

## Solvency II – A template for the GCC?

**Dr Kai-Uwe Schanz**, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, examines the prospects for Solvency II-type insurance regulation in the countries of the Gulf Cooperation Council.



Solvency II, scheduled to enter into force in January 2013, is widely expected to reshape the European insurance marketplace. This framework is not simply a sophisticated solvency standard, but a new approach of looking at enterprise risk which will heavily impact insurers' product strategy, asset management and capital management. Solvency II is frequently hailed as a global template for best-of-breed solvency regulation. Is it a role model for the GCC region, too? What are the risks of jumping aboard too soon – or missing the boat?

### Solvency II – Not just about capital

Solvency II rests on three pillars. Pillar I is about solvency capital requirements (SCRs) which reflect a company's specific risk profile. SCRs are based on an economic balance sheet view and a comprehensive perspective on company-specific risks. SCRs are not only driven by traditional underwriting (hazard) risks, but also take into account market risks (relating to a company's investments) and operational risks (eg faulty IT systems).

The key difference between Solvency II and the US-inspired Risk Based Capital (RBC) system is the view of the balance sheet. Solvency II adopts an economic perspective: an insurer's available capital (which then compares with the SCR) is defined as the difference between assets and liabilities valued at market prices.

Under Solvency II, companies will be required to hold a level of available (economic) capital so that the probability for insolvency during the coming year is less than 1 in 200. In contrast to this economic view, RBC is based on values deriving from statutory accounting.

Pillar II addresses supervisory activities and internal risk governance. A key requirement is the establishment of a company-specific Own Risk and Solvency Assessment (ORSA) framework which should cover risk identification, measurement, management and monitoring.

Pillar III is about reporting and disclosure requirements in order to promote market discipline.

### Expected implications for European insurers

Under Solvency II, insurers will have to hold more capital to support volatile areas of underwriting (eg marine, aviation and transport insurance or life insurance products with return guarantees) and asset management (eg equities and lower-grade fixed-income securities). Less volatile activities may benefit from a capital relief. On average, regulatory capital requirements for insurers are expected to rise in the wake of Solvency II. Insurers may respond by de-risking their underwriting and investment portfolios, purchasing more reinsurance, raising external capital or merge into larger, more capital-efficient entities. Against this backdrop, Solvency II is not merely a technical issue for actuaries and



risk managers, but a strategic challenge which deserves and actually receives the attention of Boards.

### **Solvency II and the GCC – Don't rush it**

How could the GCC region's insurance markets and policyholders benefit from the adoption of a Solvency II-style framework? The benefits expected from Solvency II are compelling, indeed: Economic and risk-based capital requirements (Pillar I) are set to strengthen an insurer's resilience in the face of severe market disruptions or catastrophic events. This would not just benefit policyholders but also help overall financial stability and the competitive position of European insurers operating abroad. The new framework's emphasis on the quality of internal risk management and governance processes (Pillar II) is bound to have a similar effect. And, finally, much improved disclosure rules (Pillar III) should reinforce stakeholder trust not just in individual insurance companies, but in the market place and mechanism at large.

Of course, policyholders and regulators in the GCC would be keen to capture these benefits. However, a wholesale near-term adoption of Solvency II by the GCC countries could prove premature and ineffective: Domestic companies would struggle to raise additional capital to support volatile lines of underwriting and a traditionally aggressive approach to asset management.

Further, there is little leeway to cede even more business to reinsurers for the purpose of capital relief, with a current average cession rate of more than 50%.

Also, the Pillar II requirements would be hard to meet

for domestic companies anytime soon: Many of them act as brokers rather than risk takers and, accordingly, lack a meaningful internal risk management framework.

Last but not least, Pillar III reporting and disclosure standards based on a market-consistent valuation of assets and liabilities would introduce a significant degree of volatility, in particular on the assets side where equity investments play a major role.

In certain countries, RBC regimes are in place (eg for insurers operating in the Qatar Financial Centre and the Dubai International Financial Centre) even though most domestic markets still pursue a Solvency I-type regulatory approach where capital requirements are basically a function of premium volumes, regardless of underlying risk characteristics. Even the RBC requirements have proven a stretch for a number of companies and it is fair to assume that they would be unable to cope with a regime akin to Solvency II.

In summary, regulators in the GCC region may want to tread carefully when considering an adoption of Solvency II. Certain fundamental market and corporate requirements must be met before such a move would appear sensible. Domestic insurers must have developed into genuine risk absorbers, with a vested interest in sound risk management and higher net retentions. Also, assets should be more closely matched to liabilities. Once these fundamentals are in place, a Solvency II-type regulation could make a significant contribution to helping domestic companies progress from solidity to greatness. [M](#)

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