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&

A Reputational Risk Management Framework

Report prepared for The Geneva Association
and Macros Research

by Dr. Riccardo Bigio

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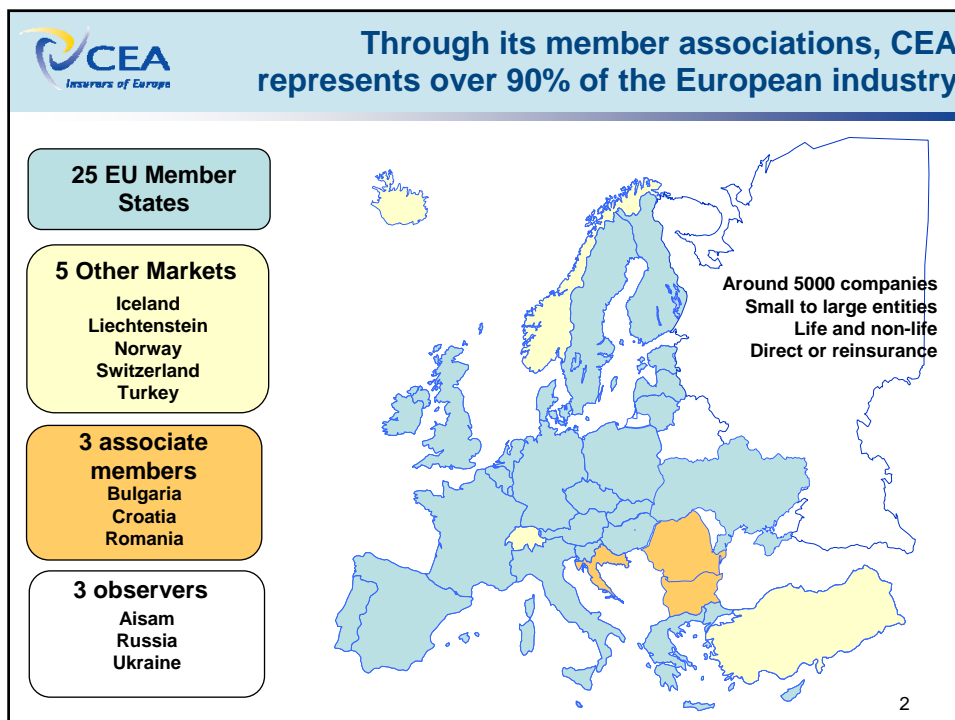
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Challenges for the European Insurance Industry

Gérard de la Martinière





Objective of CEA's Solvency II project

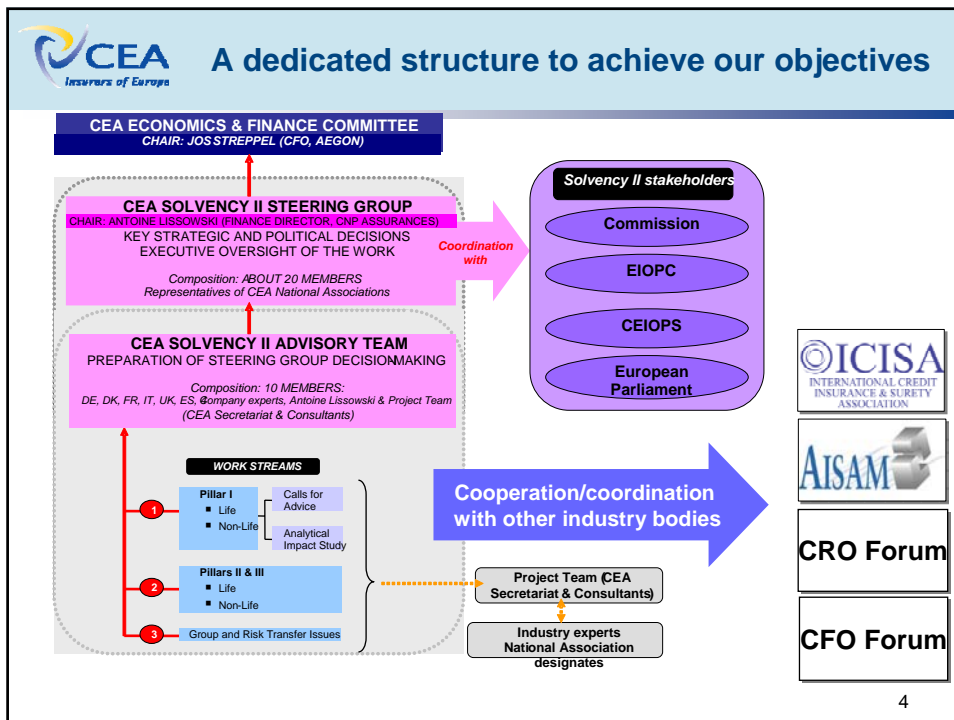
Core Objective

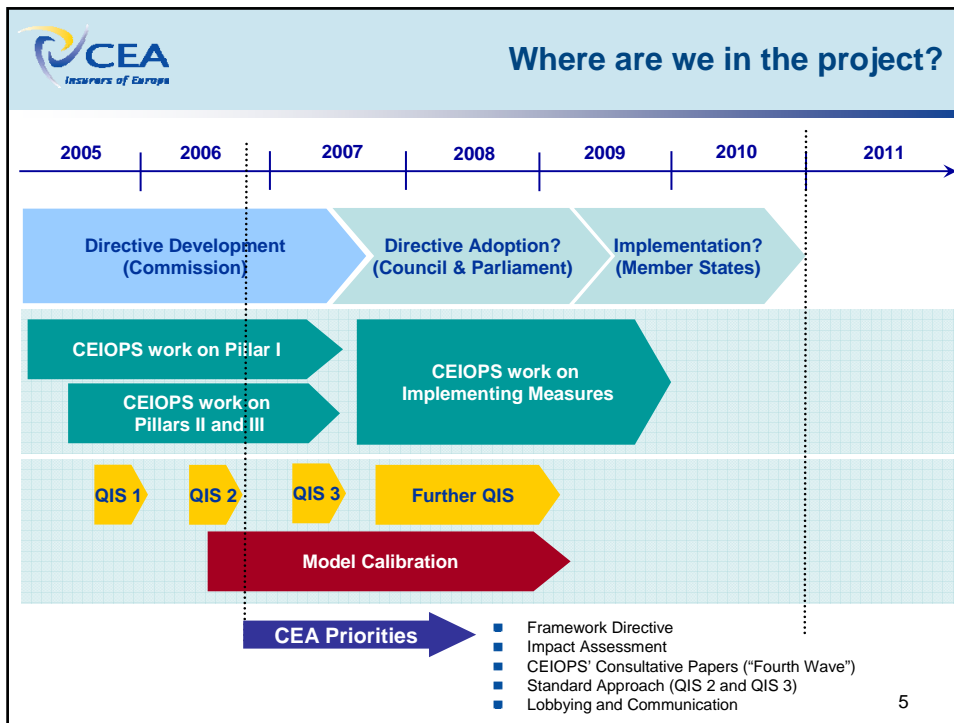
- Ensure a new Solvency regulation that is based on sound economic approach
- Develop a workable and appropriate risk based supervisory scheme
- Address the current and future needs of the European Insurance Industry
- Benefit from the tools developed by the Industry in the area of risk management
- Provide reasonable policyholder protection while achieving optimal capital allocation in line the the Lisbon agenda

Achieved through

- Developing strong and defensible industry consensus on full range of Solvency II issues
- Clear communication of this consensus to all stakeholders

3





Objectives of the Solvency II project

The industry has voiced ***strong support*** for the objectives indicated by the Commission for the Solvency II project:

- Deepen integration of the European Union insurance market
- Improve protection of policyholders and beneficiaries
- Improve international competitiveness of European Union insurers
- Promote better regulation

6



Current Solvency I rules are not aligned with the economics of the business & risks

- In some cases, current rules can actually conflict with good risk management e.g.
 - A company that increases its non-life premiums with no changes in liabilities reduces its risk of insolvency, but its capital requirements would increase
- This risk insensitivity can sometimes result in lack of confidence in the current system making it more difficult for companies to demonstrate that they are appropriately capitalised . . .
- . . . and this has led to a number of alternative and increasingly complex approaches, which can lead to confused and inefficient capital management for companies because
 - Many country supervisors have set additional local requirements based on either solvency requirements or provision calculations
 - Rating agencies have developed their own solvency models or rules of thumb
 - Companies have developed their own internal models to analyse the risks more accurately

7



The objectives of Solvency II can only be achieved through a risk based economic approach

- An economic approach is transparent and will avoid arbitrage opportunities
- Frameworks that confuse the prudence, in excess of a market consistent valuation, and capital requirements are more opaque and likely to lead to double counting
- It can be calibrated to provide a balance between protection to policyholders and encouraging efficient operations of companies
- It aligns regulatory capital requirements with best practice internal risk management processes
- It can cope with evolution in financial environments, increasingly sophisticated product designs and capital markets innovation

8

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The Industry therefore require a practical framework based on sound economic principles

- Pillar I Solvency Capital Requirement (“SCR”) should be based on a market-consistent, total balance sheet approach
 - No prudence required in excess of the market value of liabilities
 - It is the purpose of the SCR to cover the risk that the future values vary from the current market value estimates
- A two tier approach with an **absolute minimum (MCR)**, a **target (SCR)** and a ladder of intervention between the two
- Diversification as a basis for sound risk management should be recognised in both the solo and group solvency requirements
- Risk mitigation should be fully recognised in both Pillar I and II
- The SCR can be determined either by a Standard Approach or by an approved internal model
- Issues related to Insurance Groups should be recognised at outset
- All three pillars should be sufficiently harmonised

9


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The relationship between the MCR and SCR will be key to future Supervisory Intervention...

The diagram illustrates the relationship between different capital requirements and market values. On the left, two dashed boxes labeled 'Internal Model' and 'Standard Approach' are connected by dotted lines to a horizontal dashed line labeled 'Level of SCR'. Below this, a yellow box labeled 'Ladder of Intervention' is positioned between the 'Level of SCR' and another horizontal dashed line labeled 'Level of MCR'. At the bottom, a solid blue box labeled 'Market-consistent Value of Liabilities' is shown below the 'Level of MCR' line.

- Solvency Capital Requirement (SCR)
 - Target Capital that an entity should aim to meet under normal operating conditions
 - Dropping below SCR always requires a plan of action but does not necessarily require immediate supervisory intervention
- Minimum Capital Requirement (MCR)
 - Reflects a level of capital below which ultimate supervisory action could be triggered
 - Sets a control level in excess of technical provisions to ensure that intervention can occur while the company still has sufficient assets to meet its liabilities
- Ladder of Intervention
 - The framework should be designed to **guarantee an appropriate ladder of intervention** if the available capital falls below SCR and approaches MCR

10




Although much still remains to be done, the industry has already achieved certain successes

- Areas of success that have been reflected in the CEIOPS work on the Standard Approach:
 - Increasing acceptance of a **Market consistent** basis for valuation of assets and liabilities (at least if Cost of Capital approach is used)
 - Recognition that **diversification benefits** are tangible and explicitly allowing for in Standard Approach SCR
 - Recognising **risk mitigation** measures such as hedging and reinsurance
 - Recognising risk absorbing features of **future profit sharing** business
 - Recognising **expected profits** arising on next year's business
- Areas for further work highlighted by the industry*
 - Calibration (described further in following slides)
 - Greater focus on the **underlying principles** is required with elaboration of the application of the principles in the technical specification
 - The need for a **two tier** standard approach incorporating both **scenarios and factors** as well as **company specific data** as this more accurately reflects the underlying risk profiles for the company
 - The CEIOPS **approach for the MCR** is not viable and requires further consideration

* See document "CEA's Preliminary Feedback on QIS2" available on CEA website www.cea.assur.org


11



Calibration is an important issue and area for further work

- Solvency II is needed so we can introduce a economic, risk-based approach to capital assessment and regulation across Europe
 - It will replace the incomplete and outdated arrangements that exist currently under Solvency I
- Overall, the insurance industry is **not thought to be under capitalised** and the ability of the industry to withstand the recent market crises and catastrophes (natural & otherwise) seems to bear this out
- Under Solvency II, both the **Capital Requirements** and the **Available Capital** will change
 - However, there is no reason to believe that a Solvency II system that is designed to follow an economic approach and is correctly calibrated will lead to an overall increase compared to the current Solvency I position and there would be any reason to artificially adjust its parameters in reference to the old scheme


12



Calibration is an important issue and area for further work

- QIS 2 represents only a partial test with the focus on design and structure
- The industry indicated its concerns on some of the parameters included in QIS 2 via its correspondence with CEIOPS and its preliminary feedback on QIS 2:
 - Our information is that the concerns on calibration have been borne out in the initial QIS2 results particularly in relation to the non life reserve and premium risk
 - In light of this, further work on the calibration is required before QIS3 in order to demonstrate how the calibration parameters relate to the Solvency II framework (i.e. events arising over 1 year with a probability of 1 in 200 under a VAR measure)
 - This will maximise the value of the QIS 3 exercise for the industry and supervisors
- The limitations of the QIS 2 exercise means that care is required in interpreting the results of QIS2 to avoid premature conclusions on the impact of Solvency II on the capital position of insurance companies


13



There should be sufficient harmonisation of all three Pillars

- For the framework to be effective, there is a need for a sufficient level of harmonisation of the three Pillars
- The industry recognises the important role of Pillar 2 in the new Solvency II system Under the Solvency II framework we would expect:
 - Pillar 1 is the primary role for capital requirements
 - Pillar 2 focuses activities such as internal risk management processes and supervisory review
 - The requirements for Pillar 1 and Pillar 2 (add-ons and reporting requirements) are clearly articulated and achievable
- Under this system the industry expects that Pillar 2 capital add-ons should be neither routinely nor commonly applied, i.e. they should be exceptional


14



The link between Solvency II and accounting...

- In parallel to the Solvency II debate, the IASB and the insurance industry are currently working on the valuation of insurance liabilities for accounting in the context of IFRS4 phase II
 - To enhance transparency, to avoid duplication of work and costs and to reach both Solvency II and Financial Reporting objectives, the two approaches should be as consistent as possible
 - To achieve this, the underlying valuation basis for both should be market consistent even if there might be presentational differences
- It is crucial for the industry that accounting and supervisory frameworks reflect economic reality
 - Improve the credibility and relevance of the insurance industry disclosures
 - Create a level playing field with other industries and globally
 - Allow a more effective capital management of insurance companies by aligning reporting frameworks
- The CEA has been working with other stakeholders to ensure that future standards are applicable to a wide range of industry players
 - Industry proposals on Solvency II and IFRS Phase II are therefore based on a Coherent Framework for the valuation of insurance liabilities


15



Conclusions

- The Industry strongly supports Solvency II objectives
 - Solvency II is not triggered by a crisis situation but because the current rules are not aligned with the economics of the business or the risks
 - Objectives can only be reached through a risk based economic approach
- The Industry recognises the work done to date by supervisors and welcomes the constructive dialogue it has had and hopes that this will continue
- Much has been achieved thus far but the pace is increasing with challenges for all stakeholders.
 - There are areas where further work is required including calibration, issues related to insurance groups, eligible elements of capital and the articulation and functioning of Pillar 2 and Pillar 3
- The Industry will continue to actively and constructively contribute to the debate on this highly important and challenging project, which needs to deliver an efficient and workable solvency supervisory regime

16



Appendix: Background documentation

Key strategic publications available on the CEA website (www.cea.assur.org) include:

- ☞ **Comparative study of prevailing solvency models**
Factual overview of selected prevailing solvency assessment models
- ☞ **CEA “Building Blocks” for Solvency I**
Industry’s view on the underlying general principles and the building blocks of the overall Solvency framework, more specifically related to the Standard Approach SCR
- ☞ **Joint Paper with CRO Forum on Key Issues**
Raises 6 issues that appear crucial for the development of the Solvency II regulatory framework
- ☞ **Proposals for a European Standard Approach – ESA for SCR**
The ESA aims at capturing the requirements of a consistent economic risk-based approach within a workable solution
- ☞ **QIS 2: guidance note and guide on the Cost of Capital**
Introductory Guide to Solvency II
A 10-pages brochure (including synthetic executive summary) introducing the main concepts of Solvency II
- ☞ **CEA’s view on the Impact of Solvency II on the Average Level of Capital**
A guide on the comparison of the current Solvency I and future Solvency II frameworks
- ☞ **CEA’s Preliminary Feedback on QIS2**
CEA provided preliminary feedback on the second Quantitative Impact Study (QIS 2) results
- ☞ **CEA Working Document on MCR and a Proposed Ladder of Intervention**
CEA aims to contribute to the ongoing development of critical issues such as the Minimum Capital Requirement (MCR) and proposes a methodology to calculate MCR as well as an approach to a ladder of intervention
- ☞ **CEA Working Paper on the risk measures VaR and TailVaR**
This paper discusses the issues related to using VaR and TailVaR as risk measures within the solvency assessment of insurance companies

17



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18