EMBRACING CHANGE – REGULATORY INNOVATION

Angele Grech, director of the MFSA Authorisation Unit, speaks to *Captive Review* about Malta's innovative establishment of a regulatory regime for protected cell companies

Insurance is a dynamic industry operating in a world of risk and uniquely exposed to uncertainty. To succeed, it needs to be flexible and innovative. In parallel, regulatory change is transforming the face of insurance. The Solvency II project, which originated some 13 years ago, aims for a robust framework that captures the economic reality of the asset-liability position of insurers and brings capital closer to the insurers' risk profile. The framework promotes a strong risk culture embedded in the insurers' organisation and nurtures strong risk management capabilities. This is a steep shift from the fragmented and outdated approach of the current, rules-based Solvency I regime, which primarily focuses on the capital adequacy for insurers without catering for risk management and governance within firms.

As insurers respond to these new regulatory developments, they are faced with strategic and operational challenges. As insurers adjust, they innovate – and look for opportunity in change.

In developing a supervisory framework for insurance companies, the Malta Financial Services Authority (MFSA) has adopted a dynamic and proactive approach to market needs through the evolving of prudent, sustainable and innovative regulation. The

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MFSA values an open communication and dialogue with stakeholders and this has resulted in the development of new regulation to keep abreast with market changes. As an ongoing process the MFSA has sought to balance innovation with sound institutional development through sustainable regulation.

The establishment of a regulatory regime for protected cell companies (PCC) in insurance is a prime example of regulatory innovation. Malta introduced the PCC regime in 2004 and is the only full European member state to offer PCC legislation.

The PCC is a single legal entity authorised in terms of the Insurance Business Act (Cap 403) and the Companies Act (Cell Companies Carrying on Business of Insurance) Regulations, 2010 (S.L. 386.10). It is structured in two parts; a non-cellular part (the core) and an unlimited number of cells. Despite the segregation of assets and liabilities that exists between protected cells and the core and among the protected cells themselves, a cell has no separate legal identity.

For regulatory purposes, where any liability arising is attributable to a cell of the PCC, the cellular assets of a cell will be primarily used to meet the liability of that cell and the non-cellular assets (also known as the core assets) can be utilised to meet the liability of the cell, only when the cellular assets of the cell have been exhausted. Cellular assets from other cells cannot be used to meet the liability of the cell.

> **"The framework promotes a strong risk culture embedded in the insurers' organisation and nurtures strong risk management capabilities"**

PCCs may be used for reinsurance, insurance and captive business. Within a PCC structure, the cells are approved to write re/insurance business. The core, on the other hand, may or may not be authorised to write re/insurance.

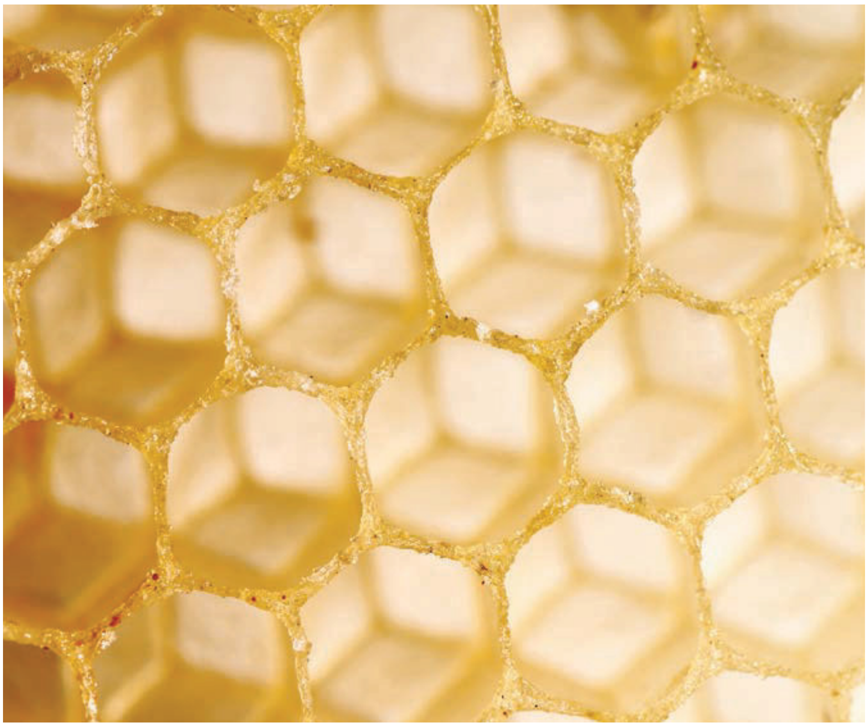
The core of the PCC is the provider of capital for solvency purposes and in the event that any of the cells become insolvent, the core should transfer capital to meet the liabilities of the cell. The core also maintains and controls all the activities of the PCC.

Under Solvency II, the core and cells within the PCC structure are treated as ring-fenced funds. The Solvency II framework adopts a complementary three pillar approach. As a single legal entity, the PCC needs to comply with Solvency II as a whole thereby offering a proportionate facility for cells. This is key when it comes to addressing all requirements under the three pillars of Solvency II.

Pillar 1 sets out a valuation standard for assets and liabilities and introduces two capital requirements, the solvency capital requirement (SCR) and the minimum capital requirement (MCR). The MCR is an absolute minimum floor that, if breached, will trigger serious regulatory intervention and potential licence withdrawal. The SCR, on the other hand, is a target level that the firm should aim for. Breaching the SCR will be considered by the regulator as a sign of a firm's deteriorating financial soundness and intervention will take place so that the firm takes appropriate action to restore the SCR. For PCCs, the notional SCR needs to be calculated for each cell as well as the core in the same manner as if they were all separate undertakings. The SCR for the PCC as a whole is the sum of the notional SCR for each cell and the notional SCR of the core.

As one legal entity the PCC has a single board of directors which manages the affairs of the PCC as a whole. It therefore follows that in respect Pillar 2 (Risk Management and Governance) all systems of governance requirements, including key functions and the 'own risk' and solvency assessment process, will be under the control of the board of directors with cost sharing opportunities for cells.

Likewise, under Pillar 3, a PCC will also need to satisfy regulatory reporting requirements as one single legal entity and this can be of a cost benefit to cells operating within the structure.



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Accordingly, and increasingly so for small captives, cells provide the facility of flexibility, speedier set-ups and cost-effective solutions while being fully compliant with the Solvency II regulatory regime. The concept of proportionality is fundamental to Solvency II and cell structures present a solution for smaller captives who may be concerned that the compliance burden may be too onerous for a stand-alone company.

Malta's regulatory framework caters for the establishment of PCCs, whether through incorporation, conversion or re-domiciliation (under the Continuance of Companies Regulations (S.L.386.05)) as well as through the creation of cells and the transfer of cellular assets from and to other PCCs.

In addition, new regulations – the Securitisation Cell Companies Regulations, 2014 – continue to build on the 'protected cell' concept by adapting and extending the protected cell company structure to cater for securitisation activity. These regulations set out a framework for a new type of cell company acting as a reinsurance special purpose vehicle in Malta – the Securitisation Cell Company. Through fusing the highly sophisticated frameworks provided in the Securitisation Act (Cap. 484) and the Reinsurance Special Purpose Vehicle Regulations (L.N. 452 of 2013) with the cell company concept, the regulations now provide a legally entrenched framework for segregation of different sets of assets and risk instruments within a single special purpose vehicle, the SCC, thereby allowing for the launch of multiple insurance-linked securities without incurring any risk of cross-contamination between the different sets of creditors and investors.

There is little doubt that significant regulatory change will continue. Faced with such a reality, in a world of uncertainty, insurers look for opportunity in change. As regulators, the MFSA continues to recognise the importance of maintaining an appropriate balance between preserving the safety and soundness of the system and allowing the flexibility for insurers to create business value through performing their intended functions in an environment which fosters sustainable growth.