Implementation of Solvency II and its Potential Impact on Market of Insurance Companies

Petra Korbasova
University of Finance and Administration, Estonská 500,101 00 Prague 10,Czech Republic
peter.korbas@email.cz

Abstract-*The ambition of this article is to demonstrate positives, but also the fall back of the Solvency II and of the delayed and uncoordinated implementation among the national regulators. This article summarizes the trends in insurance market regulation following the introduction and consequent implementation of the Solvency II as a new regulatory framework for the insurance companies. Solvency II represents a critical step in terms of tightening of the regulatory framework for the insurance providers, especially by setting stricter rules for reporting and capital adequacy. On the other hand, Solvency II represent a major risk of increased costs related to implementation of the Solvency II principles in day to day business reporting of the insurance companies potentially harming status quo of the insurance market as the costs related to implementation of Solvency II and their reporting to national regulators.*

Keywords- *Implementation; Insurance companies; New regulation; Regulatory environment; Solvency II.*

1. INTRODUCTION

The Czech Insurance market shows increased activity these months. Following the years of relative stability, the insurance market is expecting major changes in respect of the key market player as well as the new regulation becoming effective not later than 2016. The regulatory changes represent key factors affecting the insurance market as such in near future. Till 2008, the insurance market was steadily growing in terms of number of new insurance contracts signed as well as new products launched. Given the growing demand, Czech insurance market remained attractive for local as well as international investors. The number of licensed insurance companies in the Czech Republic exceeded number of 50 in total. The crisis in the financial sector that started in 2008 represented a major hit not only for banks, but also for insurance companies. The banks were hit by the crisis as first restricting their lending appetite thus affecting the overall economy and performance of creditworthiness individual companies. The insurance sector was affected by the crisis as a consequence of insurance cover provided insurance cover to lending exposures of the banks and other credit providers, e.g. trade creditors providing deferred payment terms under the insurance cover of third party insurers as part of the day to day business. Given the increased default ratio as a consequence financial instability of the global economy, the insurance providers either cancelled the limits on defaulting names or increased the insurance premium that made insurance products less attractive for the corporate sector covering their exposure towards business customers. As a consequence of difficulties to obtain banking credit and insurance cover (but also other factors such as negative market sentiment) the overall economy slowed down and volume of traded commodities has decreased.Those factors as well as the weakened purchasing power resulted in overall decrease of the number of newly signed contracts, which is one of the key parameters for measurement of the performance of the insurance companies.Besides, their balance sheets were affected by negative revaluations of their investments made into shares and debt capital market instruments made by their investment arms or directly. The fact that equity and debt product portfolios decreased dramatically has increased the need for capital injections to support the balance sheet structure in terms of capital adequacy as well as overall liquidity of the insurance companies. Some insurance companies facing difficult situations were not able to raise new equity because of the negative economic sentiment and the low activity on Equity Capital Markets. The only way how to avoid insolvency and consequent bankruptcy of the financial sector was through state subsidizing the market and providing equity injection. Even if the individual states did not have reserves to finance consolidation of the financial market, the bailout costs spent on consolidation of strategic market players of financial sector would be still lower than in case of consolidation of the overall financial market. This has resulted in number of key financial institutions being nationalized or state acquiring ownership stakes with control over the operations of the banks and financial institutions. Based on that EU through its authorities made a decision to implement a new regulatory framework for banks as well as insurance companies that increases the overall stability of the insurance and banking sectors by setting rules to improve capital adequacy requirement and enforcing the overall risk caution approach in day to day operation of the insurance providers.

2. SOLVENCY II SETTING NEW REGULATORY RULES

To secure future stability of the financial markets, governments increased the pressure on the financial institutions through increased regulations represented by Basel III for banks and Solvency II for insurance companies. Solvency II, the key regulatory reform of the European insurance industry, is knocking on the door. Forthcoming changes not only affect regulatory practice, but will have a direct bearing on the functioning of insurance companies in areas of risk management, capital or data and systems. Taking into account the planned effective date of 1 January 2016, there is still time o fine-tune the details so that insurance companies turned their training into a competitive advantage. Solvency II is built on 3 pillars representing the key principals of this upgraded regulatory framework. Pillar 1 is represented by financial requirements that will be imposed on insurance companies and are based on a market valuation of assets and liabilities. It contains rules for the calculation of technical provisions, capital requirements and the requirements of the investment policy of insurance. Pillar 2 requirements for developing qualitative aspects of risk management - prescribes the basic structure of the control system of insurance companies and the key features that must be set up. Under the second pillar insurance must also make their own assessment of risk and solvency in terms of long-term business strategy (called ORSA).Pillar 3 requirements through reporting and disclosure enhances market discipline and transparency of insurance companies. Insurance companies must disclose the amount of information, especially how to manage the risks and how they are capitalized Part of the requirements is extensive and detailed reporting to the regulator. The requirements of these pillars must be sufficient to support infrastructure including data and systems. Without them, the insurance company failed to meet the individual requirements, whether it is about calculations or quality reporting.

3. COMPARISON OF BASEL III WITH SOLVENCY II

As in banking, as well as in insurance is in the process of harmonization of reporting individual States within the European Union are preparing uniform rules of regulation. Solvency II, the key regulatory reform of European Insurance is knocking on the door. The concept of Solvency II - for insurance companies - has the same goal as Basel II - the banks - and the creation of prudent framework. Solvency II , as well as Basel II , creates incentives for better understanding and management of risk (based on a three-pillar principle). However there are also significant differences:

- Solvency II seeks to harmonize financial markets long term, while Basel II gives considerable freedom to local regulators;
- Solvency II captures all quantifiable risks in Pillar I. (in addition to banking risks still ALM , underwriting, risk of non-life insurance and life risk insurance), while Basel II addresses only selected risks – credit , market and operational risk; Solvency II capital requirement binds directly to the risk insolvency (bankruptcy insurance as 0.5 % at annual term); Basel II is calibrated to the amount of capital previous level of capital adequacy according to Basel I;
- Solvency II is based on fair valuation of assets and liabilities insurance, while Basel II deals only with the asset side Bank;
- Solvency II incorporates diversification into models, while Basel II addresses the diversification effects considerably simplified (capital requirements between different risks only add up, which is completely ignored diversification between different risk);
- Solvency II allows you to create a complete internal model of insurance; Basel II allows complete model for market risk and operational risk. For the most important banking risk, credit risk, the regulator is allowed to use only internal models to determine the probability of losses (PD) and loss in decline (LGD) . As mentioned above, Solvency II has been considered to become effective and come into practice in 2014.

4. IMPLEMENTATION OF SOLVENCY II

The strategy of the regulators has been the gradual implementation of Solvency II with implementation strategy date from 1 January 2014 with markets expectations on further delay of its effectiveness becoming January 1, 2016. Although, the whole European market allows postponement of the date of effectiveness for 1 January 2016 existing legislation (the so-called Quick fix) still contains the date of 1 January 2014. Theoretically, for unapproved Omnibu II (and in the absence Quick fix II) may cause very bizarre situation where Solvency II coming into effect on 1 January 2014 without being ready or subsequent legislation (Level 2 and Level 3) or legislation of EU member states. As every single new regulation, Solvency II has its advantages and disadvantages. As mentioned above, the goal was to increase the stability of the financial sector by setting new regulatory framework that would limit or even restrict activities outside of the core business of insurance companies. On the other hand, the capital requirements and other new regulations set in the Solvency II means that the insurance companies shall be obliged to higher equity allocation in line with the new capital adequacy requirements. On top of that the new regulatory framework sets higher requirements on the individual companies in terms of reporting to the regulator(s).

5. FINANCIAL STABILITY

The primary purposes of Solvency to come into effect shall rule the insurance market to a bigger stability. First of all, the licensed insurance companies shall be more strictly scrutinized by the national regulators with ambition to identify any difficulties of the insurance providers and take

action towards the regulated companies if needed in early stage. This should help to prevent from any major default of insurance companies negatively affecting the market and the customers. This assumes that the regulator is sophisticated enough to identify any weakness and be able to take measures that will help to prevent major defaults. The recent history demonstrated that the regulators were not able to identify weaknesses of the regulated entities and even the reputable rating agencies were rating defaulting companies at investment grades just 1 business day prior the default and consequence bankruptcy of the major market players. Besides, the common action in case of difficulties of the regulated entity is that the license is taken away in most cases. However this should be the ultimate action, but there are number of situations, where the regulators have just monitoring role with limited rights to influence the business decision of the regulated entity and thus help out of the difficulties.

5.1 Increased capital adequacy

According to Solvency II, the insurance companies have the obligation to allocate higher equity and report higher equity ratio. This is by definition a stabilization factor for the insurance providers. Nevertheless, the implementation of Solvency II is in delay and the final implementation date being continuously deferred, which does not bring the positive aspects for the insurance market stability. On the other hand, the insurance providers are forced to refocus their investments and with higher capital contribution the revenues and returns from investments are expected to decrease. At the same time, the investors, i.e. shareholders of insurance companies are expecting same or even increased returns, which is not compatible with the increased equity allocation defined in the Solvency II framework. As the Solvency II's implementation date is being deferred, the insurance companies disrespect the upcoming changes and focus their activities on revenue and profit generation to satisfy the investors' and capital market expectation. Solvency II coming into effect will definitely reduce returns of the insurance companies given the higher equity allocation and the management will be forced to seek for higher risk returns, i.e. to seek for higher risk investments resulting in less risk averse transaction generating the historically generated revenues. The task of the regulators shall be a closer monitoring looking at the quality of assets in books of the insurance providers. Assuming the personal qualities of the regulator employees and the room for data adjustments by the regulated companies proved in the recent years, the positive effect of the new legal framework implementation shall presumably not reach the expectations

5.2 Increased requirements in terms of reporting to the regulators

Implementation of Solvency II shall bring substantial changes in reporting of the insurance companies to national regulators. The new framework has been introduced to the insurance companies, which expressed that some data to be newly reported regulator are difficult to obtain since it requires changes in their own reporting and management information tools and systems or the frequency of reporting to national regulator is higher than data are produced by the individual insurance companies. Besides, data to be supplied to national regulator shall be supplied in completely new format. For comparison, the key documents currently reported are P/L and Balance Sheet of the reporting entity accompanied with some statistical and analytical data. On the other hand, Solvency II assumes data to be reported in completely new format not using P/L and Balance Sheet as key documents, but just as a source of some information representing minor part of the reporting sheet. In reality, the reporting document of reports shall be compilation of data from various sources focusing on analytical and statistical data. It is clear from the beginning that the existing capacities of the insurance companies are not sufficient and therefore the insurance companies shall be forced to allocate additional resources to their reporting and analytical team, which shall represent additional costs on top of the costs related to upgrade or even new development of the reporting and analytical IT system of the individual insurance companies.

5.3 Timing of the Solvency II implementation

As mentioned in the article already, the timing of Solvency II implementation has been postponed several times and there is no certainty of the exact timing of its launch. On top of that the national regulators do not coordinate date of implementation in their countries, which can create disadvantages for insurance providers that report to regulator, which is in more advanced phase. These insurance companies shall bear increased costs related to the mandatory reporting to the regulators earlier than those that are reporting to the regulators implementing Solvency II to their national regulatory framework in a later stage. At the same time those that shall be pioneers in the implementation of Solvency II shall naturally bear increased costs related to the testing of the systems as well as costs related to potential failures in introducing solutions related to new regulatory framework. Last but not least, the fact that insurance companies under the Solvency II shall be required to allocate large equity shall be the key disadvantage as they will be less price-competitive in same product range as their competitors reporting under the current regulatory framework.

5.4 Secondary Impact of Solvency II

Analysing the above mentioned, number of questions being raised, especially the impact of the new Solvency II regulatory framework on the competitive environment. The principles of Solvency II has been set with aim to regulate the business of insurance companies to limit potential defaults among the insurance providers. The closer monitoring and increased capital adequacy requirements lead to the idea that the insurance companies and the insurance market as such shall be more stable and the probability of default shall significantly decrease. However, this article shows that Solvency II and its

© TechMind Research, Canada

implementation have different impact on different insurance companies. The bigger the insurance company, the better costs absorption capacity and ability to implement changes in the early stage. The large market players can absorb the costs related to implementation and the needed headcount increase shall not affect the profitability that much. On the other hand, small companies will struggle with cash allocation related to upgrade of the reporting systems and tool and every increase in headcount will be more material for the profitability.At the same time, the investors are expecting stable return on investments. However, the smaller market players will have difficulties to meet the return expectations of the shareholders and thus they will potentially consider divestments. This all can lead and very likely will end up in consolidation of the insurance market. This trend was evidenced in the past, prior 2008. With implementation of Solvency II, smaller market players will very likely to be acquired by larger companies as they will be less competitive because of the increased costs. Or even mergers of smaller insurance companies is an alternative.

6. CONCLUSION

Solvency II represents a substantial change for the insurance market players. The new regulatory environment shall require changes reporting to the regulator as well as increased capital adequacy. The new regulatory framework shall increase the visibility over the insurance providers and secure higher stability of the overall insurance market with lower probability of default. However, it assumes that the regulator shall have qualified and experienced staff, which will allow to analyse the critical points well in advance and initiate measures appropriate to the level of instability. On the other hand, there are number of new regulatory requirements that will increase the personnel costs based on the increase headcount requirements as well as costs related to implementation of new software focused on new reporting. However, it is expected that the impact on insurance companies smaller in size shall be more material and thus it can initiate and raise new wave of mergers.