

# The dynamics of global insurance regulation – Should Asia care?



Solvency II looms ahead. **Dr Kai-Uwe Schanz**, Principal Partner, Dr Schanz, Alms & Company AG, Zurich, talks about the implications of Solvency II and what Asian regulators and insurers can do to prepare for it. He also highlights that this risk-based approach can be a source of competitive advantage.

**T**he global regulatory landscape is in flux. Insurance is no exception.

Partially inspired by the most recent financial crisis, there is a global trend towards different capital requirements. These are not just higher but also more closely aligned with the insurer's specific risk profile: In the European Union this risk-based approach is known as 'Solvency II' and scheduled to enter into force in early 2013. The current 'Solvency I' regime disregards non-hazard risks (e.g. the wild swings of financial markets). It stipulates capital requirements which are basically a percentage of premium income. This rather crude approach ignores the fact that, in terms of underlying risk, one premium dollar can differ significantly from the other.

## Global convergence towards a risk-based approach

In the United States, the Risk-Based Capital (RBC) system was introduced as early as 1994, with encouraging overall results. Solvency II is more ambitious though: It relies on market-consistently valued assets and liabilities, whereas RBC is based on US statutory accounting rules, and thus does not reflect the true economic reality of a company's balance sheet. It is widely believed that solvency regimes based on economic principles and an all-risk approach point the way forward for insurance and reinsurance regulatory regimes.

Across the globe, RBC-type standards are being adopted by national regulators, especially in the emerging markets. Other jurisdictions even contemplate an outright transition to Solvency II. Against this backdrop, the following article explores the direct and indirect implications for insurers in Asia. We focus on Solvency II as the more ambitious and comprehensive approach.

## The rationale behind Solvency II

The European media are full of open or clandestine complaints from insurers about the complexity as well as excessive capital and compliance requirements mandated by Solvency II. The project was launched in 2003 and has undergone various rounds of testing, feedback collection and alterations, absorbing a great deal of resources both at regulators and the regulated entities. So, why did the 27 member states of the European Union embark on it?

First of all, lawmakers and regulators were keen to apply the lessons learned during the massive equity market downturn of 2001-2003. During that period of time, many European insurers were badly hit by asset write-downs as they had invested 25% and more of their assets in equities. Not even the fiercest critics of Solvency II dispute that poli-

tics are right to explicitly incorporate financial market risk in solvency calculations.

## Offer more transparency

The financial crisis of 2008-9 has added a second dimension to Solvency II: Regulators' zeal to strengthen overall financial stability through more rigorous and 'smarter' capital and risk governance requirements.

EU officials argue that, ultimately, Solvency II will provide policyholders with more transparency and improved risk-adjusted prices. Investors are expected to profit from enhanced disclosure and 'better run' insurance companies as Solvency II promotes economic value-based performance measurement and business planning. And even society at large stands to benefit as insurance companies grow more robust and become (even) less likely to ask for government bail-outs at taxpayer's expense. How does the new framework that is expected to bring all these blessings look like?

## The three pillars of Solvency II

Solvency II rests on three pillars: Capital, risk governance and risk reporting.

Pillar I sets out the quantitative capital requirements which need to reflect the insurer's entire spectrum of risks (underwriting risk, market risk (e.g. changes to interest rates), credit risk (e.g. non-collectible reinsurance recoverables). In addition, as opposed to RBC, capital requirements are based on a market-consistent approach to valuing assets ('mark-to-market') and liabilities (discounted cash-flows using a risk-free rate). Solvency capital levels are required to absorb a 1 in 200 year event. Insurers will have the choice between a standard formula or the use of an internal model to calculate capital levels – another difference between Solvency II and RBC. Companies who wish to apply an internal model must demonstrate that it is firmly embedded in daily business, uses data of acceptable quality and is calibrated in line with the requirements of Solvency II (e.g. yielding results at a 99.5% level of confidence).

Pillar II is primarily about minimum requirements relating to the insurer's risk management practices (risk identification, measurement, management and monitoring).

Pillar III defines additional reporting and disclosure standards, ranging from the insurer's solvency ratio to its overall risk appetite. Through improved transparency regulators hope to promote market scrutiny and, ultimately, discipline.

## Implications for corporate strategy

Solvency II is poised to lead to a lower-risk product mix. Going forward, insurance products which offer long-term financial guarantees (such as life with-profit products) and

display a high volatility (such as casualty or property cat business) will have to be underpinned by significantly higher amounts of risk capital. Such products will become massively more expensive and customer demand will drop accordingly.

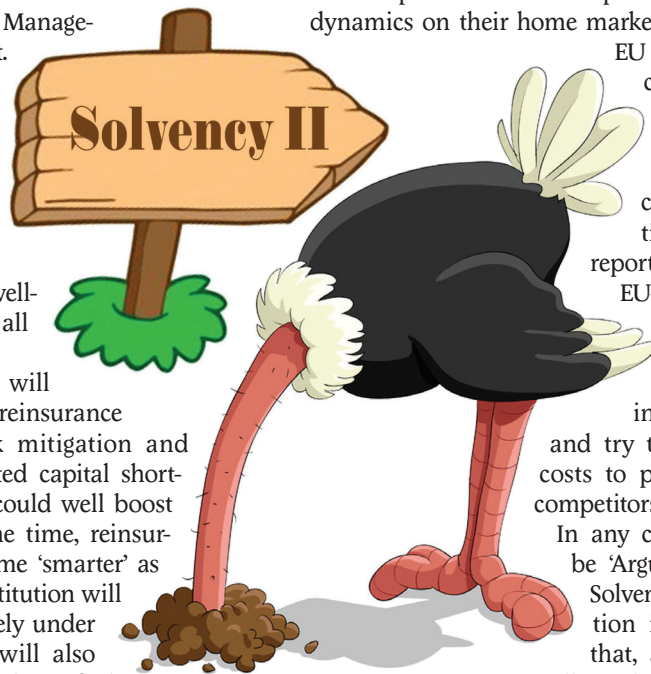
Capital management will gain in importance as the cost of capital for the various components of underwriting, market, credit and operational risk is set to drive decision-making across the insurance value chain. Insurers will be under pressure to enhance their capital efficiency, be it through additional reinsurance, improved diversification or a de-risked balance-sheet.

Solvency II will also have a profound impact on insurers' investment management. Many observers expect that, going forward, it will be uneconomical for insurers to operate with equity ratios of more than 10%.

**Increased emphasis on ERM; boost in reinsurance demand**

With Solvency II, Enterprise Risk Management will move to the limelight. Sophisticated internal models will play a more prominent role in aligning corporate risk appetite and capital resources. At the same time, regulated entities will have to put up appropriate risk management frameworks which need to be transparent, well-documented and embedded into all major business processes.

Last but not least, Solvency II will have important implications for reinsurance purchasing, a pre-eminent risk mitigation and capital management tool. Expected capital shortages in the wake of Solvency II could well boost reinsurance demand. At the same time, reinsurance buying is expected to become 'smarter' as its impact in terms of capital substitution will be recognised much more precisely under Solvency II. Ceding companies will also place more emphasis on a well-diversified panel of reinsurers, given the capital charges for reinsurance counterparty risk.



**What about Asia?**

The adoption of RBC-type regimes in Asia is in full swing. Some markets such as Japan, Singapore, Indonesia and Taiwan have a multi-year experience with RBC. Malaysia went down the RBC route in 2009 and Korea and Thailand are expected to follow suit in 2012.

Against this backdrop, we believe that Solvency II will accelerate the adoption of RBC throughout Asia as it can be regarded as a logical step between current static (premium-based) solvency regimes and the fully risk-based and economic framework of Solvency II.

**Premature adoption of Solvency II not recommended**

We would, however, not advocate a premature adoption of Solvency II-type regulatory regimes across Asia:

Most companies in the region are smallish in size and heavily reliant on reinsurance. Against this backdrop, they

would not only struggle to meet higher capital requirements but also face serious difficulty in setting up enterprise risk management frameworks as mandated by Solvency II. Further, regional regulators should bear in mind that the market-consistent valuation requirements of Solvency II are set to heighten the volatility of insurers' statutory results.

The direct impact of Solvency II on Asian insurers is limited. Except for Japanese companies, insurers from the region do not have significant operations in the European Union. The same is true for reinsurers as Asia is not (yet) a major market for inward cessions (as opposed to Bermuda, a jurisdiction for which Solvency II equivalence and the elimination of any scope for discrimination against cessions to Bermuda-based reinsurers is of vital importance).

**But ignore Solvency II at your peril**

Having said this, Asian insurers would ignore Solvency II at their peril as it has the potential to affect competitive dynamics on their home markets. Local subsidiaries with

EU parentage could have to change their strategic approach to the marketplace as a consequence of Solvency II induced higher capital requirements and tighter risk governance and reporting rules imposed by their EU-based parent companies.

In case they have to scale back their appetite for volatile and capital-intensive lines of business and try to pass on higher capital costs to policyholders, their Asian competitors are likely to benefit.

In any case, Asian regulators will be 'Argus-eyed' when monitoring Solvency II and its implementation in Europe. It is expected that, at minimum, Solvency II will accelerate the adoption of RBC-type regulatory regimes across Asia. This is another reason for Asian insurers to watch Solvency II closely.

**Solvency II can be rich source of competitive advantage**

Perhaps most importantly: Asian insurers may want to carefully examine Solvency II as a potential tool-box for improved competitiveness, rather than merely a regulatory scenario associated with onerous capital and compliance implications. Solvency II offers valuable guidance on how to promote Enterprise Risk Management, better align available capital with the corporate risk profile, focus on underwriting profitability rather than investment returns and use internal economic capital models. All in all, this may enable Asian insurers to develop smarter approaches to pricing, asset management and reinsurance purchasing.

Despite all its weaknesses and imperfections: Solvency II could well turn out to be a rich source of competitive advantage, helping Asian insurers design a more sustainable paradigm of doing business.▲

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