BULLETIN ON EARLY WARNING RATIOS

BACKGROUND

The Financial Services Commission ("Commission") has been working with a series of early warning ratios to detect risks based on information submitted in each company's annual and quarterly filings, which are subject to a more detailed analysis by the Insurance Division.

The early warning ratios form an integral part of the monitoring process for all registered companies. Monitoring is conducted to achieve a number of outcomes:

1. Understand the insurer and its business environment
2. Detect solvency problems
3. Detect non-compliance with legislation
4. Obtain information on system-wide issues
5. Gain market intelligence

As the global landscape changes, so does the monitoring requirements for entities. Accordingly, changes to some of the original ratios are being proposed. The aim of these proposed changes is to better assess the financial reports that are submitted to the Commission.

The changes are:

Net Investment Income Ratio

Amendment: The inclusion of accrued investment income in the formula

The ratio is being revised to recognise all investments at their fair values plus any earnings due but not yet received, i.e. Accrued Investment Income. *In essence, an investment must be valued at what it would be sold at today plus any earnings due but not yet received on it*. The assumption is that the **investment** and **rights** to the **benefits (accrued investment income, future income and gains)** on that investment would be transferred to the new owner (the buyer). As a result the FSC has made the decision to add ***accrued investments*** to ***investments and cash.*** The relevance of this ratio is being enhanced to recognise that accrued investment income represents a portion of the net investment income earned during a financial period and increases the value of investments held at the end of a financial period.

1. Net Investments Income Ratio

$$\frac{\textbf{Net Investment Income}}{\textbf{Average of the Investments, Accrued investment income and Cash for the last two periods Less investment income for the current period}}$$

All ratios with Capital and Surplus

Amendment: The inclusion of Investment Reserves and Capital Reserves as components of capital

Investment and capital reserves form a substantial part of a company's equity and the proposed change provides a more accurate assessment of a company's financial position. The new denominator is now **Capital and Surplus and Investment and Capital Reserves.** The amendment in the ratio is consistent with the recognition of gains and losses through equity in accordance with the provisions of IAS 39 on Financial Instruments and IAS 16 on Property Plant and Equipment.

These financial instruments are: Financial assets which are available for sale (AFS), Loans and Receivables and Investment which are held to maturity.

Financial Instruments (**IAS 39)**

IAS 39 requires financial assets to be classified in one of the following categories:

- Available for sale.
- Loans and receivables.
- Held to maturity.
- Financial assets at fair value through profit or loss.

Those categories are used to determine how a particular financial asset is recognized and measured in the financial statements.

The ratios that will be affected by the above changes are presented below:

2. Insurance Risk Ratio

$$\frac{\textbf{Net Premiums Written}}{\textbf{Capital \& Surplus \& Investment and Capital Reserves}}$$

3. Return on equity

$$\frac{\textbf{Net Income (before tax)}}{\textbf{Capital \& Surplus \& Investment and Capital Reserves}}$$

4. Amounts Due from Agents and Brokers to Capital & Surplus

$$\frac{\textbf{Due from Agents and Brokers}}{\textbf{Capital \& Surplus \& Investment and Capital Reserves}}$$

5. Solvency Ratio

$$\frac{\text{Capital \& Surplus \& Investment and Capital Reserves}}{\text{Total Liabilities}}$$

6. Change in Capital & Surplus

$$\frac{\text{(Current Cap'l \& Surplus \& Invest and Cap'l Res) - (Prior Cap'l \& Surplus \& Invest and Cap'l Res.)}}{\text{(Prior Capital \& Surplus \& Invest and Cap'l Res.)}}$$

7. Loss Reserves to Capital & Surplus

$$\frac{\text{Actuarial Reserves}}{\text{Capital \& Surplus \& Investment and Capital Reserves}}$$

8. Test of Receivables

The maximum standard is being reduced to 25% from 100%. The FSC believes that the exposure of the equivalent of 100% of a company's capital to the possibility of default is imprudent and should be avoided.

$$\frac{\text{Accounts Receivables Less amounts over 90 days in arrears}}{\text{Capital \& Surplus \& Investment and Capital Reserves}}$$

9. Liquidity Ratio

$$\frac{\text{Liquid Assets}}{\text{Total Liabilities}}$$

- *Cash and Accrued Investment Income will be included in liquid assets.*
- *Recoverable from Reinsurers will be added to liquid assets and should not be subtracted from total liabilities.*

The proposed changes will standardize the computation of the ratios

Modification of General Template

So as to facilitate the introduction of the Minimum Capital Test ('MCT') the general template will be modified to show the breakdown of investments on sheet 40.10 *(Summary of Investments)* so as to match the types of investments recognized in the MCT calculation.

Additionally, separate rows will be introduced in the template which will facilitate information on the following types of investment being reported:

- Repurchase Agreements
- Government Grade
- Bank Grade
- Investment Grade
- Non-Investment Grade

Other modification will include Sheet 10.20 *(Share Capital)* to list Redeemable and Irredeemable preference shares separately.

The number of rows on Sheets 50.20A to 50.40B *(Receivables/Payables)* and 50.50 *(Other Assets/Other liabilities)* to be increased

An additional *'Current'* column will be added to supplement the *'In Arrears'* column on Receivables schedules **–** *50.20A to 50.40B.* This will allow the FSC to be more accurate in the calculations of a company's total receivables.