MFSA

MALTA FINANCIAL SERVICES AUTHORITY

The Supervisory Objectives, Functions and Activities and The Supervisory Review Process

Insurance and Pensions Supervision Unit

2016

Contents

1. The Functions of the MFSA

The Malta Financial Services Authority ("Authority") is the competent authority established by the Malta Financial Services Authority Act (Cap. 330) to act as the single regulator for financial services in Malta. Article 4 of the said Act lists the functions of the Authority.

For the better performance of its functions, the Authority collaborates with other local and foreign bodies, Government departments, international organisations, with the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and colleges of supervisors, the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board (ESRB), the European Central Bank (ECB), the Single Resolution Board (SRB) and other entities which exercise regulatory, supervisory or licensing powers under any law in Malta or abroad or which are otherwise engaged in overseeing or monitoring areas or activities in the financial services sector and the registration of commercial partnerships, and to make arrangements for the mutual exchange of information and for other forms of assistance in regulatory and supervisory matters.

1.1 The Main Supervisory Role of the Insurance and Pensions Supervision Unit

The Insurance and Pensions Supervision Unit ("IPSU") is responsible for the prudential supervision of authorised insurance undertakings, authorised reinsurance undertakings, captive insurance undertakings and captive reinsurance undertakings ("undertakings") including business carried on by those undertakings in a Member State or EEA State, either through establishment or under the freedom to provide services. Supervision conducted by IPSU falls under the remit of five functions; namely the Actuarial, Compliance, Finance, Risk Management and Regulatory and Legal. Each function is carried out by individuals having the relevant skills, experience and competencies to make the supervisory judgements and decisions. IPSU is also responsible for the supervision of insurance intermediaries, pension schemes, pension funds and pension service providers.

2. General Supervisory Powers

The main objective of supervision of the Authority is namely the protection of policyholders and beneficiaries. The MFSA, in carrying out its duties under the Insurance Business Act is to duly consider the potential impact of its decisions on the stability of the financial system in the European Union in particular in emergency situations based on information available at the relevant time; provided that in times of exceptional movements in financial markets, the MFSA shall take into account the potential pro-cyclical effects of its actions. In exercising its functions and duties under the Insurance Business Act, the MFSA will also take into account a European dimension.

3. The objectives of the Insurance and Pensions Supervision Unit in relation to the supervision of undertakings

IPSU has two main complementary objectives in respect of insurance and pension supervision:

i. to protect policyholders, insured persons and beneficiaries; and
ii. safeguard the stability of the financial system.

The role of IPSU in protecting policyholders is to ensure there is a reasonably high probability that an undertaking is able to meet claims from policyholders or obligations to policyholders as they fall due; and to make sure that where an undertaking is unable to meet such claims or obligations, the adverse consequences for policyholders are minimised as much as possible.

IPSU contributes to an appropriate degree of policyholder protection by:

a. setting out insurance legislation which undertakings are expected to meet both in letter and in spirit; and
b. supervising undertakings to determine whether they meet these regulatory requirements, at the time of assessment and on a forward-looking basis, taking the necessary action if they do not.

4. General Provisions of the Supervisory Review Process

In terms of Article 31B of the Insurance Business Act, IPSU reviews and evaluates the strategies, processes and reporting procedures established by undertakings. This includes an assessment of the qualitative requirements relating to the system of governance, the assessment of the risks which the undertakings concerned face or may face and an assessment of the ability of those undertakings to assess those risks taking into account the environment in which the undertakings are operating. In particular, IPSU reviews and evaluates the own-risk and solvency assessment, the technical provisions, the capital requirements, the quality and quantity of own funds as well as ensures that undertakings are investing their assets in accordance with the prudent person principle. Where undertakings use a full or partial internal model to calculate their solvency capital requirement, IPSU ensures on-going compliance with the requirements for full and partial internal models. Additionally, in terms of regulation 8 of the Insurance Business (General Provisions of Supervision) Regulations, IPSU is empowered to develop where appropriate, necessary quantitative tools under the supervisory review process to assess the ability of the undertakings to cope with possible events or future changes in economic conditions that could have unfavourable effects on the undertaking's overall financial standing.

5. General Principles of the Supervisory Review Process

Supervision carried out by IPSU is based on a prospective and risk-based approach. It includes the verification on a continuous basis of the proper operation of the business of insurance and of the compliance with insurance legislation and comprises a combination of off-site and on-site supervision.

IPSU conducts its supervisory activities in a proportionate manner commensurate to the nature, scale and complexity of the risks inherent in the business of undertakings. IPSU is committed to carry on its supervisory duties in a transparent and accountable manner taking into account the protection of confidential information.

The main areas of supervisory activity carried out by IPSU contribute towards ensuring that an undertaking permitted to carry on business of insurance, ensures that:

a. its directors, senior management and key function holders are fit and proper at all times;

b. it has a culture that supports prudent management;

c. it has in place sufficient controls to minimise incentives for excessive risk-taking by management and risk-taking staff;

d. it deals with the MFSA in an open and co-operative manner;

e. any significant decisions involve at least two persons who effectively run the undertaking before the decision is implemented;

f. the Board's size and composition is suitable for the undertaking and the board members collectively possess appropriate qualification, experience and knowledge about at least: insurance and financial markets; business strategy and business model; system of governance; financial and actuarial analysis and the regulatory framework and requirements;

g. it builds an effective system of governance in accordance with the Solvency II Directive which provides for sound and prudent management;

h. it has in place clear structures of accountability and delegation of responsibilities for individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals should remain accountable for the actions of those to whom they delegate responsibilities, including where the undertakings uses third parties in respect of outsourced functions;

i. it invests its assets in accordance with the prudent person principle;

j. it maintains at all times an adequate level and quality of capital, taking into account the risks to which it is exposed. Capital should be sufficient to absorb unexpected losses, based on a wide range of internal and external stresses;

k. there is no significant risk that it cannot meet its liabilities as they fall due, and to have appropriate risk management strategies and systems in place for managing its liquidity;

l. it implements an effective Own Risk Solvency Assessment (ORSA) process which ensures an effective link between an undertaking's business plan, risk appetite, and capital management plans;.

m. it identifies all material risks to be addressed by contingency plans covering the areas where it considers itself to be vulnerable.

6. Risk-based Supervision

IPSU intends to focus its energies on those undertakings that can potentially impact or pose a threat to the overall stability of the financial system and policyholders who tend to be most vulnerable, by the way the undertakings conduct their business and/or in the event of failure.

In view of this, IPSU is committed to continue enhancing its supervisory review process with the aim of achieving a risk-based, prospective and proportionate approach to the supervision of undertakings. It is recognised that as developments in global financial supervision continues, the approach to risk-based supervision may need to evolve to reflect this, including a review of the governance mechanism within the IPSU.

The implementation of risk-based supervision provides one common framework where current and future risks that undertakings face or may be exposed to are identified and assessed in a structured and systematic way. By adopting risk-based supervision, IPSU is able to:

- apply resources effectively and efficiently;
- prioritise supervisory activities;
- determine the appropriate depth and frequency of supervision work;
- set the level of regulatory reporting.

IPSU will continue to interact with all undertakings at a level that corresponds to their overall risk category. The level of interaction principally reflects our judgement of an undertaking's potential impact on policyholders and on the stability of the financial system. The higher the impact posed by an undertaking on the overall stability of our financial system and policyholders, the higher will IPSU's level of interaction be with such undertaking.

IPSU has developed and will continue developing supervisory tools to ensure that it gauges the overall risk posed by each undertaking as well as prompting early intervention to mitigate potential risks. These tools support IPSU in:

- allocating the proper resources for active supervision based on impact and probability;
- adopting a consistent approach for gauging and monitoring risk faced by all supervised undertakings;
- making better risk judgements;
- ensuring that appropriate action is taken in a timely manner to mitigate elevated risks in undertakings;
- building a risk profile for each undertaking;
- improving supervisory work;
- achieving higher levels of governance and risk management as set by Solvency II.

7. How Do We Define Risk?

We define "risk" as anything that:

- harms the interests of any policyholder who comes in contact with any undertaking;
- threatens the stability of the financial system.

8. The Supervisory Review Process

The supervisory review process refers to all activities conducted by IPSU in order to comply with the obligations arising under Article 36 of the Solvency II Directive that includes the evaluation of strategies, processes and reporting procedures established by undertakings to comply with insurance legislation. Whilst IPSU ensures that the principle of proportionality is observed throughout all stages of the supervisory review process, it also ensures that the supervisory review process is applied in a consistent manner across all undertakings.

Inevitably supervisory judgement is to be used at each stage of the supervisory review process. IPSU reaches judgement on the risks that an undertaking is running; the risks that it poses to IPSU's objectives and how to address any problems or shortcomings identified. In particular, IPSU needs to decide which risks are the most material and must be addressed. IPSU understands that a judgement-based approach is necessary in a forward-looking regime.

The IPSU supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, our judgement will not be at par with that of the undertaking. Furthermore, there will be occasions when events will show that IPSU, with hindsight, was wrong. To ensure that IPSU allows appropriate supervisory judgement to be used whilst keeping the process flexible enough, IPSU has developed a high level policy explaining what form and level of judgement should be undertaken at every stage of the supervisory review process. The objectives of this policy are twofold:

1. To ensure that each individual member within IPSU, and the various established internal working groups or committees appropriately use supervisory judgement at each stage of the supervisory review process. This should allow the process to be kept flexible enough for supervisory judgement to be applied whilst establishing specific parameters within which such flexibility is to be exercised. More specifically, this policy aims to detail what form and level of judgement should be undertaken during any of the following critical steps of the supervisory review process:

    - Inbound Information – the consideration of qualitative and quantitative data available from different sources.

    - Risk Assessment Framework – the identification and assessment of current and future risks that undertakings face or may face including the undertaking's capacity to identify, measure, monitor, manage and report on risks. This determines the likelihood and severity of risks affecting undertakings as well as the intensity and frequency of supervision.

    - Detailed Review – taking decisions as to whether an off-site analysis or on-site inspection or a combination of both is to be carried out by IPSU, based on the supervisory plan, taking into account all relevant information and focusing on the areas of risk as identified in the risk assessment framework.

    - Supervisory Measures – identification and monitoring of supervisory measures based on the conclusions of the detailed review.

2. To ensure that a consistent approach is maintained at all stages of the supervisory review process.

9. The Risk Assessment Framework

9.1 Scope

The risk assessment framework incorporates the following stages:
- assessment of information

- determination of impact classification
- determination of probability classification
- determination of risk score
- determination of intensity and frequency of supervision based on the supervisory plan

9.2 The risk assessment cycle

As part of the supervisory review process, IPSU conducts a risk assessment cycle which is the process through which undertakings are assessed on a periodic basis in order to gain a clear understanding of the risks they face or may be exposed to and the specific controls that are in place. This assists IPSU to take appropriate measures as required. The risk assessment cycle comprises of a number of steps - risk identification, risk evaluation, analysis of undertaking's management actions and controls, risk scoring, supervisory activities and monitoring of risks and mitigation actions.

The assessment of risks includes two dimensions:

1. the level of impact (i.e. the damage the undertaking's failure could cause to policyholders and the stability of the financial system)

2. probability (i.e. the likelihood of occurrence)

9.2.1 Impact Classification

IPSU classifies impact in four categories - Low, Medium Low, Medium High and High. This assessment reflects the potential impact that the failure of a particular undertaking would have on its policyholders and financial system.

IPSU assesses impact on an annual basis through a combination of metrics and quantitative indicators. This helps in analysing changes or movements in undertakings within and between impact classifications. IPSU also uses judgement based on qualitative factors in assessing the potential impact of an undertaking in addition to the quantitative process to ensure that the impact classification of undertakings adequately reflects their particular characteristics. This sometimes leads to overriding the quantitative assessment of an undertaking's impact classification. This is subject to a defined decision making process which oversees and approves such adjustments. Quantitative indicators are also affected by particular factors which include but not limited to the different insurance business categories (i.e., Non-Life, Life, Composite, Captives, etc) and concentration in business lines. Significant movements in reported metrics are monitored.

The impact classification at insurance group level will take into account the potential impact of the failure of the insurance group on the group's policyholders and financial system. When assigning an impact classification of an insurance group, IPSU will be taking into account the complexity and inter-connectedness of the insurance group.

9.2.2 Probability Classification

IPSU classifies probability in four categories - Low, Medium Low, Medium High and High. The following elements are considered when carrying out a probability classification - analysis/assessment of risks, analysis/assessment of risk controls, analysis of risk drivers and analysis of relevant risks to the insurance sector.

When determining the probability classification, IPSU identifies and assesses the current and future risks that undertakings face or may face, including the ability of undertakings to withstand possible events or future changes in economic conditions, their potential adverse effect on the solvency and financial position and their ability to meet its obligations to policyholders if the risks materialise. The same will apply with regards to the assessment of probability classification at group level. However IPSU will also be considering other group-specific issues.

IPSU takes into account both quantitative and qualitative information to arrive at a net probability score of an undertaking. Additionally, IPSU also uses judgement in assessing the probability score of an undertaking to ensure that it does not rely on an automated mechanical process based solely on thresholds and scores. The assessment is carried out at least annually. The process starts off with identifying inherent risk and continues with analysing the effects of risk-specific controls and overall risk controls to ultimately end with the residual risk.

9.3 Risk Drivers

IPSU considers that the risks faced by undertakings or to which they can be potentially exposed are influenced by three main risk drivers - the quality of governance, macro-economic risks and the undertaking's business model. The analysis of these risk drivers in addition to the ORSA report submitted by undertakings will assist IPSU in obtaining a picture of future risks that an undertaking may be possibly exposed to and the effects that such risks may have on the undertaking's strategy, business model and capital requirements. This is complemented by the powers conveyed by Article 31B of the Insurance Business Act, where IPSU is able to assess the adequacy of the methods and practices of the undertakings designed to identify possible events or future changes in economic conditions that could have adverse effects on the overall financial standing of the undertaking concerned. IPSU also has the power to assess the ability of undertakings to withstand those possible events or future changes in economic conditions. In the case of events or future changes in economic conditions that could have unfavourable effects on the overall financial standing of undertakings, in addition to the calculation of the Solvency Capital Requirement, IPSU also has the power to require undertakings to carry out such tests as may be determined to assess the ability of the undertakings concerned to withstand such events or future changes in economic conditions that could have unfavourable effects on their overall financial stability.

9.4 Determining the outcome of the risk assessment framework

The combination of impact and probability classifications assist IPSU to prioritise its supervisory tasks and activities and in directing its supervisory resources to undertakings that present the greatest risk to policyholders and financial stability. The impact classifications and probability classifications of all undertakings are compared to each other on a risk map to understand which undertakings pose the highest combined risk. IPSU has developed IMPROVE (IMpact and Probability Risk OVErsight System) which is a supervisory tool that assists in determining the overall risk score of undertakings based on the impact and probability dimensions.

The combination of the impact and probability classification scores in conjunction with other supervisory information, leads to the setting of the supervisory plan for each undertaking. The supervisory plan is commensurate to the nature, scale and complexity of the relative undertaking.

9.5 Notification of the frequency of regular supervisory report

IPSU makes use of the outcome of the risk assessment framework in conjunction with other supervisory information and exercises supervisory judgement to determine the frequency when the regular supervisory report needs to be submitted by the undertaking. In the case of an insurance group, IPSU will communicate changes to the regular supervisory report frequency to the group supervisor before notifying undertakings.

10. Detailed Review

Following the outcome of the Risk Assessment Framework, IPSU carries out detailed review activities consisting of off-site analysis, on-site inspections or a combination of both, based on the supervisory plan, taking into account all relevant information and focusing on the areas of risk as identified in the risk assessment framework.

11. Supervisory Measures

Where IPSU identifies any weakness or deficiency as a consequence of the supervisory review process, based on the conclusions of the detailed review, IPSU requests the undertaking concerned to remedy such weaknesses or deficiencies within such period and in such a manner as it may deem necessary or appropriate in the circumstances in terms of the powers given to it by the Insurance Business Act. The measures taken by IPSU will vary according to the level of significance of the weaknesses and the actual or potential deficiencies or non-compliance faced by the undertaking.

IPSU will notify the undertaking in writing about the specific measures that the undertaking should implement. Where appropriate this will include a specification of the appropriate timeframe in which the undertaking is to implement the actions necessary to comply with the measures. IPSU is also responsible to monitor whether the measures are properly implemented by undertakings. Once the measures are implemented, IPSU will update the supervisory plan to reflect the degree of effectiveness of the supervisory measures as implemented by the undertaking.

12. Power to set Capital Add-ons

In terms of the powers given by Article 31C of the Insurance Business Act, following the supervisory review process, the IPSU may, in exceptional circumstances, set a capital add-on for an undertaking stating the reasons for its decision. Such power shall be exercised in the cases specified in article 31C of the Insurance Business Act.

13. Group Supervision

IPSU shall provide for supervision, at the level of the group, of insurance and reinsurance undertakings which are part of a group in accordance with the Insurance Business (Supervision of Insurance and Reinsurance Undertakings in a Group) Regulations, (S.L 403.17).

The following functions are carried out by IPSU where it acts as the group supervisor:

a. coordination of the gathering and dissemination of relevant or essential information for going concern and emergency situations, including the dissemination of information which is of importance for the carrying out of the supervisory tasks of authorities responsible for the supervision of an individual undertaking in the group;

b. supervisory review and assessment of the financial situation of the group;

c. assessment of compliance of the group with the rules on solvency and of risk concentration and intra-group transactions as set out in Articles 218 to 245 of the Solvency II Directive;

d. assessment of the system of governance of the group, as set out in Article 246 of the Solvency II Directive, and of whether the board of directors of the participating undertaking fulfils the requirements of fitness and properness set out in Articles 42 and 257 of the Solvency II Directive;

e. planning and coordination, through regular meetings held at least annually or through other appropriate means, of supervisory activities in going-concern as well as in emergency situations, in cooperation with the authorities responsible for the supervision of an individual insurance or reinsurance undertaking in a group, and taking into account the nature, scale and complexity of the risks inherent in the business of all undertakings that are part of the group;

f. other tasks, measures and decisions assigned to IPSU, as group supervisor, by the Solvency II Directive or deriving from the application of that Directive, in particular leading the process for validation of any internal model at group level as set out in Articles 231 and 233 of Solvency II Directive and leading the process for permitting the application of the regime established in Articles 237 to 240 of the said Directive.

13.1 Co-operation and exchange of information with respect to group supervision

Where IPSU is the group supervisor, it shall cooperate closely with the other authorities responsible for the supervision of individual undertakings in a group, in particular, in cases where an undertaking within the group encounters financial difficulties.

Where IPSU is one of the supervisory authorities responsible for the supervision of an individual undertaking in a group, it shall cooperate closely with other responsible authorities in the group and the group supervisor, in particular in cases where an undertaking encounters financial difficulties. As part of a college of supervisors[1], IPSU also has ongoing responsibilities to communicate and involve the college in the supervisory review process, particularly when taking supervisory measures, or when undertakings or groups enter into financial difficulties.

In the case where IPSU is either the group supervisor or one of the supervisory authorities responsible for the supervision of an individual undertaking in a group, it shall:

a. provide other authorities responsible for the supervision of an individual undertaking in a group with such information so as to allow and facilitate the exercise of the supervisory tasks concerned under the Solvency II Directive;

[1] college of supervisors means a permanent but flexible structure for the cooperation, coordination and facilitation of decision making concerning the supervision of a group

b. communicate all relevant information to such authorities without delay, as soon as it becomes available or exchange information on request; and

c. call immediately for a meeting of all the authorities involved in the supervision of the group, at least where -
   i. it becomes aware of a significant breach of the Solvency Capital Requirement or a breach of the Minimum Capital Requirement of an individual insurance or reinsurance undertaking;
   ii. it becomes aware of a significant breach of the Solvency Capital Requirement at group level calculated on the basis of consolidated data or the aggregated group Solvency Capital Requirement, in accordance with whichever calculation method is used, in Title III, Chapter II, Section I, Subsection 4 of the Solvency II Directive; or
   iii. other exceptional circumstances are occurring or have occurred.

Without prejudice to Article 248 of the Solvency II Directive, IPSU may decide not to consult other authorities in cases of urgency or where such consultation may jeopardise the effectiveness of its decision. In such a case, the IPSU shall without delay, inform the other authorities responsible for the supervision of an individual undertaking in a group.

14. Information to be provided for supervisory purposes

In terms of article 32 of the Insurance Business Act, undertakings shall submit to the IPSU the information which is necessary for the purposes of supervision, taking into account the objectives of supervision, as may be specified by means of regulations or Insurance Rules which shall also specify the period within which this information is to be submitted.

15. Thematic Work

The IMROVE tool will assist IPSU to undertake thematic work in a more structured and systematic way. The tool is able to identify specific risks or issues that are common across a range of undertakings. IPSU will be in a better position to assess the specific issues and adopt a common approach towards mitigating such risks or tackling such issues.

16. Will IPSU prevent failures of authorised undertakings?

The MFSA accepts that risk-based supervision does not eliminate risks but mitigates risks and in the event of a failure of an undertaking, IPSU will ensure that the undertaking winds up in an orderly manner.

17. Conclusion

By adopting a risk-based, prospective and proportionate approach to supervision, IPSU believes that it shall be creating incentives for undertakings to keep raising their standards and maximising their success whilst keeping within the parameters of the regulatory framework.