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Recent Regulatory Changes in the Korean Insurance Industry

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Summary

Insurance regulation in South Korea has always kept pace with global standards. The recently announced risk-based capital (RBC) road map will bring it to an even higher level.

A brief overview of the Korean insurance market

South Korea had been impressive in catching up with the more advanced economies, when it was caught by the "Asian flu" (the 1997 Asian financial crisis) that hit many of the newly emerging Asian economies. It had to take emergency bailout funding from The International Monetary Fund (IMF) in December, 1997. However, the country made a swift recovery within four years and paid back all the bailout loans from IMF in 2001. Since then, South Korea has made modest yet steady economic progress and currently, according to 2014 IMF figures, ranks 13th in the world in terms of GDP.[1]

The insurance market in South Korea has also shown robust growth. At the end of the 2013 fiscal year, the total premium volume of the Korean insurance market was USD 145.4 billion, ranking it 8th in the world following Germany and Italy; the insurance penetration rate, or premiums in percent of GDP, was 11.9, putting it in 5th place in the world; and with an insurance density (or premiums per capita) of USD 2,895, it ranks 20th in the world.[2]

On the regulatory side, South Korea has made great efforts to keep abreast of the global standard. The South Korean financial supervisory authority [the Financial Supervisory Service or FSS] introduced EU-type Solvency rules for regulating insurance capital in 1999 following the IMF's recommendation. Although simple and easy to apply, the Solvency approach had a critical weakness as it does not reflect all the relevant and necessary risks of insurance companies. Consequently, the current Solvency framework is weak at assessing the total risks the insurance companies bear and therefore cannot calculate the adequate level of buffer capital the insurance companies should hold in order to prepare for unexpected shocks and fulfil their contractual obligations. Despite its weaknesses, Solvency contributed greatly to capital regulation in South Korea by increasing insurers' capability to cope with unexpected shocks.

As the South Korean insurance market matured, the risks of insurance companies became more complex, with more diverse and sophisticate products being introduced on the market. Reflecting this market change, South Korean insurance supervisors changed capital regulations to adopt the risk-based capital (RBC) method following the U.S., Canada, and Australia. After a two-year testing period, from 2009 to 2011, Korean RBC regulation became fully operative in April, 2011.

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1 World Economic Outlook Database, Oct. 2014.

2 Swiss Re, World Insurance in 2013: Steering towards Recovery, *Sigma* No.3/2014.

As for accounting standards, South Korea made major improvements after the 1997 financial crisis. Since then, South Korea has been keeping up with current international accounting standards and has fully adopted International Financial Reporting Standards (IFRS) from 2011, which all listed companies as well as financial companies must apply in disclosing their financial status. Both insurance regulators and companies in South Korea are well aware of the upcoming IFRS 4 Phase II and are in the process of preparing for the major change in "fair" value accounting for insurance liability.

RBC road map

As we all witnessed for the past six years, financial sectors have been undergoing major regulatory shifts towards stronger financial regulation. The insurance sector is also taking part in this regulatory transition. The International Association of Insurance Supervisors (IAIS) published new insurance core principles (ICPs) in 2010 that reflected this important shift by including macroprudential aspects in insurance supervision and calling for supervisory coordination and cooperation, as well as information exchange among supervisors in different jurisdictions. Designation of global systemically important insurers or G-SIIs was also an important step towards financial stability. ComFrame and an international capital standard (ICS) will also change insurance regulation by ensuring greater regulatory harmonisation across the continents.

South Korea is no exception and is actively improving insurance regulation to protect consumers in the South Korean insurance market. We would now like to focus on the change in capital regulation of South Korea.

In South Korea, the Financial Services Commission (FSC) is the government agency responsible for the regulation and supervision of the financial market, and the Financial Supervisory Service (FSS) conducts actual inspection and supervision of financial companies under the guidance and oversight of the FSC. Hereafter, they will be collectively referred to as the "financial supervisory authority".

The financial supervisory authority of South Korea is in the process of strengthening the capital regulation of the insurance industry, following global standards such as those of the EU with its more rigorous Solvency 2 capital regulation and the U.S. with its already implemented Solvency Modernization Initiative, or SMI, which strengthens and modernises U.S. capital (or RBC) regulation. Following these examples, the FSC and FSS jointly announced the final version of the so-called RBC road map on 31 July 2014.[3]

The RBC road map is a collection of policy changes the financial supervisory authority is to implement over the next five years to enhance the prudential regulation of insurance companies active in South Korea up to level. These regulatory changes will go into effect step by step to reflect changes in market conditions and other financial developments.

The RBC road map is about risks and liability. It contains many policy change elements to make prudential regulation better. On the "risks" side of the RBC road map, the measurement and management of the risks of insurance companies or groups are to be more sophisticated and strengthened in order to make the insurance industry more robust and to protect its consumers better from less frequent yet stronger shocks. On the "liability" side of the RBC road map, it is imperative to assess insurance liability in a more refined way to reflect "fair" value. And IFRS 4 Phase 2 is in the process of being implemented as a standard for measuring the fair value of insurance liabilities. All of these changes need to be explained in more detail.

First, the value at risk (VaR) of interest rate risk and credit risk, or the inverse of the probability of capital shortage of insurance companies, will increase from the current confidence level of 95 per cent to 99 per cent: interest rate risk is the first to be applied in 2014, followed by credit risk over the ensuing two years, attaining 50 per cent in 2015 and 100 per cent in 2016.

Second, risk measurement is to be refined to reflect the actual risks insurance companies bear more closely. Operational risk will be refined to reflect the sources, such as different distribution channels, starting in 2016.

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[3] Press Release, "The comprehensive roadmap to modernize prudential regulation of insurance companies", FSC and FSS, July 2014 iIn Korean).

Currently, operational risk is measured as 1 per cent of gross written premiums. In addition, the correlations of individual risks (insurance, market, credit, interest and operational) are to be used in a more refined way from 2015.

Third, longevity risk will be included in the RBC calculation, as South Koreans are ageing rapidly—it is projected to take South Korea only 18 years (2000–2018) for the population aged over 65 to reach 14 per cent from 7 per cent. In contrast, it took Japan, well known for its ageing population, 24 years (1970–1994) to reach the same level.

Fourth, a consolidated RBC system will be introduced for measuring insurance group's risks at group-wide level to reflect subsidiaries' risks to which parent or holding companies are exposed. At present, the system is being tested and will be implemented, based on the test results, during 2015.

Fifth, the own risk and solvency assessment, or ORSA, will be introduced in 2017 for insurance companies to manage their own risks in order to complement quantitative regulation.

Sixth, internal models will be allowed for insurance companies in calculating the RBC ratio using own models and risk coefficients based on own statistics. Actual introduction of internal models will be reviewed during 2015 and implementation is due after 2018, depending on the international trend.

Seventh, evaluation of technical provisions will be reviewed and improved step by step as a bridge method to determine the "fair" value of insurance liability until IFRS 4 Phase II is implemented. In the meantime, overall system improvement and legislation will be undertaken to ensure a smooth transition to the new "fair" value-based solvency test.

Meaning of the changes

The IMF and World Bank conducted the Financial System Stability Assessment (FSSA)on South Korea in 2013. They evaluated South Korea's insurance supervisory system using the IAIS' insurance core principles and concluded that South Korea's insurance supervisory system shows a high level of observance of the ICPs. The limited weakness of the supervisory system is well understood by the supervisory authorities and reforms are under way.

The RBC road map is a statement by South Korea that it is committed to keeping up with the global standard in insurance regulation and supervision. Once the RBC road map is fully implemented, compliance to global standards in insurance capital regulation of South Korea will be at a higher level, and both insurers and consumers will benefit from the increased level of financial robustness for fulfilling the obligations from insurance contracts.

The road ahead

As the insurance market evolves, regulation must keep pace in order to ensure the soundness of insurers and the welfare of the consumers participating in the market. One of the more important roles of supervisors is to make sure the market is functioning well enough to preserve transparency, so that one side of the market does not receive unfair treatment from the other. Equally important is promoting effective competition among market participants in order to ensure optimal prices and the soundness of insurers.

South Korea's insurance supervision has done a good job in keeping the insurance industry sound and safe to protect the insureds already participating in the market. Now is the time to promote freer competition and innovation, the prerequisite of which is the safe and soundness of the insurance companies to deliver contractual obligations; the RBC road map, by strengthening the prudential side of the regulation, is a big step in that direction.

Now the road is open. We need to run to reach to the goal.