



International Association for the
Study of Insurance Economics

Études et Dossiers

Extract from

Études et Dossiers No. 342

KIDI International Conference 2007
**“New Risk Management Environment
and Strategy”**

Seoul, 6 September 2007

&

Montepaschi Vita Annual Forum 2007
**“Insurers and Banks: Complementarity
and Competition”**

Rome, 12 October 2007

March 2008

Working Paper Series of
The Geneva Association

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The Geneva Association Working Paper Series “Études et Dossiers” appear at irregular intervals about 10 - 12 times per year. Distribution is limited.

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Layout & Distribution: Valéria Kozakova

Current and Future Trends in International Risk-based Supervision and Regulation

Gerry Dickinson and Patrick M. Liedtke

Overview

About The Geneva Association

Part 1 Background to the Development of New Risk-based
Regulatory and Supervisory Systems in Insurance

Part 2 Main Features of the Emerging Solvency 2 in Europe

Part 3 Characteristics of 2nd Generation Risk-based Regulatory
and Supervisory Systems in Insurance

Part 4 Potential Market and Economic Impact of Solvency 2
and other 2nd Generation Risk-based Systems

Part 5 Conclusion



The Geneva Association

- The International Association for the Study of Insurance Economics
- Existing since 1973 in Geneva
- Formed by a maximum of 80 CEOs from the most important insurance companies in the world
- Think-tank for the insurance industry
- Research the growing importance of insurance activities world-wide in all sectors of the economy



The Geneva Association

- Identify fundamental trends and strategic issues in or linked to insurance
- Develop and encourage initiatives concerning the evolution - in economic and cultural terms - of insurance, risk management and the notion of uncertainty in the modern economy
- Organisation, co-organisation and sponsoring of conferences, seminars and lectures
- Publication of several newsletters, the Geneva Papers and special books/reports



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- Risk Management: Walter Stahel
 - Non-fin. RM, nat. cats, risk analysis, prevention & mitigation etc.
- PROGRES: Jan Monkiewicz
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 - Health insurance, demographics, medical & biotechnology
- Insurance Economics: Patrick M. Liedtke
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Part 1

Background to the Development of New Risk-based Regulatory and Supervisory Systems in Insurance



Introduction

- With globalisation and more convergence within the financial sector, Basel Committee of Central Bank Governors of G10 countries decided to improve and standardise international regulatory architecture across the whole financial services sector. This led to a major revision of the Basel Accord (Basel 2) in 1999 and its updates which still continue.
- Following the financial crises of the 1990s, the Financial Stability Forum was set up in 1999, with representation from IMF, World Bank, leading Central Banks and financial supervisors. Its aim is to ensure that global financial system could withstand economic and political shocks and reduce potential systemic risk. More effective global regulation and supervision for the financial services sector is part of this aim.



Introduction

- During the mid and late 1990's some countries moved to risk-based capital systems for insurance e.g. United States, Japan, Canada, Singapore and Australia. These decisions were to be more consistent with risk-based capital systems in banking under Basel 1 (1988), and occasionally a wish to follow the example of other countries.
- European countries and a number of other countries, such as South Korea, decided to wait before deciding to move to a risk-based capital system.



Evolution to Solvency 2 in Europe

- Current European solvency system (Solvency 1) dates back to 1st EU Establishment Directives: Non-Life Insurance (1973) and Life Insurance (1979). There were minor changes in 2001.
- The Müller Report to the European Commission in 1997, based on the findings of a committee of European insurance supervisors, stressed the need to update the European solvency system to a risk-based system. But it proposed that any major change should wait until the new Basel 2 framework for banking regulation had been finalised.
- Due to slow progress, UK, Sweden, Netherlands, Germany, Finland, Switzerland and Denmark decided in the early 2000s to change their solvency systems to a risk-based system in advance of Solvency 2.



Evolution to Solvency 2 in Europe

- In 2003, the EU Commission set up a Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to speed up the process of setting up a new risk-based solvency system for insurance, Solvency 2.
- CEIOPS has been very effective and it maintained a close dialogue with the European insurance industry, especially the Comité Européen des Assurances. The Chief Risk Officers Forum set up the Geneva Association has also been active in sharing views with CEIOPS.



IAIS and Emerging International Solvency Systems

- IAIS (International Association of Insurance Supervisors), with a membership of 140 countries, has instructed its Solvency and Actuarial Issues Subcommittee to develop a framework for a more standardized international structure for assessing insurer solvency.
- This IAIS framework is designed to help national supervisory authorities to develop new risk-based solvency systems or amend their existing risk-based systems. It will be designed around the Basel 2 framework, but it is drawing on the experience of CEIOPS in developing Solvency 2.



IAIS and Emerging International Solvency Systems

- The IAIS framework will not be compulsory and will allow for differences between national regulatory regimes, but it is hoped that there will be a gradual convergence of regimes over time.
- Since IAIS has supervisory authorities from many emerging countries, it is aware of the less developed market and legal environments in these countries, and the shortage of actuarial and financial modeling technical expertise.



Links to the IFRS regime

- The EU Commission has viewed that it would be beneficial if the IFRS regime could be used as the basis for accounting valuations for Solvency 2, with a few adjustments to reflect particular prudential considerations.
- CEIOPS that has gone further than the current IASB position on IFRSs by proposing all financial assets and liabilities are valued on market consistent or fair value basis. The wind-up or liquidation scenario implicit in a fair value accounting system is more suited to regulatory reporting than to general purpose financial reporting.



Links to the IFRS regime

- The Accounting Subcommittee of IAIS is also proposing similar emphasis to CEIOPS on the use of a market-consistent/fair value approach for Balance Sheet valuation in the valuation of all financial assets and technical insurance reserves, and in the use economic capital as a basis for determining eligible (admissible) capital.
- Slow progress by IASB in developing Phase 2 of the Insurance Contract Project (which will emerge as a IFRS for insurance liabilities in about 2011) has resulted in Solvency 2 recently having some influence on the Phase 2, especially in calculating risk margins and the accounting treatment of participating life insurance contracts.



Links to the IFRS regime

- Under CEIOPS and IAIS proposals, insurance liabilities (technical reserves) for life and non-life insurance will be determined by discounted expected cash outflows at a risk-free rates with risk margins added. This is similar to the current thinking within the IASB (as evidenced by Insurance Discussion Paper issued in 3rd May 2007). But there are differences from the IASB's current provisional position, as CEIOPS and IAIS both think it inappropriate to include 'own credit risk' and that the value of liabilities must take into account eventual settlement of claims and not just the value of current transfer payment to a third party.




Links to the IFRS regime


- European insurance companies also consider it cost effective if Balance Sheets under IFRS and Solvency 2 are similar, but consider more important that valuation and accounting systems are similar to those used internally in managing their businesses.
- While many insurance companies now use market-consistent Balance Sheets internally to measure economic capital, they do not use fair value for measuring internal profitability or for their financial planning and control. Moreover, their shareholders and other users of their financial statements do not use full fair value to measure or forecast earnings performance.
- Hence there is a different attitude on Balance Sheets compared to Income Statements (Profit and Loss Accounts) by insurance companies and by the users of their published financial statements.




Part 2




**Main Features of the
Emerging Solvency 2 in Europe**

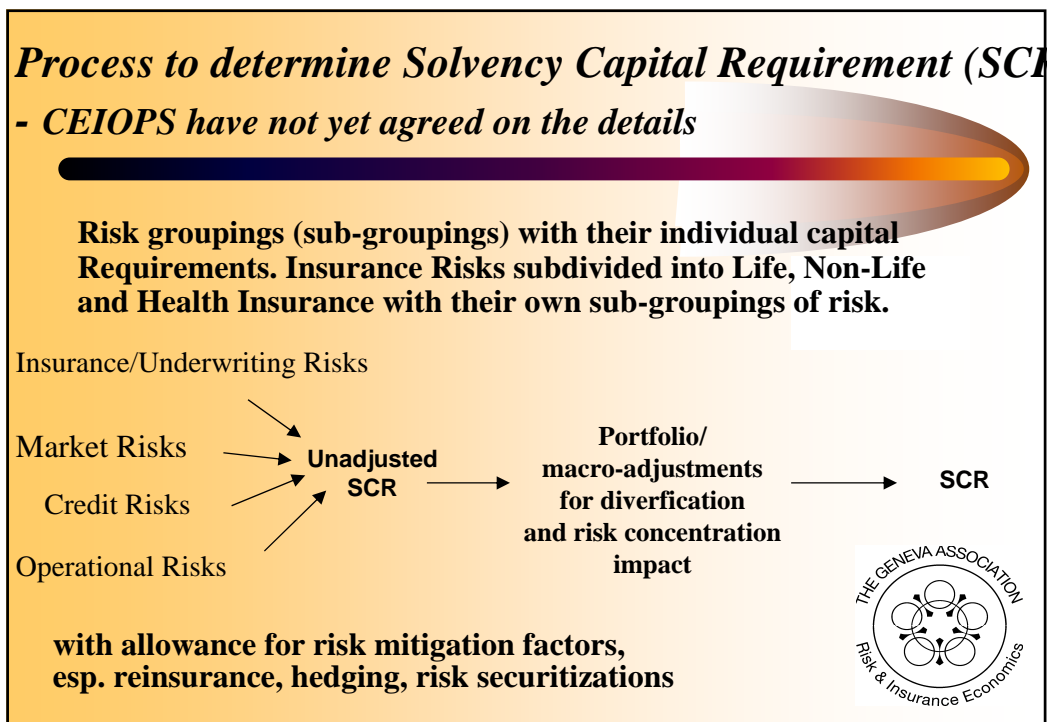
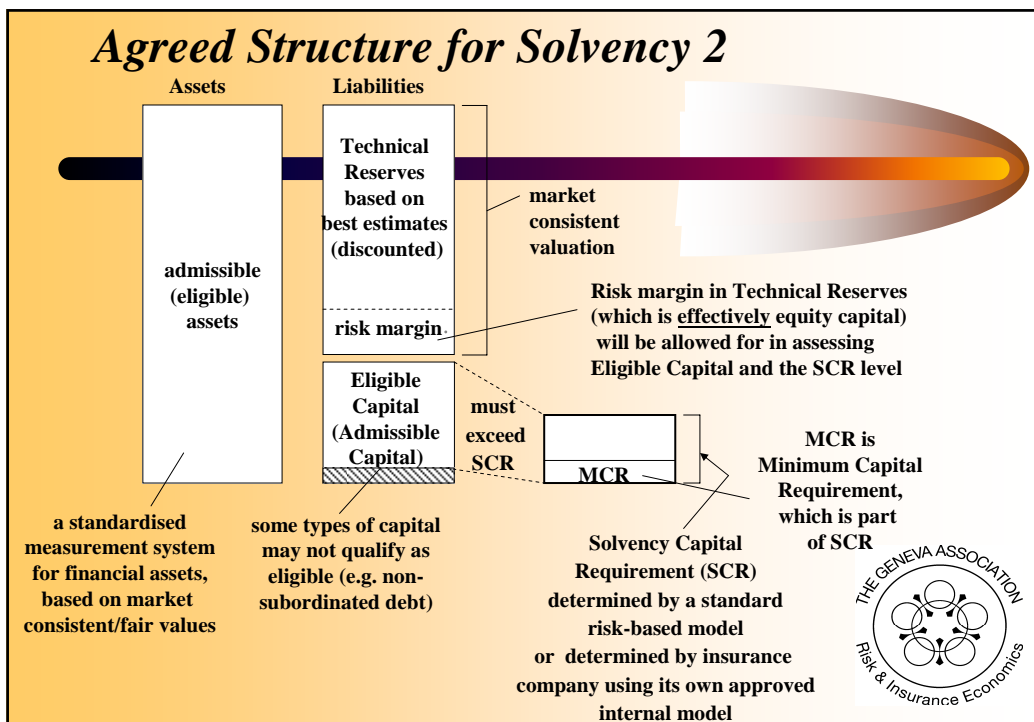


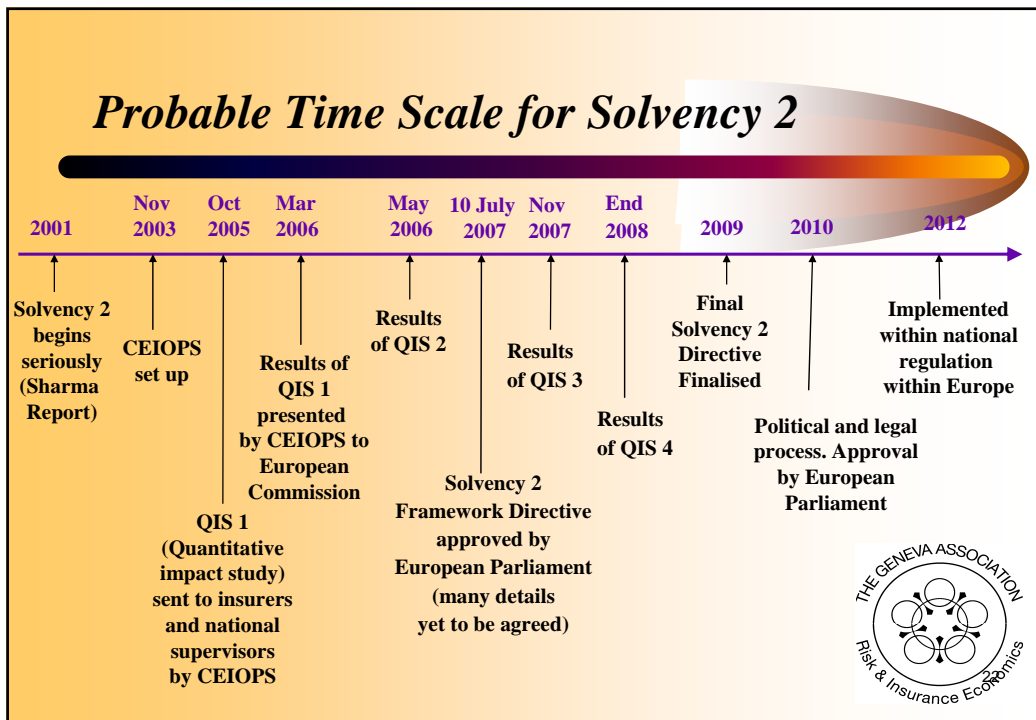
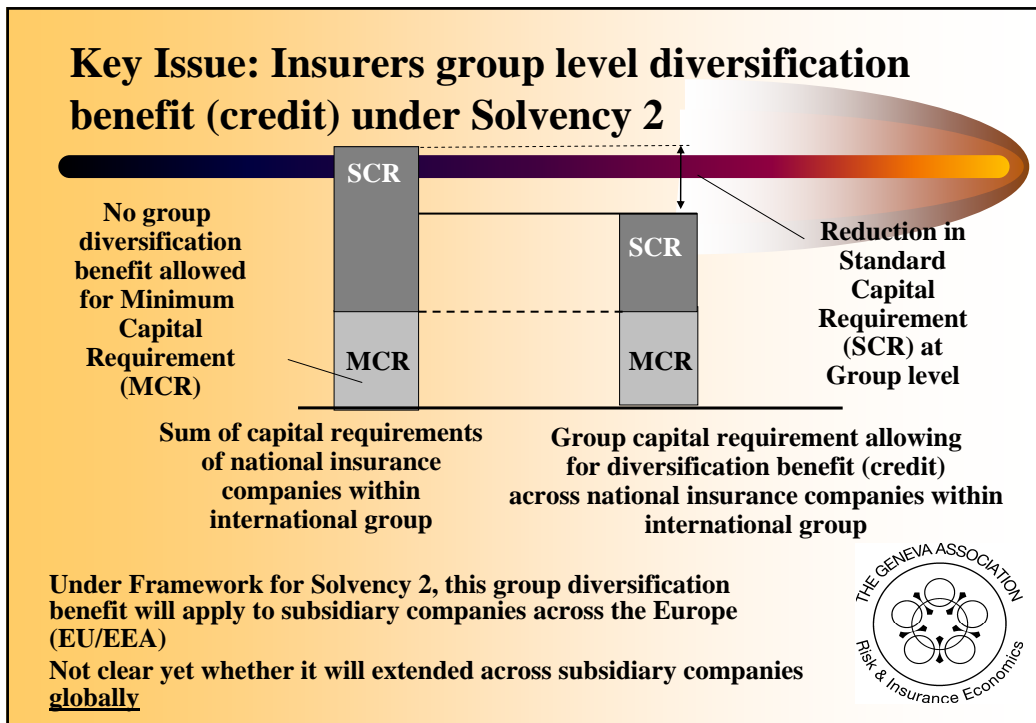
*The 3 Pillar Approach of Basel 2
Applied to Solvency 2*



Pillar 1	Pillar 2	Pillar 3
Quantitative Capital Requirements	Qualitative Requirements and Supervisory Review	Market discipline via external disclosure
<ul style="list-style-type: none"> • Minimum Capital Requirements (SCR and MCR). • Measurement of Liabilities (Technical Reserves) and Assets • Determining Eligible Capital (Admissible Capital) • Diversification effects across risks and risk mitigation 	<ul style="list-style-type: none"> • Corporate governance and internal controls • Internal capital and ALM models and enterprise risk management systems • Multi-year continuity and stress testing • Run-off risk sensitivity analysis over lifetime of the insurance and investment portfolios 	<ul style="list-style-type: none"> • Market transparency to consumers and other stakeholders • Sound market conduct • Build on risk disclosure requirements under IFRS







Part 3

Characteristics of 2nd Generation Risk-based Regulatory and Supervisory Systems in Insurance



Features of 2nd Generation Risk-based Systems (Solvency 2 and IAIS proposals)

- They are principles-based and consistent with the 3 Pillar framework of Basel 2. Quantitative capital requirements are supplemented by:
 - Evidence of sound internal ALM, enterprise risk management and governance systems.
 - Adequate external risk disclosure and transparency.
 - Appropriate market conduct and treatment of policyholders.
- They allow approved insurance companies to determine their own capital adequacy requirements, using their own internal model, instead of applying the standard capital requirement.
- They define eligible (admissible) capital as economic capital, where asset and liabilities are measured on, or close to, a market-consistent/fair value basis.



Features of 2nd Generation Risk-based Systems (Solvency 2 and IAIS proposals)

- They permit, within limits, new sources of capital, such as subordinated debt, hybrid capital, contingent capital.
- They encourage greater cooperation between national insurance supervisors and avoid the duplication of regulation for international insurance companies, which inhibits market efficiency and development.
- They seek to gradually move toward the concept of home/host country supervision of insurance groups with regional or international operations. Under this concept, home country supervisor (where the insurer is headquartered) assesses the capital and risk management systems of the group as a whole.

Host country supervisor regulates the national subsidiary of the international group, but not in all areas as they do for purely local insurers.



Features of 2nd Generation Risk-based Systems (Solvency 2 and IAIS proposals)

- They seek to ensure that supervision is consistent with fair and competitive markets, not only between insurance companies but also with other financial services providers that compete with insurers in their core businesses of risk transfer and long-term saving provision.



Part 4

Potential Market and Economic Impact of Solvency 2 and other 2nd Generation Risk-based Systems



Impact on Human Resources and IT systems

For insurance companies

- The increase in complexity will increase the demand for accounting, actuarial and risk modelling capabilities within insurance companies. Investment in staff, IT and risk modelling capabilities will increase. More Chief Risk Officers (CRO) will be appointed.
- Smaller insurers with insufficient internal expertise will hire actuarial, risk management and IT modelling consultants.

For insurance supervisory departments

- More complex risk-based capital systems will also require new staff with appropriate technical expertise to be hired as well as the retraining of existing staff.
- These human resource demands will need to be considered by supervisory authorities in planning the speed of introduction of a new risk-based regime.



Potential Impact on Structure of Insurance Markets

- Solvency 2 will probably encourage greater market concentration, including M&A, due to probably higher capital requirements, by permitting new external sources of capital (e.g. hybrid capital) where there are economies of scale, and a recognition for group risk diversification.
- Further market concentration in many insurance markets would probably have occurred in any event, but Solvency 2 will help speed up the process.
- If capital requirements under Solvency 2 are much higher than for the banking and securities sector, European banks owning insurance companies might decide to sell their insurance companies and become again only distribution channels. This would be to use the capital tied-up in insurance companies more effectively in expanding other areas of their business.



Potential Impact on Structure of Insurance Markets

- As Solvency 2 will be based to market-consistent valuation of liabilities, this is likely to encourage a further development of securitization markets. But this will also depend on how securitization is treated within the new risk-based regulatory regime, both for insurers and for investors in securitizations.
- Solvency 2 may also stimulate the demand for new financial derivatives or risk transfer products to hedge increased volatility in key financial numbers and remove 'costly' items from balance sheets.
Investment banks and lawyers are always looking for new areas of business !
- Allowing insurance companies to raise new sources of capital, such as - more types of subordinated debt, hybrid capital and contingent borrowing - will probably lower their cost of capital, thus making the insurance industry more competitive.



Potential Impact on Role of Insurance Industry in Economic System

- Since a market consistent or fair value system is essentially a ‘marked-to-market’ valuation system, it might change risk appetite’s over time and make insurance management take a shorter term perspective. If so, this would reduce the industry’s risk absorption capacity and make it less willing or able to diversify insurance risks over time.
- But a more transparent valuation system might encourage more consumer, intermediary and investor confidence in the insurance industry, especially if there is more effective and less costly regulation.



Potential Impact on Role of Insurance Industry in Economic System

- If the cost of valuing interest rate and surrender value guarantees by life insurers is overstated under Solvency II, or in IAIS future proposals, more life and pensions products will be offered that transfer risk to consumers or new saving products with less attractive risk/return profiles.
- More market consistent valuations of assets and liabilities may encourage more rationale pricing and hence more sustainable supply, forcing out less professional insurers and reinsurers.
- Solvency II could impact on the structure of capital markets. Equity securities might become less attractive than bonds, if incentives to match assets and liabilities are over-emphasized or equity securities is given a too high a capital charge in the risk-based capital system. If so, this would adversely affect the long term development of equity capital markets and the financing of industry and commerce.



Potential Impact on Role of Insurance Industry in Economic System

The Group of Thirty Report (2006) concluded that the reinsurance industry is not a potential source of instability within the global financial system. Indeed there is some evidence that it has a stabilizing macro-economic effect.

Hence governments should consider how regulations they approve might impact on these wider global financial stability issues, which includes assessing if there might be an adverse effect on the global risk absorption capacity of the world's insurance/reinsurance industry.

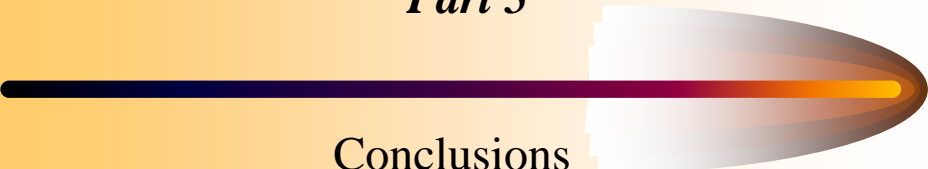
Particular government attention should be paid to the following potential dangers:



Potential Impact on Role of Insurance Industry in Economic System

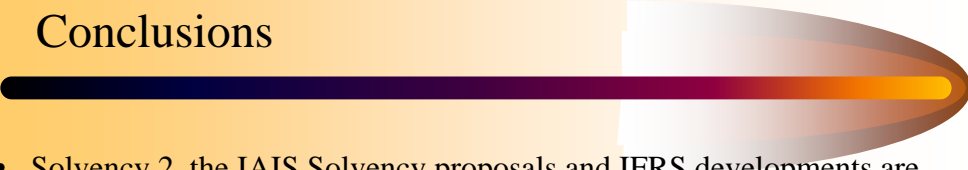

- Overemphasis on short-term market/fair values that could increase exposure to rapid shifts in the psychology/ sentiment of traded markets (market 'bubbles'). Traded markets are now interconnected globally.
- Excessive regulatory capital demands on the insurance/ reinsurance industry that will increase its cost of capital and reduce its ability to attract new capital resources.
- Pressures that encourage a shortening of the time horizons of insurance management and the capital suppliers to the insurance/reinsurance industry, as insurance is a long-term business.






Part 5

Conclusions



Conclusions

- Solvency 2, the IAIS Solvency proposals and IFRS developments are all running parallel to each other, and they will all have an international impact.
- There is a tendency to underestimate the market impact of regulatory change. Hence it is important not rush forward with a major change. There must be careful planning and detailed discussion with the insurance industry and others stakeholders on its likely impact.
- Over-complex regulation is not only costly but can be less effective, as it is harder to monitor and enforce.



Some final questions

- How fast will Solvency 2 and IAIS proposals encourage countries without risk-based solvency systems, such as South Korea, China, India, to introduce new 2nd Generation risk-based solvency systems?
- How fast will Solvency 2 and emerging IAIS proposals influence the reform of regulation and supervision in United States, Japan, Australia and other non-European countries that still have 1st Generation risk-based solvency systems?
- To what extent will the growing spread of IFRS (about 100 countries have decided to implement) speed up the introduction of new risk-based regulation in insurance?
- How far will Solvency 2 and IAIS proposals act as a stimulus to senior management to invest in improved internal capital management, ALM and enterprise risk management systems within their companies?

