



International Association for the  
Study of Insurance Economics

# Études et Dossiers

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Extract from

## Études et Dossiers No. 326

### **The Insurance Industry: Risk Governance and Solvency II**

Milan, 28 November 2006

**&**

### **A Reputational Risk Management Framework**

Report prepared for The Geneva Association  
and Macros Research

by Dr. Riccardo Bigio

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## Working Paper Series of The Geneva Association

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# Session I: Insurance Regulation Solvency II – Strategic Dimension

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## *Session I: Insurance Regulation Solvency II – Strategic Dimension*



*About winners, losers and  
a series of dilemmas*



## *Solvency II is about winners and losers*

- The industry in general
  - The impact on cost of capital will determine its competitiveness in the capital markets
  - It might improve or worsen its position relative to other financial services providers
- Groups of companies that share certain qualities:
  - Large versus small
  - Mutuels versus plcs
  - Multi-liners versus specialised
  - Geographically diversified versus concentrated



## *Valuation Dilemma*

- How much capital does an operation need?
  - How to value assets?
  - How to value liabilities?
- ⇒ Currently fundamental difference among regulators:
- ⇒ 75th percentile approach versus
  - ⇒ Cost of capital approach



## ***Risk Retention Dilemma***

- Solvency II will impact the risks that companies take/ keep on their balance sheets
- ⇒ What types of risks are insurers willing to take on in the future?
- ⇒ How much of each risk class?
- ⇒ Where will the remainder end up?
- ⇒ There might be a push of risks into other channels, where they are less well understood and/ or not as well regulated



## ***Equity Investment Dilemma***

- Solvency II could impact the size of equity investment holdings of insurers
- McGreevy: "*EU Commission sees insurance as an important long-term investor.*"
- ⇒ Higher level of equity investment
- ⇒ Will the new rules really facilitate/encourage this type of equity investment over other investments?



## ***Capital Access Dilemma***

- The status of own capital versus access to external capital
  - ⇒ Will own capital be preferred to other sources of capital?
  - ⇒ What happens to proportional reinsurance?
  - ⇒ What happens to non-proportional reinsurance?
  - ⇒ How about other (new) forms of contingent capital?



## ***Governance Dilemma***

- Not all governance structures in the insurance sector are the same
- The most important difference is between plcs and mutuals
  - ⇒ What type of governance might be favoured by Solvency II?
  - ⇒ Could Solvency II trigger another round of demutualisation or might it reinforce this organisational set-up?
  - ⇒ A lot of special lobbying efforts



## *Modelling Dilemma*

- Use of an internal model versus the standard (simplified) model
  - ⇒ Coherence between the two approaches
  - ⇒ Benefits for using an advanced model
  - ⇒ How to assure that enough freedom and flexibility for internal modelling is available while keeping enough common characteristics and comparability?



## *SCR versus MCR Dilemma*

- MCR is supposed to be an objective measure that can be calculated in a straight-forward and quick way
- SCR is supposed to be a more complex, risk sensitive measure that relates a truer picture at the expense of objectivity and rapidity of calculation
- SCR is supposed to be higher than MCR
  - ⇒ Field testing for European life insurers revealed that in almost 25% of cases this was not true!
  - ⇒ Current model being considered has to be adapted



## *Political Process Dilemma*

- The EU Commission is making all the right comments:
  - "Strengthen competitiveness"
  - "Proportionate approach"
  - "Adequate solutions"
  - "Wide-ranging consultation" etc.

However: Most issues are open to interpretation

⇒ The insurance industry has to make sure that the right interpretation is used:

- Compatibility with insurance business models
- Positive incentives for markets and players
- Easy and inexpensive to run and monitor
- Consistent with requirements of all key stakeholders
- Consistent with demands placed on other industries

