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Symposium
International Solvency Standards and Financial Stability
18 November 2004 in Washington D.C.

International Standard Setting

Introduction

At the 7th Annual Conference of the International Association of Insurance Supervisors (IAIS) Sir Andrew Crockett, at that time the Chairman of the Financial Stability Forum (FSF), stated in his keynote address that “financial markets cannot be relied on to function satisfactorily without regulation and supervision”. This is also agreed by the insurance industry. I therefore do not see a problem that I now as a representative of the Geneva Association report on the setting of standards for insurance supervision although my view on the necessity and kind of such international standards has not changed since I represented the IAIS. I like what I read in an interview with Mrs. Hauw Soo Hoon, Executive Director and responsible for insurance supervision at the Monetary Authority of Singapore (Insurance Day of 7 May 2003). Mrs. Hauw there mentioned that she wanted the government not to “regulate” the industry, but more supervise it in a very real sense of partnership.

Insurance supervision has a long history, far longer than banking supervision. International standards for insurance supervision, however, only have a very short history. Even 10 years ago when the IAIS was founded there was no intention to develop international insurance supervisory standards. The activities of the IAIS at the beginning were restricted to the exchange of information and experience amongst insurance supervisors. The insurance markets were national and well-protected markets. But later in the 1990s the situation changed dramatically. In particular after the liberalisation and deregulation in the European Union (EU) competition in the insurance sector increased enormously, also on an international level. Insurance companies followed the banks in discovering the opportunities that globalisation offers, leading to the emergence of international insurance groups and even international financial conglomerates.

The new international aspect of the insurance business created a challenge for insurance supervisors. It became clear that the activities of the IAIS could no longer remain in only exchanging information. The IAIS By-laws were accordingly supplemented and in 1997 the Association started developing practical standards for effective insurance supervision. By now the IAIS already issued 25 principles, standards and guidance papers. They provide a globally accepted framework for the regulation and supervision of the insurance sector. The most important paper contains the Insurance Core Principles (ICPs). The ICPs first issued in 1997 but fundamentally revised in 2003 cover practically all critical areas of insurance supervision. They are the base of all other IAIS principles, standards and guidance papers. IMF and World Bank are using the ICPs within the scope of their Financial Sector Assessment Programme (FSAP) to assess the insurance regulatory and supervisory regimes of jurisdictions all over the world. This creates a considerable momentum for jurisdictions to observe the ICPs.

Financial stability as an objective of insurance supervision

This symposium deals with the role of international standards, in particular on solvency, for financial stability. The main objective of insurance regulation and supervision is the protection of the policyholders, the insured, and of victims in the case of third party liability insurance. The IAIS had a controversial discussion if financial stability could be a matter of

concern for insurance supervisors. This discussion took place in 1999 when the FSF was established and the IAIS invited to delegate two representatives to the FSF as members. Already at its first meeting some members of the FSF expressed serious concern regarding insurance, in particular life insurance and reinsurance. Several prominent IAIS members recommended ignoring the concern since financial stability was seen as an issue that insurance supervisors need not be concerned of. Fortunately, the majority did not agree. A small group of IAIS members prepared a study paper for the FSF providing some key information about insurance and insurance supervision. The study paper concluded that so far vulnerabilities in the insurance sector had not posed a risk to the financial system generally but that new risks had to be monitored carefully. Identified weaknesses and gaps in supervisory standards had to be addressed in order to ensure that the insurance sector continues to pose no risk to financial stability. Weaknesses were seen in particular in the fact that – unlike in the banking sector – no common international standard on capital adequacy and solvency exists, in the absence of common international accounting standards, and in the absence of an international standard on the supervision of reinsurance. On the basis of this paper the IAIS has decided to give highest priority in its work to developing supervisory principles and standards on solvency requirements, accounting and reinsurance supervision.

Today, IAIS members no longer dispute that there are interdependencies between insurance business and financial stability. For example, if the governments had not intervened when insurers cancelled aviation insurance on short notice after September 11, air travel would have been interrupted and that certainly would have affected financial stability. Also in general, insurability of risks has effects on financial stability. According to its revised By-laws the goals of the IAIS therefore are now policyholder protection, the development of sound insurance markets and global stability. As regards financial stability, insurance should, however, not generally be regarded as a potential risk for financial stability but in the first place as means to protect financial stability.

Standard setting activities on solvency requirements

The FSF agreed that international supervisory standards on solvency requirements, accounting and reinsurance supervision were of particular importance with regard to financial stability. Since this symposium deals with the interdependency of international solvency standards and financial stability I will restrict my presentation on the standard setting activities with regard to capital adequacy and solvency.

Developing international standards on capital adequacy and solvency requirements for the insurance sector is of eminent importance. Insurer solvency takes a central position in risk management by insurers and in insurance supervision. As is explained to ICP 23, “a sound solvency regime is essential to the supervision of insurance companies and the protection of policyholders.” The implications of bankruptcies of insurance companies on financial stability are not as serious as bankruptcies of banks taking into account the contagion risk that in the insurance sector does not really exist. However, the bankruptcy of a leading life insurer, for example, can affect financial stability if it puts the system of old age provision at risk as it could happen particularly in Japan.

Unlike the banking sector with the Basel Accord, by now there is no common internationally agreed standard by which capital adequacy and solvency requirements for insurers may be set or measured. There are many well-established but fundamentally different approaches, such as the European solvency margin regime or the U.S. risk based capital regime. The IAIS has committed itself to working to achieve convergence between the different systems.

Capital adequacy requirements are only one part of the whole supervisory requirements on solvency. In particular, unlike the banking sector, the major risks the insurance industry holds

are less in assets but primarily in liabilities. Insurance companies and supervisors have to face risks in liabilities, i.e., risks to underestimate future payments. Insurers and supervisors also have to deal with the considerable risk of mismatching between assets and liabilities. Thus a simple analogy of the capital requirements for banks to the insurance sector would be misleading. Whole risk assessment or solvency assessment is always essential to the supervision of insurance companies.

As a first step in its work on solvency requirements, the IAIS in 2002 adopted *Principles on capital adequacy and solvency*. This paper sets out the key features that a well-defined solvency regime should have without favouring a specific solvency regime. It spells out that “adequate technical provisions are the cornerstone of a sound capital adequacy and solvency regime. Accordingly, technical provisions have to be calculated in a reliable, objective and consistent manner across insurers. ... The technical provisions have to be adequate to meet the obligations to policyholders.” In addition, a minimum level of capital has to be specified. It is designed to provide a minimum assurance of financial capacity and soundness of the insurer but should by no means be used to compensate for normal foreseeable obligations and costs. The required capital should serve as a safety cushion in case of unexpected or extreme events. It has to be considered the last resort after all other measures taken by the insurer to secure its financial stability have failed.

In 2003 the IAIS issued additional four related papers. The paper *Quantifying and assessing insurance liabilities* discusses current practices on quantifying and assessing life and non-life insurance liabilities.

The *Guidance paper on the use of actuaries as part of a supervisory model* states as one of its conclusions (conclusion 14) that, where a responsible actuary model is in place, “the actuary should provide advice on the level of technical provisions. Consideration should also be given to other areas where advice of the actuary will be valuable, such as: level of premiums; adequacy of risk assessment; reinsurance arrangements; investment policies; statistical inference; and stress testing of the future financial condition of the insurer.”

The purpose of the *Guidance paper on solvency control levels* is “to discuss why it is important to set a solvency control level, to identify key factors in setting a solvency control level, and to discuss possible supervisory actions when a control level is breached.”

The *Stress testing by insurers guidance paper* provides an overview of the various factors that need to be considered in designing and undertaking stress tests as part of an appropriate risk management system including a discussion of possible modelling techniques that can be used.

This year the IAIS commenced work on a general supervisory framework, which shall act as a roadmap in respect of standard setting, in particular on solvency and capital requirements. The IAIS supports the general concept of the three pillar approach stated in the Basel Accord framework and the Solvency II project of the EU. However, the IAIS has yet to specify what it means: how and when it would be applied. The framework paper will try to clarify some of these questions. A significant current focus is the development, as part of the framework, of the key elements or “cornerstones” of a common structure and common standards for the assessment of insurer solvency. They shall not be developed in isolation but be embedded in, and be part of, an overarching framework for insurance supervision that is also globally acceptable and applicable. This framework shall serve to clarify and enhance the interrelationship between the solvency standards and the other IAIS Principles, Standards and Guidance Papers and also the interdependencies with other ongoing IAIS work. It will consist of three groups of issues: financial issues, governance issues and market conduct issues. It also will encapsulate three levels or aspects in relation to these issues, reflecting three different responsibilities: preconditions for effective insurance supervision, regulatory requirements, and supervisory action. The framework for insurance supervision will

encompass the overall spectrum of insurance and insurance supervision. It is also compatible with the approach of “Basel II.” Both address regulatory requirements, supervisory review and market discipline through disclosure, although they are structured differently. Building on its *Principles on capital adequacy and solvency* the IAIS will formulate a more precise view on a number of key elements or “cornerstones” in the common structure and common standards for the assessment of insurer solvency. The “cornerstones” shall address, inter alia:

- The risks that an insurer faces, the determination of which risks may be reflected in a solvency requirement, individually and/or in combination, and how they may be reflected;
- the estimation of the realistic costs of meeting insurance contract obligations;
- the need for, and transparency of, the determination of the level of prudence in the financial position of an insurer;
- the valuation of assets and the determination of liabilities, including the issue of discounting and the interrelationship between the determination of insurance liabilities and capital requirements within a solvency structure; and
- the setting of control levels for the financial position of an insurer.

The “cornerstones” will be elaborated upon in a paper that is currently under development and expected to be issued in 2005. This will outline a roadmap for the development by the IAIS of a common structure and common standards for the assessment of insurer solvency. Since this paper will be of eminent importance for insurance companies the insurance industry represented by the IAIS observers should closely follow the drafting of the paper and comment on it where appropriate and necessary in order to ensure that the paper reflects the real needs and problems of insurance and avoids regulatory overburdening the insurance industry.

In parallel to this paper the IAIS is drafting a *Supervisory standard on appropriate forms of capital* which also should be ready for adoption at the IAIS Annual Conference in 2005.

Conclusions

Concluding my presentation I will give you my answers to the questions raised in the invitation to this symposium.

Do the same rules work for all countries and all types of financial institutions?

The ICPs and additional IAIS papers are applicable to the insurance sector only. The Basel Committee on Banking Supervision has developed Core Principles for the banking sector and IOSCO has issued Core Principles for the securities industry. The Joint Forum has prepared a comparison of the Core Principles of the three financial sectors and pointed out similarities and differences (2001). With regard to capital adequacy and solvency standards the Basel Accord is not applicable to the insurance sector. The insurance sector has to develop its own framework. It is however intended to use a similar structure as Basel II for the solvency framework in the insurance sector.

The IAIS standards, in principle, apply to all insurance markets. Where appropriate they set specific rules for life, non-life and reinsurance. But they do not distinguish between big and small insurance markets and companies or between insurance markets in developed and in emerging market countries. They provide, however, only a not too detailed framework for an effective insurance supervisory regime and allow the jurisdictions to shape it according to the needs of their insurance markets. With regard to emerging markets the IAIS already in 1997 issued *Guidance on insurance regulation and supervision for emerging market economies*. It “describes the unique challenges specific to emerging market economies and specifies the

measures to be taken in order to move from the current regulatory regimes to ones meeting the level of supervision described in the IAIS insurance standards.”

What rules will govern the future operations of global insurers? Who will make them?

Jurisdictions should follow the *Principles applicable to the supervision of international insurers and insurance groups and their cross-border business operations*, the *Insurance Concordat*, which the IAIS issued in December 1999. They are based on two main principles: All insurance companies have to be subject to effective supervision and good collaboration of home and host supervisors is necessary. The rules are set by national legislation of the jurisdictions where the insurance business is executed. The legislation should take into account the international principles and standards developed by the IAIS.

Will harmonised capital standards increase or decrease the cost of capital?

In principle, harmonised capital standards should neither increase nor decrease the cost of capital. Harmonised and risk adjusted capital requirements rather will increase or decrease the amount of the required capital.

With the new Basel Capital Accord in place for banks, is insurance a weak link in the global financial architecture?

With or without the new Basel Accord in place for banks, insurance is not a weak link in the global financial architecture. The insurance sector does, in principle, not pose any serious risk to financial stability. On the contrary, insurance and reinsurance are means to protect financial stability. Nevertheless, weaknesses and gaps do exist in certain areas noted by the FSF. These gaps have to be filled in the interest of effective insurance supervision.

What do the Financial Sector Assessments actually reveal about the soundness of financial supervision?

This question can only be answered by the IMF and World Bank who jointly carry out the financial sector assessments. The results seem to be different from jurisdiction to jurisdiction. But very likely all jurisdictions could further improve financial supervision. Many jurisdictions apparently only recently discovered that financial supervision is at the core also of insurance supervision. In the past mainly legal supervision was predominant.

Do significant cultural and practical impediments render international standards inappropriate for emerging economies?

Cultural and practical impediments do not render international standards inappropriate for emerging economies. Cultural differences and practical impediments, particularly the instability of the financial sector including insurance, have to be taken into account for the implementation of international standards. The IAIS therefore issued a *Guidance on insurance regulation and supervision for emerging market economies* as one of its first papers in 1997 in order to support these countries in establishing a sound and reliable insurance system. In addition, the IAIS is assisting IAIS members implement the standards by organising training and regional seminars, developing implementation tools and facilitating the provision of technical assistance, in collaboration with other international organisations such as the IMF and World Bank, always taking into consideration the specific needs of emerging market economies.

Is a level playing field possible? Will we know it when we see it?

A level playing field is possible, does to a certain extent already exist but will never be perfect. It will always be controversial who should be the players and if they are treated appropriately. Nevertheless, these discussions are necessary and should lead to improved competition.