# Challenges to Solvency II Reform in Insurance Industry

Ramosaj, Berim

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Berim Ramosaj, PhD
Faculty of Economics at the University of Prishtina, Republic of Kosovo

## Abstract

Insurance Industry is going through a very important stage of its transformation - the transition from the classical system of management into a risk-based management. These changes were launched in Europe by international organizations which deal with the development of the necessary infrastructure for a better-managed industry and with a proper legal infrastructure through different European directives in insurance area.

These changes have intensity in the finalization of the general technical, legal and structural infrastructure, which would be developed based on three pillars. The consequences of the current financial crisis as well as its impact towards the implementation of Insolvency II have not been analyzed yet. Its implementation, perhaps, would be an adequate response in facing this crisis.

**Key words:** Solvency II, insurance industry, insurance reform, risk-based management.

**Jel code:** G10, G11, G18, G20, G22, G23, G28, G30, G32, G38.

# 1. Introduction

Solvency I framework has been effective since 1970, using a very simple model in the calculation of requirements for capital. Noting this state which resulted in the failure of many companies as well as in the lack of knowledge about new risks, many countries established special regulations for preservation and supervision of the above-mentioned companies, therefore there was a diversity of different regulative. Given this state and monitoring the developments in the banking system, especially in the emerging of Basel II, an idea emerged for the insurance industry to have its own system which was entitled Solvency II. The purpose of Solvency II system is to improve the insurance regulation and moreover:

- Risk-based system
- Joint access to reserves and requirements for capital
- Comprehensive framework for risk management
- Requirements for defined capital according to a standard approach or internal models
- The recognition of diversification and the mitigation of risks

# 2. Why and how to reform the requirements for European insurance solvency?

Following the implementation of Solvency I, new requirements emerged for the development of a new approach known as Solvency II. The reason for development is that we are dealing with a development where the companies were exposed to their risks which were not taken into consideration at all by the form of the functioning of Solvency I.

## 2.1. Reasonability of reform

The main reason for establishment of a new system is the establishment of a new solvency infrastructure and architecture of the insurance companies. This is a detailed reform which is based on the risk-based principles, known as a new risk-based approach.

### a) Three current pillars of insurance industry solvency

Solvency II is based in three overall pillars. The first pillar is related to the requirements for capital, whereas the second pillar is related to the internal system of the company operation, while the third pillar deals with the transparency of the companies towards the public.

### (b) Limits of current regulations

Given that all the countries have different regulations, it is very hard to understand that there will be a harmonization of the regulations within the EU as well as outside European Union in those countries aiming to implement solvency II. The calculation of Solvency varies from country to country because if the calculation is considered to be proper for one country, it will deem as improper calculation for the other country. Risk-based approach as a new approach establishes the necessity to establish a model approach which would be adequate.

Facing all these weaknesses, one had to launch the initiative of establishing a unique system in the calculation of Solvency I, a system which was inspired by the system of banks in the risk-based approach which is Basel II. Adequate regulation is still under process until the finalization of the process and which upon the completion of the entire process is thought to begin its practical implementation sometimes between 2001/2012. Kosovo has the will and the desire to harmonize the entire regulation which would move towards the harmonization of its regulation with the European regulation with an aim of enabling the implementation of Solvency II as soon as possible.

## 2.2. The importance of the open process of reform

In our times it is impossible to work on something that would be of general interest such as Solvency II in a secret manner or far from the key stakeholders of this area. This system is being established in an open and transparent way, with participation of all the possible stakeholders, both from industry and the regulatory body.

### a) Insurance regulation cannot be externally imposed

Given the complex nature of insurance and given the developments which take place in this industry are very rapid, it is very difficult for the authorities which create policies and regulate this area to create mandatory policies for implementation, without the participation of the insurance industry.

### b) Participants in Solvency II process

The logical question which arises is who are stakeholders or the participants in the creation of this entire infrastructure, both technical and legal, for the establishment of this system. The very important stakeholders in the creation of this model are CEIOPS[1], then EIOPC[2] which have created a regulation on Solvency II, whereas CEA[3] and IAIS[4] have an advisory role in relation

[1] CEIOPS – Committee of European Insurance and Occupational Pension Supervisors
[2] EIOPC- Europian Insurance and Occuptional Pension Committee
[3] CEA – Comite Europeen des Assurances ( Shoqata Evropiane e siguruesve)
[4] IAIS – International Association of Insurance Supervisors

with provision of comments and recommendations, whereas a very important role was played by IAA[5] and CRO[6] Forum as well.

## 3. Primary orientations of Solvency II

There are many divergences between the proposals of Solvency II and the European insurers; however it is clear to the both parties that it is necessary to move forward towards the establishment of a proper system and its implementation in EU countries and beyond. Initially, the involved parties have agreed to create several basic orientations on the work and the approach to be taken in this project.

### 3.1 The reform should be reasonable

Initially, the main point was for the parties to agree that the reform should be reasonable. In what context it should be ‘reasonable’? Given that the company capital is limited and that new additional requirements for capital should be in harmony with the real capabilities of the company, in order to increase the capital, depending on the new requirements which derive from this model.

### 3.2 Solvency margin should serve the absorbing of funds rather than cutting of funds

The company capital serves to cover the unexpected events which come as a result of a catastrophic damage or any failure in investments. The margin should be in a level which according to the calculations made by the company or the standard approach enabling sufficient space for the company to create funds which would generate profit.

### 3.3 Supervision should be proportional based on the financial power of the insurer, particularly based on the level of solvency margin

Supervision exists to protect the interests of policyholders; therefore its intervention is necessary when the company exceeds the minimum levels of solvency margin, and when it intervenes in cases when it estimates that the company is going towards the worsening of the internal situation in the company, which in return would harm the interests of policyholders. According to the new approach, the intervention of supervisors is required to take place only when the minimum limits are violated. This implies that managements have a key role to play in managing the company based on the standard approach or based on the internal model. Companies should have sufficient capacity in creating internal models. The establishment of internal models of calculation and control requires an approval by the authority.

[5] IAA – International Actuarial Association
[6] CRO – Chief Risk Officers

### 3.4 New standard formulas should consider the slight application of the basic risks

The so far calculation of solvency was very easy based on the lump sum which took into consideration the calculation of solvency on prime pal basis of the damage. The new approach or requirements for the calculation of Solvency II are more meaningful and have two ways for calculation. One way is the standard war which is established by the experts and by the authority and is a model which can be applied by the companies that do not have internal models. The second way is if the companies have their internal models of solvency calculation. The distinction between the two ways is that the first way or as it is known Solvency I considers the underwriting risk or the damages, and from these calculations they have rendered the solvency margin. The new approach involves in itself many risks which should be considered in calculation of solvency and these are: underwriting risk, interest rate risk, market risk and asset liability mismatch risk.

### 3.5 The reform should take into consideration the internal models in the calculation of requirements per capital

The reform should consider one fact and that is if that the authority should recognize the rights of the companies if they have created internal models of accepting to calculate the solvency according to their model. The internal model should be based on requirements according to criteria of Solvency II which should be based on three pillars. Upon the completion and the calculation of solvency, the models should seek for the approval by the respective authorities, in order for them to be efficient.

### 3.6. In case of groups, the solvency control should take into consideration the facts of the group during assessment

The calculation of solvency according to the new approach will take into consideration the entire team, in addition to the host company; it should also take into consideration the branch or subsidiary. Regulatory bodies were not in favor of this approach because they believed that each entity will secure its own risks. This deals only with the underwriting risks, however in cases of severe financial situations in the entire corporation or entity, the impact is inalienable. Therefore during the calculation of solvency, in addition to the fact that each entity will have estimated the solvency, the entire group as well should estimate the solvency according to the new approach for the entire group.

## 4. Some issues in the actual debate about Solvency II

Many negotiations took place before the reaching of the final decisions, as well as many consultations within CEIOP until the setting out of basic principles on which the work of the working teams would be based in the future. The creation of basic principles also aimed at harmonizing the orientations of all the players in this project, such as EU, CEA and insurance industry.

## 4.1 Principles of the European Commission framework

The framework for preparation of Solvency II is based in seven principles and these include[7]:

- Compliance with the IAS processes[8] related to the assets and liabilities which will be estimated at real value for the sake of margin calculation
- The acceptance of internal models
- The application of risk-based formula
- The application to be extended to groups as well
- Application of solvency requirements in two spheres and MCR and SCR
- SCR should be 99.5% of MCR
- Harmonization not only of solvency ruled, but the solvency of supervisions as well

### 4.2 Issues discussed in CEIOPS

Since the project on Solvency II has reached its active stage, the European Commission has sent to CEIOPS three waves of questions which included:

- The first wave was related to the internal and external controls as well as asset management principles.
- Second wave was concentrated in relation with the adequacy of reserves, solvency required level, solvency group, risk assessment techniques, supervisory authority and studies on the future impact.
- Whereas the third wave was related to the focus on which asset should be used for the calculation of solvency, cooperation between the supervisors, reporting, and provision of adequate systems as well as the treatment of minor insurers.

Many of the questions encountered on critiques in CEIOPS, whereas many others are still being reviewed by the insurance industry. Below are elaborated the issues which are still under process, and open for discussion.

### a) The sufficiency of the desired and the planned margin (SCR)

[7] Philippe Trainer, The challenge of Solvency Reform for European Insurers, Geneva papers, 2006.
[8] IAS- International Accounting Standards

Given that each industry or each country has its own specifics and characteristics in purchasing risks. Considering these distinctions, the question which arises is how to find a unique model formula in assessing risks during the underwriting process. This unique form would facilitate the unification of standards and methods of risk assessment. This unique method is called Value at Risk (VaR) and the using of this method would help to assess the risk according to the value at the moment of underwriting, i.e. at the moment of purchasing risk. Upon the creation of this model or risk assessment, because through this method, all the characteristics and changes which have various targets as specifics, or the different companies would assess fairly the risks according to the real values. After this, there has been a lot of talk on the assigning of the solvency margin and jointly with other stakeholders in the creation of this project, reached to the conclusion that SCR should probably be 0.5% a year.

### b) Sufficiency of the technical reserves

The assigned percentage of 0.5% will not be applied for different funds, but will be applied for the future liabilities of the company per year. Percentage of 99.5% of assets should cover the reserves in unpredictable situations. Solvency II should be compatible with International Accounting Standards (IAS), which is the process of assigning the level and the manner of reserve calculation. The establishment of the model of reserve calculation based on international accounting standards would facilitate the companies in calculating properly the reserves which are based on the risk assessments of a company.

### c) Minimum Capital Requirements

There is a lot of discussion with regards to estimate or what should be the minimum capital requirement (MCR). There are various requirements for the MCR to be at 25% less than SCR, while the others professionals who believe that MCR should be estimated according to the internal model.

### d) Margin cover

In order to cover the margin, there is a lot of discussion on which assets should be included within SEIOPS and there are differences on this issue. During the discussions on this subject, it was requested to clarify the assets to be included in the estimation of the solvency margin. There are several opinions emphasizing the need for creation of a list which should include the unacceptable assets for estimation.

### e) Standard formula structure

In the standard estimation, we use the formula which is a risk-based formula, which could be divided into two groups. The first group contains the factor-based formula which prepares the accounts based on different coefficients which shall estimate the company exposure to risks. The second group contains scenario-based formulas which through stress-tests and through different scenarios which should be applied using the company balances and applies different coefficients in establishment of different variances.

### f) Discretion of supervision

During these discussions, a distinction was created between different groups of interest with regards to the role of the supervisors in Solvency II. There are two groups of opinions with regards to this issue. One group believes that supervisors should create regulations and exact procedure with regards to its implementation, and this group consists of the representatives of the continental Europe, whereas the second group believes that supervisors should face with the open and pragmatic access to market, by establishing a consensus between the policymakers and the businesses, an access enjoyed by the Anglo-Saxon representatives.

### g) Credit risk of European supervised reinsurers

In assessment of reinsurance companies which should not be supervised by EU countries, other assessment criteria should be used with regards to those reinsurers which are supervised by European authorities.

## Conclusions

Solvency II is an unstoppable process towards the achievement of a bigger goal of the insurance industry in the perfection of the methods of company management on risk-based method. The process of establishment of this modality was not easy and more time is required for its full implementation by the insurance industry. Insurance industries in countries such as Kosovo do not need to follow the same path in establishment of both, technical and legal infrastructure of Solvency. They need to create the necessary environment and to prepare the internal environment of the companies, so that they could start thinking about making the necessary preparations and initiate procedures to work on the creation of the adequate modality for Solvency II.

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