International Association for the
Study of Insurance Economics

Études et Dossiers

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"New Developments in the Regulation and Supervision of Financial Services"

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Controlling insurer insolvency risk: An international comparison

Robert Gibbons

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Geneva, November 4, 2004

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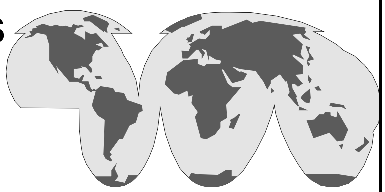
Solvency matters

- Core supervisory responsibility
- Financial stability concern
- Mutual recognition depends on satisfactory solution
- Trade issue: prudential supervision

Therefore important to clarify national perspectives



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Solvency requirements

- fixed minimums
- proportional solvency margin
- risk sensitive capital requirement
- dynamic analysis
- probabilistic analysis

- IAIS Issues Paper on Solvency

- KPMG Study for Solvency II Project

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Problems with this approach

- Attempts to be too precise
- Oversimplifies choice of solvency regime
- Ignores institutional factors
- Does not capture experience adjustments
- Can create misplaced confidence in supervisory system

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Better approach

- Recognize effect of different environments
- Consider market structure
- Identify all factors contributing to solvency

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Every system has strengths and weaknesses

- Sound supervision builds on strengths
- Design of supervisory system involves a series of tradeoffs

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Public policy tradeoffs

- competition vs. stability
- moral hazard vs. policyholder protection
- safety vs. growth [attractiveness for investors]
- price freedom vs. stability
- regulatory burden vs. market soundness

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Value of staying in business

- franchise value higher with:
  - fewer players
  - more brand recognition
  - expectation of professionalism
- goal is to maximize franchise value
- otherwise greater risk of insolvency

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Components of Insurer's Market Value

Franchise Value
- "Economic rents," present value of future profits
- Charter value
- Reputation
- Distribution network
- Personnel

Net Tangible Value
- Market value of tangible assets less Present value of liabilities
- Closely related to liquidation value

Put Option
- The value of issuing debt (i.e., policies) at below-market rates due to the insurance insolvency guarantee programs
- The value to equity holders of capturing the upside earnings while not incurring all of the costs of default

Source: David Babbel

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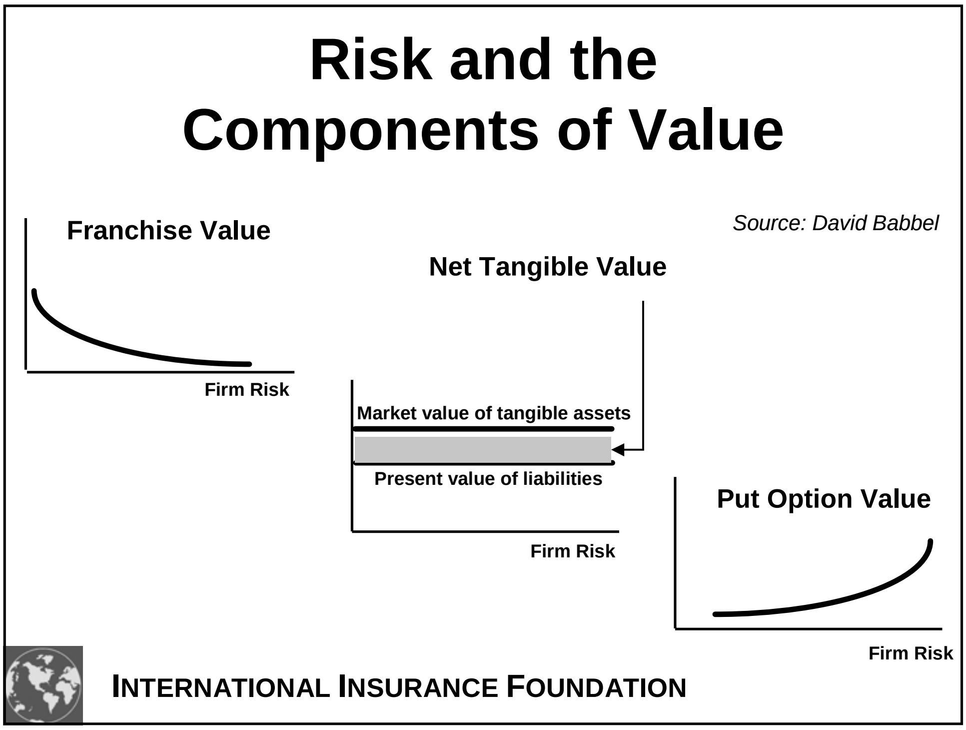
Risk and the
Components of Value
Source: David Babbel
Franchise Value
Firm Risk
Net Tangible Value
Market value of tangible assets
Present value of liabilities
Firm Risk
Put Option Value
Firm Risk
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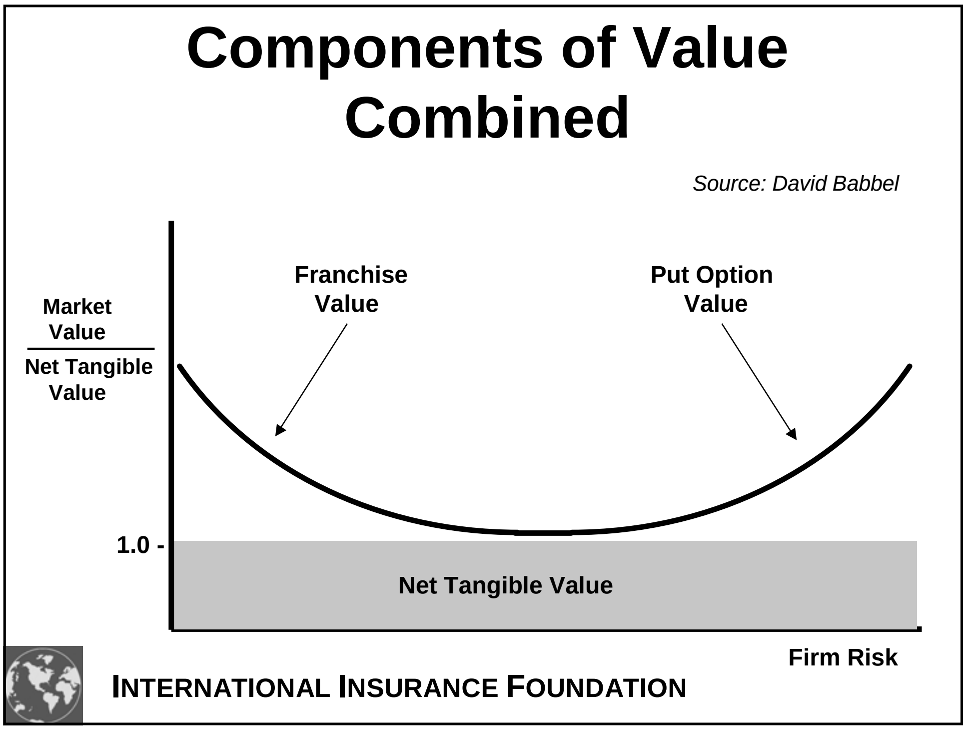
Components of Value
Combined
Source: David Babbel
Market Value
Net Tangible Value
Franchise Value
Put Option Value
1.0 -
Net Tangible Value
Firm Risk
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U.S. insurance market

- longer experience
- more market participants
- more classes of risk
- more naive competition
- more risk of insolvency
- more competitive capital market
- paradoxically, more regulated [because of political imperatives]

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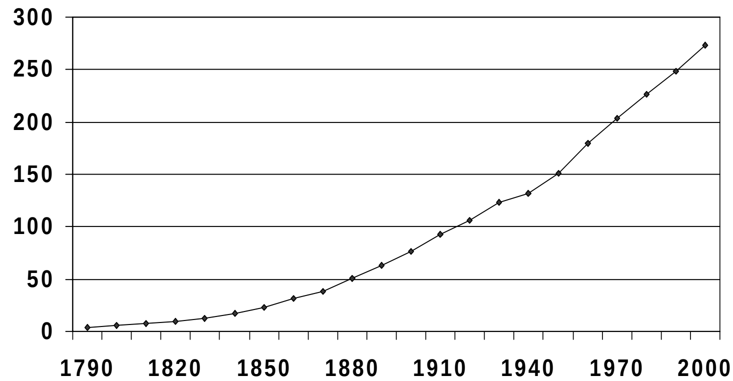
Population of U.S.



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Development of Solvency Evaluation

- Rapid growth and westward movement
- Wood construction
- Frequent fires

•Insolvencies

Solvency regulation

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Responses to insurer insolvency

- Licensing
- Financial reporting - 1828
- Supervision - 1859
- Separation of life and non-life accounts
- Investment regulation
- Uniform accounting rules
- Financial examinations
- Public disclosure
- Mandatory audits
- Actuarial opinion letter
- Risk-based capital requirements

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Effects of market discipline

- More eyes looking for problems
- Scrutiny of enterprise, not merely policyholder funds
- Greater differentiation among firms

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Markets develop progressively

➔monopoly

➔limited market, regulated prices

➔licensing - entry and exit

➔increased competition makes market more dynamic

➔more differentiation of firms

➔many players requires more supervision, especially **potential** financial condition

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Conclusion

- Solvency monitoring should build on features of market
- Avoid rules that distort market
- Promote market discipline

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