Financial Services
Commission
of Ontario

Improving Solvency Supervision of Insurers in Ontario

A proposal to upgrade solvency standards for the benefit and protection of Ontario policyholders

Consultation Paper

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EXECUTIVE SUMMARY

In Canada, the regulation of insurance companies has two different but interrelated purposes: the regulation of market conduct by insurers and the regulation of insurance solvency.

Market conduct regulation is the responsibility of the provinces and solvency regulation is the responsibility of both provincial and the federal government, depending on where the company is incorporated. Insurers that incorporate federally are subject to the solvency regime administered by the Office of the Superintendent of Financial Institutions (OSFI). Insurers that incorporate in a specific province are subject to the solvency oversight of that province. Most insurers incorporate federally and are under OSFI's solvency oversight.

Historically, provincial regulators have harmonized their solvency standards with those of OSFI, thereby ensuring that all insurers are subject to similar solvency requirements regardless of their place of incorporation. However, over the past two decades, new technologies and the emergence of conglomerates have transformed insurance into a global business. The 2008 financial crisis also affected the sector by exposing gaps in solvency supervision regimes that need to be closed. In responding to new risks arising from these developments, insurance supervisors around the world, including OSFI, have been embracing stronger solvency standards.

The International Association of Insurance Supervisors (IAIS), an international standard-setting organization that represents insurance regulators and supervisors from 140 countries, recently established common standards for solvency assessment of insurers worldwide.[1] OSFI is a member of the IAIS and has for the past ten years been an active contributor to the development of IAIS standards.

IAIS standards are designed to enhance financial stability and increase consumer protection. They also form the basis for evaluation of insurers' supervisory systems by the International Monetary Fund (IMF) under its Financial Sector Assessment Program (FSAP). The FSAP are established international reviews to determine whether a jurisdiction is meeting internationally established principles for solvency regulation. Canada is a member of the IMF and will be assessed under the FSAP program within the next year, and every five years thereafter.[2]

In Canada, OSFI has adopted the higher IAIS solvency standards while provincial regulators are either in the process of implementing the new standards (e.g. Quebec), or considering bringing their system of solvency supervision up to the new international guidelines. Ontario is in the

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[1] IAIS is one of three major international standard setting bodies in the financial sector. Since its inception in 1994, the IAIS has developed a number of Core Principles, standards and guidance to help promote the development, at a global level, of well-regulated insurance markets. Over 190 jurisdictions, representing 97 percent of the world's insurance premiums, are IAIS members. Members, including Canada, approved and agreed to observe the IAIS principles and standards on the path toward global convergence of insurance regulatory and supervisory frameworks.

[2] The International Monetary Fund (IMF) is an organization of 187 countries that fosters international monetary cooperation and secure financial stability. Since 2000, the IMF has been using the IAIS standards in its FSAP reviews to assess the insurance regulatory and supervisory systems of jurisdictions all over the world. An assessment of U.S. compliance with IAIS standards was carried out as part of the 2010 U.S. FSAP.

latter group and recognizes that without adopting the new solvency standards, companies incorporating in Ontario would be subject to less stringent rules than companies incorporated elsewhere.

In light of these changes, in particular the emergence of new globally-accepted standards for solvency supervision, it is timely and appropriate for Ontario to consider solvency reforms. Ontario has the option to invest the resources needed to bring its system of solvency supervision up to the standards and continue duplicating the federal solvency regime in much the same way as it does currently. However, this may not be the most practical or prudent approach given the small and declining numbers of companies incorporated in Ontario. Thus, before investing resources in the upgrade of the solvency framework, Ontario needs to consider if there is a more cost-effective way of achieving the same outcome.

This paper sets out proposals that will ensure continued consumer protection while eliminating the need for Ontario to maintain a separate and duplicative solvency regime for the few Ontario incorporated companies that remain.

The proposals are to:

1) Cease providing for the provincial incorporation of new insurers;

2) Require as a condition of licensing that insurers are incorporated in a jurisdiction that meets the new international solvency standards; and

3) Provide a transition period for insurers incorporated in Ontario to transfer their incorporation to jurisdictions in compliance with these standards.

Ontario-incorporated insurers include farm mutual insurance companies[3] (farm mutuals) and the solvency rules that apply to these 45 companies are different. This paper explores the overlapping responsibilities in the solvency regulation of farm mutuals in Ontario and sets out a proposal to eliminate duplication while continuing to provide a regime that is appropriate for them.

The policy proposals discussed in this paper are consistent with the approach Ontario has already adopted in the loan and trust, and credit union sectors. They also align with Ontario’s commitment in its 2012 Budget to enhance the effectiveness of FSCO’s regulation of the insurance sector and improve the solvency supervision of Ontario insurers.

THE INSURANCE INDUSTRY IN ONTARIO

Insurance is vital to Ontario’s financial stability. It facilitates economic growth by helping individuals and businesses reduce risks to which they are exposed and it is an important source of employment.

[3] Commonly referred to as “farm mutuals,” Ontario's mutual insurance companies are community based companies owned by their policyholders. They provide a range of products similar to other P&C insurers but focus on specialized products for Ontario’s agricultural sector.

Every insurer that operates in Ontario must be licensed by the Financial Services Commission of Ontario (FSCO) and is subject to FSCO's market conduct supervision. As of April 13, 2012, there were 351 insurance companies licensed in Ontario. These companies consist of[4]:

- 253 federally-incorporated insurers (including foreign branches);
- 31 insurers incorporated in other provinces;
- 7 Ontario P&C insurers;
- 1 (Ontario) fraternal:
- 1 (Ontario) reinsurer;
- 45 Ontario farm mutuals, including the Farm Mutual Reinsurance Plan (FMRP);
- 8 reciprocal insurance exchanges.[5]

The majority of companies operating in Ontario are incorporated outside of Ontario. They must be licensed to conduct business in Ontario and are all subject to the same market conduct rules.

Regardless of where they are incorporated, insurers offer similar products and services, and compete for the same business. Combined, they wrote about $39.9 billion in premium in 2010 and employ approximately 102,711 Ontarians. Most employment (100,905 jobs for Ontarians) and ninety percent of premium written is generated by insurers incorporated federally or operating as branches of foreign companies subject to OSFI's supervision. Eighty-one percent of federally incorporated companies are licensed in Ontario and have head offices in Ontario.

Farm mutuals in Ontario represent about $500 million of the total premium written in the province, and employ approximately 1,056 Ontarians.

Recent Market Trends

Non-mutual Companies

Historically, a company chose its place of incorporation based on the location of its business. For example, a company seeking to operate across Canada would incorporate federally, while a company planning to do business in only one province would incorporate in that province.

At one time, smaller insurers could survive selling exclusively in Ontario's marketplace. However, over the past two decades, amalgamation, globalization, new technology and the growing complexity of insurance products means that insurance is no longer a small business venture and businesses need significant capital to be able to compete successfully in today's insurance marketplace.

[4] The breakdown does not include those companies in run-off.

[5] Reciprocal insurance exchanges are alternative insurance vehicles that operate as a loss-sharing pool, with the power to retroactively assess member participants for any losses beyond their existing funding. FSCO oversees their solvency, but they are subject to separate and distinct rules. Given their low solvency risk, reforms to Ontario's reciprocal regime, although important, are not a priority and thus not part of this proposal.

The number of insurance companies incorporated in Ontario has been steadily declining. In 2001, there were 29 companies in operation. Today, there are 9 companies with the last incorporated in 2002. This trend is expected to continue as companies merge to grow their business, opt for federal incorporation to be able to compete nationally, or are forced to exit the market for solvency reasons.

While insolvencies are rare in Canada, they do occur. Independent reports by the Property and Casualty Insurance Compensation Corporation (PACICC) indicate that small, less diversified insurers – like some incorporated in Ontario – are at a greater risk of becoming insolvent.[6] In the last period of weak profitability, between 2000 and 2003, six P&C insurers exited the market involuntarily. One of the exiting companies, Markham General Insurance, a company incorporated in Ontario, affected nearly 65,000 consumers.

A recent Standard & Poor's report stated that although the number of insurance company insolvencies has declined in recent years, the trend in insurer insolvencies is likely to change and begin to move upward. Historically, two-thirds of P&C insolvencies in Canada have involved provincially regulated insurers. In the life insurance sector, there have only been three insolvencies in Canada – the most recent in 1994 – all of which were managed successfully by Assuris and OSFI.[7]

Farm Mutuals

Although farm mutuals are faced with the same challenges as other insurers, their solutions may be significantly different because of their system of support and the market niche they serve. For farm mutuals, the risk to compete and survive (as described in the PACICC report) is much lower than that of the non-mutual Ontario insurers. This is because they operate as a system, rather than as stand-alone small firms.

Farm mutuals have access to the reinsurance market through their own reinsurer and maintain their own guarantee fund which covers 100 percent of claims and unearned premiums in the event of a farm mutual insolvency.

Although farm mutuals enjoy a network that supports a viable business model, it is highly unlikely that there will be a new entrant to the system. The last time a new farm mutual incorporated in Ontario was 100 years ago.

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[6] PACICC is an industry-funded, non-profit compensation fund that will respond to claims of policyholders in the unlikely event of the collapse of a P&C insurer in Canada. As of 1998, all P&C insurers in Ontario (except farm mutuals who have their own guarantee fund) must be members of PACICC. See *Why Insurers Fail: the Dynamics of Property and Casualty Insurance Insolvency in Canada*, Property and Casualty Insurance Compensation Corporation, 2007.

[7] Assuris is the equivalent to PACICC in the life insurance sector. Its goal is to mitigate the impact of financial failure of a member life insurance company on Canadian policyholders. Assuris closely follows concerns that arise through OSFI's supervisory activities. In the wake of the 1994 Confederation Life experience and other international pressures discussed in this paper, OSFI continues to tighten its supervisory practices. Today, it is highly unlikely that a federally regulated life insurer would be allowed to deteriorate to the levels reached by Confederation Life.

SOLVENCY SUPERVISION OF INSURERS

International Solvency Standards

The increasing globalization of insurance and the impact of the global financial crisis that began four years ago have resulted in international bodies playing an increasingly important role in the setting of harmonized supervisory standards that are more rigorous and effective. The IAIS, in particular, has been instrumental in raising international expectations for insurance supervision.

One of the key areas in IAIS standard setting is solvency.[8] At the top of IAIS standards are the Insurance Core Principles (ICPs), the globally-accepted framework for the regulation and supervision of the insurance sector. The ICPs are also the framework used in the evaluation of supervisory regimes under the FSAP conducted jointly by the World Bank and the IMF.

The ICPs are the base of all other IAIS principles and standards, including the IAIS's *Common Structure for the Assessment of Insurer Solvency* (Common Structure). The IAIS Common Structure has become the globally-recognized benchmark for jurisdictions in assessing their own solvency regimes and supervisory practices, and strengthening them towards conformity with IAIS standards. (See Appendix 1 for a description of the IAIS solvency Common Structure.)

OSFI has not only contributed as an IAIS member to the development of the ICPs and IAIS solvency Common Structure, but has consistently updated its supervisory framework to ensure its compliance with IAIS standards within the context of its mandate. OSFI is recognized as a leader in solvency regulation worldwide.

Ontario's Solvency Regime

In Canada, insurers must meet the solvency requirements of their jurisdiction of incorporation. Both the provincial and federal governments have the power to incorporate an insurance company. Insurers that incorporate in Ontario must satisfy the solvency requirements (minimum capital, actuarial and governance standards) established under Ontario's Insurance Act. Except for some reforms in 2006 regarding investment (prudent portfolio) rules, there has been no major reform of Ontario solvency rules since the Act was passed in 1924.

As of April 2012, FSCO directly oversees the solvency of 9 Ontario companies.

Over the years, Ontario has harmonized with solvency standards and guidance set out by OSFI. For the safety of policyholders, Ontario has always placed importance on Ontario insurers being subject to similar solvency standards, regardless of their jurisdiction of incorporation.

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[8] Although there are many IAIS standards, this paper refers only to IAIS solvency standards.

However, supervisory standards continue to evolve and the pressure to implement higher standards of corporate governance and risk-based supervision in line with IAIS principles is increasing. Ontario would need to invest significant resources to keep up with new developments as adopted by OSFI and the international community.

To do this, Ontario would need to update insurance legislation. Further, Ontario would need to expand its staffing capacity and expertise to examine solvency in an era where so much activity transcends provincial and national borders.

Solvency Regulation in Other Provinces

Significant resources are required to maintain and enforce an up-to-date solvency regime, even in in provinces where there are few or no provincially-incorporated companies conducting business. The result has been a trend among provincial regulators to delegate and transfer authority in many areas of solvency supervision to OSFI. Delegation, however, does not mean relinquishing responsibility. It may also no longer be an option going forward.

Some provinces, especially those with a significant mass of provincial incorporations (e.g. Quebec), have chosen to preserve their autonomy in this area and become compliant with IAIS standards. Others, with the assistance of the Canadian Council of Insurance Regulators (CCIR) are assessing the legislative changes, resources and expertise required to meet the new international standards.

CCIR is using the IAIS self-assessment questionnaire and methodology to assist provincial regulators to determine where they stand regarding the IAIS standards. (These are the same tools used by the IMF for the FSAP assessment of compliance with the IAIS standards.) The IAIS assessments and methodology are designed to allow insurance supervisors to identify any actual or potential weaknesses, and initiate an appropriate strategy for addressing them.

Solvency Oversight of Farm Mutuals

As Ontario-incorporated companies, farm mutuals must satisfy the solvency requirements established under Ontario's Insurance Act. However, some of the solvency rules that apply to farm mutuals are different. For example, farm mutuals are exempt from the minimum capital requirements imposed on P&C insurers because of their participation in the Fund.[9] Both FSCO and the Fund have solvency responsibilities over farm mutuals under the Insurance Act. Because the Fund covers 100 percent of policyholder claims, it has an obligation and an interest to ensure farm mutuals are solvent, and makes recommendations to correct any deficiencies. In 1999, to remove duplication and minimize burden and cost to farm mutuals, FSCO entered into an agreement with the Ontario Mutual Insurance Association (OMIA), the association of Ontario farm mutuals. Under the agreement, OMIA undertakes solvency reviews on behalf of FSCO, and it does this through the Fund.

[9] The Insurance Act provides for the establishment of a Fire Mutuals Guarantee Fund (the Fund), to be governed by an agreement subject to the approval of the Superintendent, under which the Fund is authorized to review and monitor the financial condition of its participants. All farm mutuals are Fund participants.

The IAIS recognizes the special nature of smaller mutual and community-based companies, such as the farm mutuals in Ontario. In a paper on mutual, cooperative, and community based insurers, the IAIS proposed that the regulatory and supervisory treatment of these organizations – as long as they remain small – should be equivalent to the approach taken with other insurers, but with the necessary adjustments to take into account their particular characteristics.[10]

According to the IAIS, material differences with other insurers, such as member ownership, democracy, solidarity, and surplus retention, may provide an opportunity for special regulatory arrangements and supervisory obligations.

NEED FOR REFORM OF ONTARIO LEGISLATION

Non-mutual companies

The insurance industry is changing in response to a wide range of social and economic forces and supervisory systems must be continually upgraded to cope with these developments.

Over the years, Ontario has adopted the standards and guidance related to solvency rules set out at the federal level by OSFI. However, higher solvency standards promoted by the IAIS and adopted by OSFI continue to emerge and there is a potential for gaps between the two regimes unless major reforms are undertaken.

Any material deviation in the quality of solvency regulation between a federal company and a company incorporated in Ontario is not justifiable. Ontario should not be seen as a second tier regulator and a place where companies that cannot meet or choose not to meet the new standards will seek to incorporate. The only way to maintain a stable insurance market that protects the interests of Ontario policyholders is to ensure that every company undertaking the business of insurance in Ontario is subject to the same solvency standards.

The IAIS recognizes that full adherence to the solvency Common Structure and related standards may in some instances require an adjustment period. OSFI has adopted the IAIS standards and Ontario now has a window within which to make a decision about the significant investment that would be necessary to keep up its solvency infrastructure. The decision is made more difficult because Ontario would need to rationalize such an investment for a small number of companies. (Regulators with a higher number of incorporations are in a better position to rationalize the costs.)

Furthermore, it is expected that the number of companies incorporated in Ontario will continue to decrease. Some are already in the process of transferring their incorporation to the federal government or merging with a parent company in another province for a better opportunity to compete. As well, some of the companies incorporated in Ontario may be eventually forced to

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[10] International Association of Insurance Supervisors, *Issues Paper on the Regulation and Supervision of Mutuals, Cooperatives and Other Community-Based Organizations in Increasing Access to Insurance Markets*, October 2010.

exit the Ontario market. These companies may not have sufficient capital to survive in today's competitive marketplace.[11]

It may also be difficult for Ontario to justify the resources and expertise required to upgrade its solvency framework when the prospect of new insurers incorporating in Ontario is almost nil. The last year in which an insurer incorporated in Ontario was 2002.

With the exception of farm mutuals, many Ontario incorporated insurers now conduct business outside of Ontario and their scope has become national. It is not necessary for insurers to incorporate in Ontario to maintain head offices and employment in Ontario and the majority of insurance business and jobs generated in Ontario come from companies incorporated federally.

If Ontario no longer provided for the incorporation of insurers, there would be no impact to jobs or to the availability of insurance in the province. There is no economic benefit for the province or for Ontario consumers associated with maintaining a regime for the incorporation of insurers in Ontario.

Finally, it should be noted that compliance with new international standards is not just about making amendments to laws. It also involves the capacity to undertake effective solvency supervision. When solvency supervision is delegated, the incorporating regulator remains responsible for any function delegated. Although the capacity issue may be somewhat eased when delegating, an updated solvency infrastructure must be established and maintained along with the expertise to monitor those delegated functions.

Farm Mutuals

In accordance with IAIS principles, the special nature of farm mutuals, their system and their history in Ontario justifies a different solvency regime. The solvency regime for the system must be appropriate to their particular risks and needs. The Fund and OMIA maintain the expertise and resources to examine the solvency of farm mutuals and determine how regulatory requirements may impact smaller firms.

An effective solvency regime must be free of duplication and currently, both FSCO and the Fund have solvency responsibilities over farm mutuals under the Insurance Act. The delegation agreement in place to avoid this duplication is working well but it needs to be formalized in law.

POLICY PROPOSALS

This paper sets out proposals aimed at ensuring the continued protection of consumers while eliminating the need for Ontario to maintain a separate, costly, and duplicative solvency regime for the few Ontario incorporated companies that remain. The proposals are to:

1) Discontinue providing for the provincial incorporation of new insurers;

[11] *Why Insurers Fail: Lessons Learned from the Failure of Maplex General Insurance Company*, PACCIC, 2008.

2) Require as a condition of licensing that insurers (except farm mutuals) be incorporated federally or in a jurisdiction where the company is subject to solvency supervision that meets the new IAIS solvency standards;
3) Provide a transition period for the few remaining companies incorporated in Ontario (other than farm mutuals) to transfer their incorporation to a jurisdiction that meets international standards; and
4) Amend the Insurance Act to clarify that the Fund is solely responsible for solvency examination of farm mutuals.

Discussion

Ontario would continue to license insurers, even if Ontario no longer allowed for the incorporation of insurers in the province. As part of the licensing requirement, Ontario would require the regulator of the incorporating jurisdiction to attest that its solvency regime aligns with IAIS international standards.

Provincial regulators are all seeking how best to ensure alignment with the IAIS standards. As previously discussed, the IAIS has developed a questionnaire and methodology that allows supervisors to assess its laws as well as its capacity to implement IAIS standards. A CCIR Committee is facilitating these self-assessments. In this way, Ontario would avoid duplicating regulation and oversight while ensuring that consumers would continue to be adequately protected.

A transition period would be established to allow companies time to transfer their incorporation to a jurisdiction that meets international standards. To minimize disruption, Ontario could establish transition mechanisms to assist companies with their transfers. For example, the Insurance Act could allow a period of time for companies to continue to do business in Ontario while they complete the transfer of their incorporation.

Some insurers are already in the midst of transferring their incorporation federally or to another jurisdiction. Most have sufficient capital to incorporate federally or have sufficient ties (e.g. a parent company) to incorporate in another province and still continue to operate in Ontario. A transition period would also require those lacking an appropriate governance structure, sufficient capital or the means to acquire the necessary capital, to consider changing their existing business models while still solvent.

The transition period would also give provincial regulators the opportunity to demonstrate to Ontario that their regimes meet the new international solvency standards so that those companies currently incorporated in that province can continue to be licensed and operate in Ontario.

For farm mutuals, amending the Insurance Act to clarify that the Fund is solely responsible for solvency examinations will clarify roles and eliminate duplication. The responsibilities of the Fund and FSCO would be clearly set out in legislation. Such a move would merely formalize in law a practice currently authorized by the Superintendent’s delegation. To ensure the Fund is appropriately discharging its responsibilities for solvency examinations, and continues to have the capacity to honour its guarantee, a formal reporting to the Minister on a regular basis would

also be set in legislation. An adequate solvency framework must be continued and FSCO would work with the Fund to ensure suitable standards in line with IAIS guidance for these types of organizations.

FSCO would retain its market conduct and enforcement role and would continue to authorize, assume control or impose licensing conditions on farm mutuals where required. Curtailing services to incorporate new farm mutuals (with the exception of mergers and acquisitions) would not be an issue since the likelihood of new entrants is nil.

The policy proposals related to non-mutual insurers are consistent with the approach Ontario has already adopted in the loan and trust sector, where the province no longer provides provincial incorporation of trust and loan companies and only federally incorporated and regulated entities can be licensed to conduct business in Ontario. (Under this proposal, however, no trade barrier is created as any insurer can operate in Ontario as long as the province that incorporates it meets international solvency standards).

The policy proposal related to mutual insurers is consistent with the approach Ontario has adopted in the credit unions sector, where responsibility for ensuring compliance with solvency related standards was transferred from FSCO to the Deposit Insurance Corporation of Ontario. The transfer streamlined regulatory oversight and strengthened solvency regulation while allowing Ontario's credit unions to remain competitive and serve their members in communities across the province.[12]

CONSULTATION DETAILS

FSCO invites interested parties to make comments on the policy proposals outlined in this paper. The information FSCO gathers through the consultation process will inform any government decision regarding the policy proposals. Submissions should be made in writing and sent to the attention of:

Mercedes Aldana
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Insurance Policy & Deposit Institutions Policy
Financial Services Commission of Ontario
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Toronto ON M2N 6L9.

Alternately, submissions may be sent by e-mail to Mercedes.Aldana@fsco.gov.on.ca or by fax to 416-226-7870.

The deadline for providing comments is July 9, 2012.

Please note that FSCO plans to publish the comments you provide on FSCO's website. If you wish your comments to remain anonymous, please state this explicitly in your response and

[12] The direction is similar to the credit union model, but this proposal is not envisioning for the Fund to have as much powers as the Deposit Insurance Corporation of Ontario.

FSCO will take the necessary steps to meet your request. Nevertheless, please be aware that FSCO may be required to make your submission available if a formal request under Freedom of Information legislation is received.

APPENDIX 1 - IAIS Solvency Standards

On October 1, 2011, the IAIS adopted new and revised Insurance Core Principles and Methodology (ICPs). Any IAIS Principle, Standard and Guidance have to first be adopted at a General Meeting, where all IAIS members (180 jurisdictions/140 countries, including Canada and Quebec) are entitled to participate and vote. Industry also participates and provides its input as “observer”.

The ICPs are the base of all other IAIS principles and standards, including the IAIS’s *Common Structure for the Assessment of Insurer Solvency.* The IAIS *Common Structure for the Assessment of Insurer Solvency* is based and expands on those aspects of the ICPs as they relate to solvency supervision. It provides a globally-accepted framework for the evaluation of insurance solvency legislation and supervisory systems.

Although the IAIS does not prescribe a specific solvency regime to be applied compulsorily by its members, the *Common Structure* is intended to form the benchmark for jurisdictions to assess their own solvency regimes and supervisory practices, and strengthen them (i.e. develop and carry out an action plan for addressing these weaknesses) towards conformity with the IAIS solvency framework and standards.

The *Common Structure* is basically a coherent risk-based framework that reflects international best practices. It is composed of both quantitative (capital and other technical requirements) and qualitative components (governance, market conduct and disclosure). The *Structure Elements* described below prescribe essential elements that must be present in a solvency supervisory regime in order to promote market stability and protect policyholders. The IAIS continues to work on detailed principles-based standards and guidance that are globally acceptable.

IAIS *Common Structure for the Assessment of Insurer Solvency*
Structure Element 1: *The supervisor must have adequate powers to:* • *require an insurer to assess and manage the risks to which it is exposed;* • *set regulatory financial requirements for individual insurers to protect policyholders’ interests; and* • *require that, if necessary, an insurer holds additional capital or takes action to reduce its risks so that the assets it holds are sufficient and appropriate.*
Structure Element 2: *Risk sensitive regulatory financial requirements should provide incentives for optimal alignment of risk management by the insurer and regulation.*

Structure Element 3: *A solvency regime should address all relevant potentially material risks, including underwriting risk, credit risk, market risk, operational risk and liquidity risk. All risks should, as a minimum, be addressed by the insurer in its own risk and capital assessment.* *• Risks that are generally readily quantifiable should be reflected in sufficiently risk sensitive regulatory financial requirements.* *• For risks that are less readily quantifiable, regulatory financial requirements may need to be set in broad terms and complemented with qualitative requirements.*
Structure Element 4: *A total balance sheet approach should be used to recognize the interdependence between assets, liabilities, capital requirements and capital resources and to ensure that risks are fully and appropriately recognized.*
Structure Element 5: *Insurance contracts are written in the expectation that obligations under them will be settled with the claimant or beneficiary. The vast majority of obligations are discharged by insurers through settlement of insurance contracts rather than the transfer of obligations to another insurer. In the absence of deep liquid secondary markets that provide sufficiently robust values of insurance obligations, elements of insurance obligations should be valued using cash flow models or other methods that reflect the settlement of the insurance obligations and accord with principles, methodologies and parameters that the market would expect to be used. Such valuations could be considered to be "market consistent". Such valuations provide consistency with the other elements of the balance sheet for which reliable market values are available and with the assessments made by market participants of value and risk.*
Structure Element 6: *A market consistent valuation of technical provisions should be based on the risk characteristics of the portfolio rather than the characteristics of the specific insurer holding the portfolio. However it may be appropriate to use assumptions that reflect aspects of the insurer's specific business model and practices where they can be sufficiently substantiated.*
Structure Element 7: *Given the intrinsic uncertainty of insurance obligations, the technical provisions need to include a risk margin over the current estimate of the cost of meeting the policy obligations. The risk margin should be calibrated such that the value of the technical provisions is equivalent to the value that an insurer would be expected to require in order to take over the obligations.*
Structure Element 8: *From a regulatory perspective, the purpose of capital is to ensure that, despite adverse conditions, policy claims and obligations will still be met as they fall due and the required technical provisions remain covered.*

Structure Element 9: *In a market consistent valuation methodology, technical provisions should be calibrated based on assumptions about diversification of the relevant risk factors, which are consistent with market assumptions. Lack of diversification within a risk factor, relative to these assumptions, should be reflected in (increased) required capital, not in technical provisions. Therefore, volatility in underwriting risk greater than used to calibrate the technical provisions should be covered by capital requirements and not technical provisions.*
Structure Element 10: *Mismatch risk exposure which is not intrinsic to the policy portfolio and is assumed voluntarily by the insurer should be reflected in required capital, and not in the technical provisions.*
Structure Element 11: *The risk reflected in the risk margin in technical provisions relates to all liability cash flows and thus to the full time horizon of the insurance contracts underlying these technical provisions. Capital requirements should be calibrated such that, in adversity, assets will exceed technical provisions with a specified level of safety over a defined time horizon.*
Structure Element 12: *The supervisory regime should require insurers to have and maintain corporate governance policies, practices and structures and undertake sound risk management in relation to all aspects of their business. Sound governance is a pre-requisite for a solvency regime to operate effectively.*
Structure Element 13: *The supervisory regime should require insurers to have sound market conduct policies and procedures. The regime should be transparent as to how policyholder expectations should be expressed and reflected in solvency assessment.*
Structure Element 14: *There should be a number of solvency control levels which trigger different degrees of intervention by the supervisor in a timely manner. The solvency regime should have due regard to the coherence of the solvency control levels and any corrective action that may be at the disposal of the insurer, and of the supervisor, including options to reduce the risks being taken by the insurer as well as to raise more capital.*
Structure Element 15: *The supervisory regime should specify which solvency information should be made public to enhance market discipline and provide strong incentives for insurers to conduct their business in a safe, sound and efficient manner which treats policyholders fairly. Information provided to the supervisor and subject to confidentiality supports and fosters openness on commercially sensitive issues between the supervisor and the insurer. The regime should be open and transparent as to the regulatory requirements in force, and be explicit about its objectives and the level of safety that it requires.*