultimate supervisory intervention
- Pillar 2: Qualitative requirements
  - This covers the firm's internal controls and risk management activities as well as the supervisory process
- Pillar 3: Reporting and disclosure requirements
  - There will be public disclosures on business overview and performance, governance and the valuation basis employed , etc.

THE MISSING LINK

- Our peculiar challenge, as I see it, is the fact that we have migrated to a RBS framework that has not yet admitted RBC.
- **"The central tenet of RBS is the relationship between risks and capital – the higher the risk profile of an insurer, the higher the capital it must hold."** Tony Randle, Risk Based Supervision
- "Most supervisors that have adopted a RBS approach have introduced it gradually and in tandem with their existing compliance approaches. Only once they have become confident in the ability of their supervisors to make sound risk judgements and the reliability of their measurement tools do they become entirely risk based. This is a pertinent example of supervisors trying to minimise their own risk – the risk of ineffective supervision." Tony Randle

CHALLENGES OF RBS

- Shortage of skilled personnel
- Costs involved tend to be high; but one can introduce a RBC framework that is simple to implement and requires less human and technological resources
- Lack of data
- Lack of co-operation by insurers

HIGH GOVERNANCE RISK

- The functioning of the Boards of many insurers leaves much to be desired:
  - No formal charters that defines boards' role and distinguish them from management
  - No processes to deal with potential and actual conflicts of interest
  - No formal process to evaluate their own performance periodically
  - No succession plan for key members of Management
  - No idea of top ten risks at regular intervals, etc

FOOD FOR THOUGHT

MARKET	GROSS PREMIUM	NUMBER OF COMPANIES	PENETRATION	MINIMUM CAPITAL REQUIRED
	US$ (‘000)		%	US$ (mill.)
South Africa	45,000,000	161	16.99	1.1 (0.710)+
Morocco	4,000,000	10	3.7	1.0
Ghana*	600,000	53	1.2	3.0 (5.0?)
Lesotho				0.286
Kenya				4.0 (6.0)+
Botswana (Proposed)				1.0 (0.5)+
* Further consideration		+ Life & Non-Life respectively		

WAVES IN INSURANCE WORLDWIDE – 2 ISSUES

GLOBALISATION

- In Insurance, globalisation can be defined as ‘responding to common customer needs using common delivery and support processes across several territories’.
- Insurance companies are attracted to globalisation in order to:
  - service the local needs of their multinational customers;
  - derive profit streams from growing economies;
  - replicate their home model in different markets;
  - spread risks

CONSOLIDATION

- The pattern of consolidation that took place in the UK among the top ten general insurers in the beginning of the 1990s have been repeated in many other countries
- Consolidation has taken place in all sectors including insurers, reinsurers, brokers and adjusting firms.
- Our industry is not immune to this global reality

SUGGESTED WAY FORWARD

CONSIDER MCR FREEZE

- The NIC should strongly consider a MCR freeze in dollar terms. A case can be made, based on indexation, for returning the minimum capital requirement to its original dollar amount
- The implication of this suggestion is that any minimum capital requirement should not go beyond the cedi equivalent of the of US$5.0 million which was the US dollar equivalent of the extant capital.
- Assuming a worse case exchange rate of US$1:GHC6 we are looking at thirty million Ghana cedis .

ADOPT RBC

- The NIC should as a matter of urgency prioritize the migration to a full-blown RBS regime that allows for the computation of a RBC using a simplified algorithm.
- RBC will promote fairness since the one-size-fits-all capital phenomenon will cease
- RBC could put to sleep, hopefully, the regular rounds of emotive debate that characterise the establishment of minimum capital requirements a la fixed capital standard
- Under RBC, insurers will have to price their risks appropriately or use their capital to cover risk charges

‘COOLING OFF PERIOD’

- Suggested ‘cooling off period’: now to the end of 2020; that is the new capital regime is suggested to take effect in January 2021.
- The lag will allow the NIC to obtain technical support to establish a comprehensive RBC regime, test it and obtain buy-in from insurers before its implementation.
- This waiting period will also enable current insurers, where applicable, to generate the additional capital through fresh funding and/or restructuring of their balance sheets, etc.
- The immediate aftermath of the banking sector shakeout does not appear to be the best time to raise capital

ENFORCE CURRENT FRAMEWORK

- The current solvency framework carries enough bite when strongly implemented to ensure that insurers keep to the straight and narrow.
- Use the cooling off period to resuscitate 'ailing companies' who are amenable to help. Those in this category who fail to meet the bar after all the necessary support would have to consider sale, mergers and other alternatives.
- Corporate Governance needs to be strengthened.

CONCLUSION

- Globalisation has changed the dynamics of our business and industry situation. The larger issue is that the Insurance Industry in Ghana must work hard at putting its house in order.
- "It has been said that arguing against globalisation is like arguing against the laws of gravity." Kofi Annan