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# Europe leads the way in insurance regulation

**Roger Ferguson**

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# Europe leads the way in insurance regulation

*With insurance regulation in global flux, Roger Ferguson looks at how the EU's Solvency II could become the benchmark for insurance regulators elsewhere.*

On July 10, the European Commission finally presented Solvency II, its much-anticipated proposals for a new supervisory framework for insurers within the European Union (EU). The ramifications however could be more far-reaching than anticipated, as the framework directive offers a visionary approach likely to transform the insurance landscape not only throughout Europe but also the world.

In the US, the industry has pushed hard to modernise the overall regulatory framework, principally through proposed legislation referred to as the "Optional Federal". In Asia, market access is a dominant issue and insurance regulation is still focused largely on price and product regulation. Regulators must respond quickly to the fast-growing market. In Latin America, Brazil abolished the reinsurance monopoly, one of the world's last remaining reinsurance monopolies, early this year, the latest example of the trend towards liberalisation.

When the European Commission's proposed Solvency II framework directive comes into force, in or after 2013, the EU will have the most modern and progressive insurance and reinsurance regulatory standards in the world. In the same way that Basel II changed the banking sector, Solvency II should lead to a new risk culture, stricter requirements for risk management and greater transparency in the insurance sector. Solvency II gives Europe a unique chance to take the global lead and create a competitive advantage for its insurance industry. It is likely, therefore, to impact on the political debate in the US about reforming insurance regulation. Supervisory authorities, global insurers and reinsurers in the US, Asia and elsewhere are watching developments in Europe with great interest.

## Solvency II's three pillars

What exactly will change under Solvency II? The new solvency requirements, those

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governing the capitalisation of insurance and reinsurance companies, are meant to create a more risk-sensitive capital regime. Like Basel II in the banking sector, Solvency II is built on three pillars.

The first sets out the capital requirements an insurance company's financial resources must meet. The second pillar has a qualitative aspect: it establishes the principles for the supervisory review process and as well as for the internal risk management of insurers. A key component here is that the use of internal risk models will be permitted to determine the required capital. The third pillar concerns disclosure and transparency, with the aim of promoting market discipline.

But Solvency II is not just the application of Basel II to the insurance industry. It is even more ambitious in its holistic view towards all risks. Other significant differences between the two regimes largely reflect the different business models of banks and insurers. Both available capital and capital requirements will be calculated based on the market-consistent valuation of assets and liabilities. The available capital is calculated as the economic net worth plus additional liabilities which have loss-absorption characteristics. The solvency capital requirements (SCR) is determined to take into account all the risks facing insurance or reinsurance companies' balance sheets in an integrated way, in particular also financial risks and options built into insurance products. By contrast, Basel II applies separate models for market, credit and operational risks that focus on creditworthiness. As the objective of Basel II is to reinforce the soundness of and stability of the global banking system, its more sophisticated elements are primarily directed at internationally active banks. In the insurance industry, the main driver for regulation is consumer protection; hence Solvency II targets all insurers.[1]

## Other differences

The main difference between Solvency II and the old Solvency I system is the explicit recognition of the accumulation potential and diversification benefits, and the economic valuation of assets and liabilities. Diversification is a fundamental principle of the insurance business and can vary greatly across organisations. Insurance companies will be required to check whether their available capital is sufficient to pay even for rare large-scale claims, taking into account correlations between risk factors, that is to say, their accumulation potential.

For instance, a hurricane can trigger claims in a several lines of business at the same time: not just in property insurance, but also in liability and life business. A pandemic would impact life insurance business, but could also cause losses in the company's investment portfolio. Conversely, Solvency II will recognise diversification benefits when no correlation exists between risks. Because a hurricane in Florida is not correlated with an earthquake in Japan, broad diversification reduces the cost of taking on risk and improves the efficiency of the capital deployed. The current solvency regulations largely ignore both the accumulation potential and the benefits of diversification. The new Solvency II system foresees also a new approach to the supervision of groups, recognising the economic reality under which insurance groups operate on a global basis. The concept of a lead regulator will bring administrative as well as capital relief to the pan-European market.

## Effective from 2013

Solvency II is only scheduled for implementation in the 27 EU member countries from 2013. The debate about the new regime, however, has already changed the risk culture in the insurance industry. Many leading European insurers have created the position of a chief risk officer, separating risk management from product design, pricing and underwriting. Solvency II introduces incentives for professional risk and capital management, as well as for an improved sharing of risk between insurance companies, reinsurers and capital markets.

Solvency II may speed up the integration of insurance and capital markets because risk-mitigating instruments will be adequately recognised in the calculation of the capital requirements. These risk-mitigating instruments will be treated in a consistent manner, whether they are reinsurance, hedging or securitisation products. As a prerequisite, the insurer must quantify the actual contribution to risk reduction. Solvency II is therefore expected to spur the development of new risk hedging and risk-transfer tools, such as insurance-linked securities. All insurance liabilities are a type of debt, and the capital markets are very efficient in trading all kinds of debt except so far (other than in a very limited manner) insurance liabilities.

This could change under Solvency II. There are several advantages. First, it means there is a new source of capital which can be tapped. Second, the trading of insurance liabilities in a secondary market improves transparency and efficiency. Third, a market price tag will be attached to risks. A broader securitisation market would increase the capacity of the insurance market and allow covering even larger amounts of risks. Investors can benefit from the opportunity to invest in very specific risks which may improve the diversification of their investment portfolios.

## A spur to change

The interest in Solvency II and possible implications for non-European insurers is likely to spur the political debate in the US with regard to overall insurance regulation reform. This would be a very positive development. Many market participants and observers are understandably concerned about the competitive disadvantage that US insurers may suffer under the current regulatory system. Insurance regulation in the US is state-based, resulting in more than 50 jurisdictions adopting and implementing laws, regulations and other mandates in a sometimes duplicating or inconsistent and conflicting manner. This is a particular concern when states apply their laws on an extra-territorial basis. As the US Chamber of Commerce pointed out in the report of their Commission on the Regulation of US Capital Markets in the 21st Century:

## States' rights

"Unfortunately, the competitive position of our capital markets is under strain – from increasingly competitive international markets and from the need to modernise our legal and regulatory frameworks. Over the last two decades, markets have truly become global … Yet, the US regulatory structure is deeply rooted in the reforms put in place in the 1930s, a period that was closer in time to the Civil War than it is to today."

The recommendations to reform and modernise the federal government's regulatory approach to financial markets and market participants include the proposal for the US Congress to enact legislation to establish an optional federal insurance charter. This would allow insurance companies to engage more efficiently on a national and international scale, thus increasing competitiveness and reducing costs to consumers.[2]

## US concerns

Large multi-national insurers in particular are concerned they may not enjoy a comparable system. When the US insurance supervisory authorities introduced the Risk Based Capital (RBC) system in 1994, it was the most advanced regulation around, based on a multi-risk-factor model. It was considerably more sophisticated than the previous rules and the rather crude solvency margin calculation under Solvency I in the EU. This is no longer the case as Solvency II and similar frameworks like the Swiss solvency test (SST) have eclipsed US RBC. A main difference is that Solvency II will rely on market-consistently valued asset and liabilities (in particular given credit to the time value of money), whereas RBC is based on US statutory accounting rules, which in many instances do not reflect the market value of assets and liabilities.

The US and other countries still have the opportunity to leapfrog the EU in adopting state-of-the-art capital regulation as Solvency II will not be implemented in the member states until 2013. (However the UK, Switzerland and the Netherlands have already introduced models similar to Solvency II). Congress has shown a greater interest, of late, in considering regulatory modernisation for the insurance and reinsurance industry.

## The future: greater convergence

In the meantime, there is no doubt about the direction of future insurance regulation. The following are key characteristics of modern insurance regulation:

- valuation based on economic principles;
- all risk approach to capital requirements based on internal models;
- incentives for good risk management and risk mitigation practices, and
- increased transparency.

Differing stakeholders' views on the required and available capital are converging, based on economic and risk-based capital models (companies' internal models, rating agencies, regulators, standard setting organisations). These converging views on risk and capital will lead to increased transparency, a more efficient allocation of risk and capital, and reduced costs of compliance. Market mechanisms and sound competition will create a level playing-field for all insurers. Ultimately all this will deliver benefits to policyholders, insurance companies and society at large. It will help foster innovation and advance the search for the most efficient risk-transfer mechanisms.

### Notes

1 See also Swiss Re, sigma No. 4/2006.
2 US Chamber of Commerce: Report and Recommendations of the Commission on the Regulation of US Capital Markets in the 21st Century.