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# Études et Dossiers

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# The Changing World of Insurance Regulation and Supervision

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The Chief Risk Officer Forum – an industry view with a large company focus

## The Chief Risk Officer Forum

- Comprised of risk officers of the **major European insurance companies and financial conglomerates**, and was formed to work on key relevant risk issues for advanced practitioners
- A **professional risk management group** focused on developing and promoting **industry best practices in risk management**

## An industry view with a large company focus – three core aims

- Alignment of regulatory requirements with best practice risk management
- Acknowledgement of **Group synergies** (especially diversification benefits)
- **Simplification of regulatory interaction** (as part of the Group aspect)

Content

1. Overall framework
2. Description of the 6 priority issues

Section 1  
Overall framework



Our proposals promote transparency by better aligning capital requirements with risk

Overall framework (1/2)

- Pillar I Solvency Capital Requirements should be **based on a total balance sheet, market-consistent value based approach**
- The valuation of assets and liabilities and the SCR can be determined **either by approved internal model or by a Standard Approach**
- While Pillar I and the **SCR will be based on a one-year value based approach**, any risks not taken into account in Pillar I should as a separate requirement be taken into account in Pillar II<sup>1</sup>

1. Note that failure to meet such requirements (should they be necessary), should be tackled firstly by requiring adequate action by the company. Any capital add-ons within Pillar II will need careful design and implementation in European legislation to ensure adequate harmonisation.

We support harmonisation, to limit regulatory arbitrage

Overall framework (2/2)

- **All three Pillars should be sufficiently harmonised** so that it is the nature of the business and risks that determines solvency and reporting requirements and not the location
- **There should be no prudence included on top of the market value of liabilities** to cover the risk that the actual values over time vary from the current market value estimates
- **Accounting considerations should not affect the definition used for solvency calculations**
- **Legacy rules should be eliminated** to the extent they can lead to perverse incentives



## Section 2

### Description of the 6 priority issues

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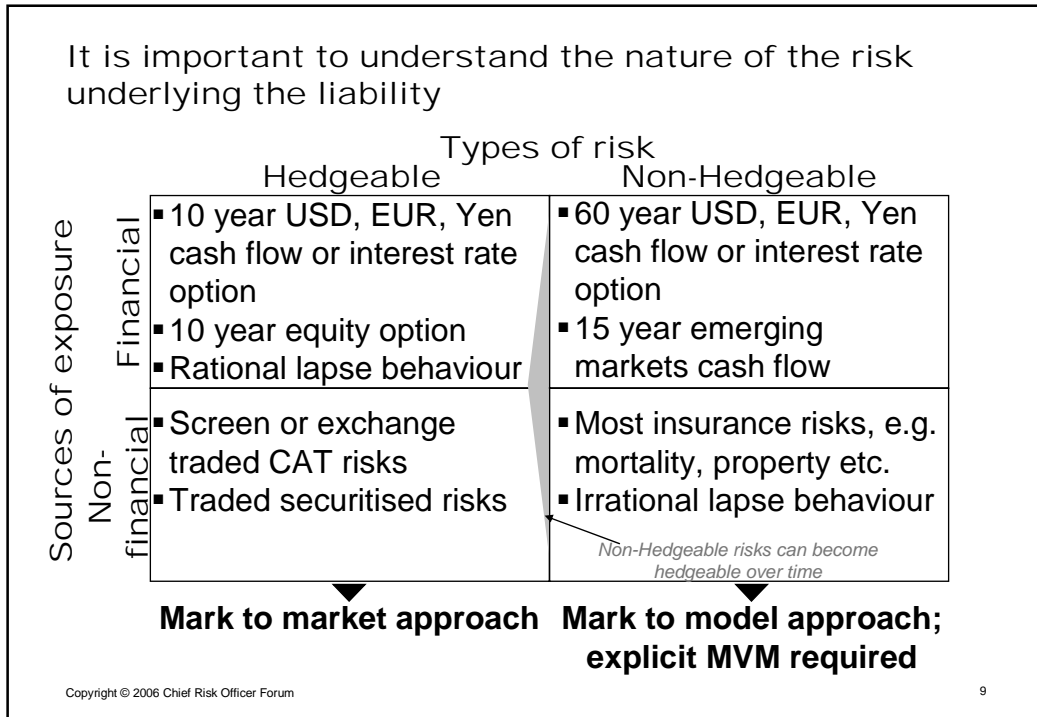
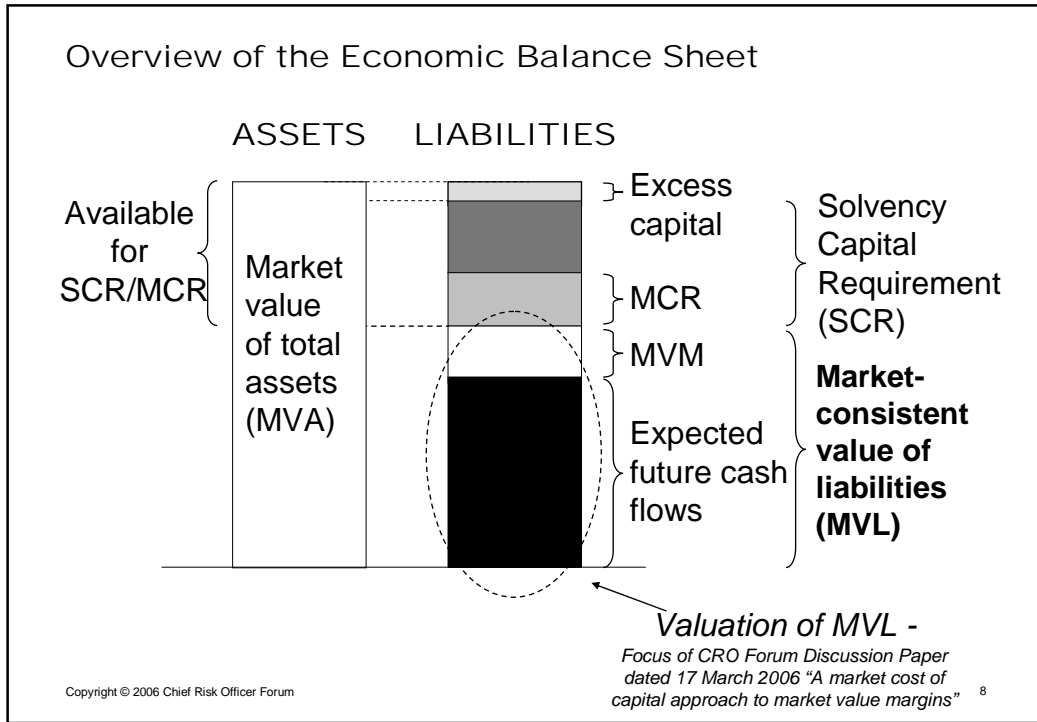
Liability values for solvency purposes should reflect the cost to sell or hedge them

Issue #1: Valuation of insurance liabilities

- Technical provisions for solvency purposes should be set equal to the MVL, including value of both hedgeable and non-hedgeable risks
- The value of **hedgeable risks** should be determined by **mark-to-market** approaches
- The liability value for **non-hedgeable risks** is determined by an appropriate **mark-to-model** approach:
  - Liability value equals best estimate plus MVM (**'market cost of capital' approach to MVMs is recommended**)
- Additional prudential margins for solvency should be reflected in the MCR and SCR rather than the technical provisions

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The CRO Forum endorses a market cost of capital approach to MVMs for a number of reasons

- It supports **appropriate risk management** actions
- It provides a **more appropriate reflection of risk**, both in terms of risk type and between product group
- It ensures a **better response to a potential crisis**
- It allows for simplifying assumptions, which makes the approach **easy to implement**
- It is **transparent, easily verifiable and understandable** by the supervisors and other constituencies
- It **passes the “use test”** envisioned in the Solvency II framework

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The solvency framework should encourage companies to improve their risk management capabilities

Other priority issues (1/3)

## 2. The standard approach

- Same economic principles as an internal model but simplified as far as possible
- Incorporate risk mitigation, diversification and other best practice modelling elements; avoid perverse incentives; yet still be practical to apply

## 3. Diversification

- Basis for sound risk management
- Ignoring leads to a material excess capital burden, above what is economically required to meet obligations
- Consequently, recognised in both the solo and group solvency tests

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A principles-based approach avoids practical limitations of a 'one size fits all' type-solution

Other priority issues (2/3)

#### **4. Risk mitigation**

- Should be fully recognised in both Pillar I and Pillar II
- A principles-based approach will ensure that some forms of mitigation are not arbitrarily favoured over others
- Widening of the tool box is recommended with increased CRO obligations<sup>1</sup>

#### **5. Principle-based and not rule-based**

- E.g. with respect to investment rules, the standard approach and internal approach take market and credit risk into account, no further arbitrary restrictions on investment flexibility (apart from large concentrations akin to banking rules)

<sup>1</sup> Refer CRO Forum paper released 28 March 2006 titled "Financial Risk Mitigation in Insurance – Time for Change"

A principles-based approach avoids practical limitations of a 'one size fits all' type-solution

Other priority issues (3/3)

#### **6. Group lead vs. home supervisors**

- The roles and authorities of the group lead and home supervisors should be clarified and role of lead supervisor strengthened to guarantee adequate harmonisation and keep the framework practical and efficient.