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Supervision of the Insurance and Reassurance Market According to Solvency II

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**SUPERVISION OF THE INSURANCE
AND REASSURANCE MARKET ACCORDING
TO SOLVENCY II**

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Key words: insurance and reinsurance supervision, principles of supervision, solvency system Solvency II, publication of information, risk management.

A b s t r a c t

Evaluation of solutions proposed in Solvency II concerning organization and operation of insurance supervision is the objective of the paper. Analysis that involves examination of the components of proposed solutions was applied as the research method. The scope of analysis covered the current and the proposed solutions as well as so far accumulated experiences of the Polish insurance supervision (Polish Financial Supervision Authority [PFSa]) as concerns the effectiveness of organization and operation of insurance supervision.

**NADZÓR NAD RYNKIEM UBEZPIECZENIOWYM I REASEKURACYJNYM
WEDŁUG SOLVENCY II**

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Słowa kluczowe: nadzór ubezpieczeniowy i reasekuracyjny, zasady nadzoru, system wypłacalności Solvency II, publiczne ujawnianie informacji, zarządzanie ryzykiem.

A b s t r a c t

Celem artykułu jest ocena proponowanych w Solvency II rozwiązań dotyczących organizacji i funkcjonowania nadzoru ubezpieczeniowego. Jako metodę badawczą zastosowano analizę, która polega na badaniu części składowych proponowanych rozwiązań. Zakres analizy obejmuje dotychczasowe i proponowane rozwiązania oraz dotychczasowe doświadczenia polskiego nadzoru ubezpieczeniowego (Komisja Nadzoru Finansowego) w zakresie efektywności organizacji i funkcjonowania nadzoru ubezpieczeniowego.

Introduction

According to the Solvency II, protection of the insuring and the beneficiaries is the main goal of regulation and supervision of insurance and reinsurance companies. The European Union Member States, subject to the main goal of supervision, are responsible to assure appropriate consideration of the potential influence of the decisions taken on stability of the EU financial systems, in particular in crisis situations and taking into account the information available at the time in performance of its general tasks by the supervision authority. Future-focused approach based on assessment of all the risks involved in operation of insurance and reinsurance companies is the base of the supervision.

General principles of supervision

According to Solvency II, protection of the insuring and the beneficiaries is the main goal of the supervision (Directive... 2009, art. 27). The insuring and the beneficiary is, in most cases, the same person, however, generally the beneficiary is any natural person or legal entity that according to the insurance contract is eligible to specified rights. All other goals of supervision activity must take into consideration the main goal and as a consequence it is required that the Member States should assure appropriate consideration by their supervision authorities of the potential influence of their decisions on the stability of the financial systems in the European Union, in particular under crisis situations when they should consider also the potentially pro-cyclic consequences of their actions. In addition to the financial stability of the insurance and reinsurance companies, the other goals of supervision activities concern stabilization of the insurance markets, observation of regulations determined by the supervision, consideration of the principle of proportionality in determining the executive means, particularly in case of very small insurance companies. The principle of proportionality also applies to the nature, scale and complexity of risks specific to operations of an insurance company or a reinsurance company. The term “risks specific” deserves particular attention as it applies to all risks that occur in operations of those companies and not only the operational risk that was indicated in Solvency I. Additionally, the future orientation approach based on evaluation of those risks is the base of the supervision. This means that supervision should carry continual control of appropriate conducting of the insurance or reinsurance activity. That control should be a combination of the company operations control and at the spot control (this applies to branches of companies in other

Member State of the EU). Control of company operations can be conducted on the base of adequate information necessary for supervision purposes so the Member States should impose the requirement of providing such information to the bodies of supervision. In case of reinsurance activity supervision the special nature of that activity, including its global nature should be considered, which means the need for evaluating the risks present in reinsurance companies from the perspective of its scattering and scope of activities encompassing all the countries. The Solvency II solvency system is to improve significantly the process of risk management at companies understood as taking decisions and actions leading to achievement of the acceptable risk level in the company (JAJUGA 2009, p. 15). Solvency II allows the insurer noticing the new dimension treating reinsurance as an immensely effective method of dealing with capital requirements (HARTMANN 2010, p. 12). The design of the new solvency system within the Solvency II project is based on the structure of three mutually interrelated pillars to which separate risk categories have been allocated (GAŚIORKIEWICZ 2010, p. 102). The first pillar encompasses quantification of risk types; the second pillar encompasses the risks that are not covered by the first pillar and standard procedures of supervision by bodies of supervision, i.e. the national body of supervision and the European Union level supervisor body (CEIOPS) while the third pillar encompasses market self-regulation tools through creating conditions for its transparency and information duties of companies as well as appropriate accounting solutions.

Authorities and scope of supervision

The Directive of 2009 requires Member States to assure availability to the supervision bodies of not only adequate funds but also adequate professional knowledge to assure achievement of the main supervision goal that is the appropriate protection of the insuring and the beneficiaries. It also imposes on the states the exclusive responsibility of supervision for the activities of the insurance and reinsurance companies with headquarters in a given state. Financial supervision involves verification, in relation to the entire activity of the insurance and reinsurance company, of their solvency, establishment of technical-insurance provisions, quality of assets and allowed own funds according to the established principles or the practice applied in the Member State of headquarters according to the regulations enacted at the community level. If the body of supervision of the Member State where the risk is situated or the Member State where the liability occurs has the reasons to believe that operations of the insurance or reinsurance company might disturb its appropriate financial standing they notify about that the supervision body in the

Member State of the registered headquarters of that company. This is an immensely important solution as it allows bodies of supervision establishing whether the company acts according to the prudential principles established in the Directive. Additionally, the bodies of supervision, in applicable cases, should be authorized – assuring performance of that requirement rests on the Member State – to develop the necessary quantitative tools for assessment of the ability of the insurance or reinsurance company to meet the possible occurrences or future changes in economic conditions that could have unfavorable influence on their general financial standing. That is why bodies of supervision should also be authorized to require companies to conduct appropriate tests.

Supervision transparency is expressed in the responsibility and transparency of its operations, including the independent observation of confidential information protection. However, the Directive clearly imposes on the Member States the duty of publication of some information such as:

- texts of statutory, executive and administrative regulations and major guidelines in the field of insurance activity regulation,
- aggregated statistical data concerning the major aspects of applying the prudential supervision,
- methods of exercising the possibility of selecting the options provided in the Directive (e.g. choice of solvency computation method),
- basic criteria and methods, including tools applied in the supervision process,
- goals of supervision and its major functions and activities.

The information must be published in the uniform format with appropriate structure of information and table of contents and publication date as well as it must be updated regularly and available at one electronic address in every Member State. Additionally Member States are required to enact transparent procedures on appointment and dismissal of the management and control bodies of their supervision authorities.

Information provided for supervision purpose

The Directive imposes on the bodies of supervision the duty of establishing the possibilities of obtaining from the insurance and reinsurance companies of the information necessary for the purpose of supervision including at the minimum the information necessary to conduct the following operations during the supervision process:

- evaluation of the management system applied by the companies, activities conducted by the companies, principles of valuation applied for the purpose

of solvency determination, risk related to company operation, risk management systems as well as company capital structure, capital needs and capital management,

- taking all the adequate decisions resulting from performance of their supervision rights and duties.

Member States must also assure that the supervision body is authorized to:

- define the character, scope and format of the information providing which they require from the insurance and reinsurance companies,
- obtain any information concerning contracts made by intermediaries or contracts made with third parties,
- demand information from external experts such as certified auditors and actuaries.

The information provided to the body of supervision must satisfy the following principles:

- must reflect the nature, scale and complexity of operations of a given company,
- must be available, complete in all significant aspects, compatible and consistent over time,
- must be valid, credible and understandable.

As a consequence, each company must develop the internal procedures, approved by the body of supervision, assuring continual adequacy of information transmitted. It is also required from the Member States to impose on the bodies of supervision of duties concerning conduct of reviews and evaluations of reporting strategies, processes and procedures established by insurance and reinsurance companies to assure compliance with the statutory, executive and administrative regulations enacted on the base of the Directive. The review and evaluation encompass quality requirements related to the management system, that is they apply to evaluation of risk types to which the given company is or may be exposed and evaluation of the ability of the company to estimate those risks considering the conditions under which those companies operate. In particular, bodies of supervision conduct review and evaluation of compliance with the regulations concerning, among others, the management system, technical-insurance provisions, capital requirements, investment principles, quality and quantity of own funds. Additionally the supervision bodies implement adequate monitoring tools allowing detection of deteriorating financial standing of the insurance or reinsurance company and monitoring of the process leading to remedying the situation, elimination of weaknesses or shortcomings found within the frameworks of the supervision process. This may also apply to the investment policy of companies that usually build their investment portfolios of debt securities and other fixed income securities but not always offering the sufficient liquidity level (CZERWIŃSKA 2009, p. 308).

The reviews and evaluations then must take place regularly with the frequency and scope considering the character, scale and complexity of the given insurance or reinsurance company.

As a consequence of the review and evaluation the bodies of supervision may, in exceptional circumstances, establish the capital requirement for the insurance or reinsurance company when, for instance, the body of supervision establishes that the risk profile differs significantly from the assumptions forming the base of the capital solvency requirement computed using the standard formula because some measurable risk types were not represented sufficiently. The capital requirement, however, must be adequate to the character of the risk. The consistence of capital requirements and profile of risks covered by the companies are subject to review by the bodies of supervision at least once per year and it is not eliminated by the fact of remedying the shortcomings that resulted in establishing it.

Legal forms, domestic reinsurance companies, foreign companies from the EU and major branches outside the EU

The Directive divides the reinsurance companies into:

- domestic,
- foreign originating from the EU Member States performing operations in the territory of an EU state within the frameworks of freedom to provide services,
- main branches of foreign reinsurance companies of countries that are not EU members.

The Directive introduces the general principle applicable to reinsurance (and insurance) companies operating within the territories of the European Union countries that the financial supervision over those companies, including the activities conducted through branches or on the base of free supply of services, is within the responsibility of the Member State of the registered domicile of the company. A Polish reinsurance company may conduct similar activity within a EU Member State. In case the reinsurance company possessing the license granted in another EU Member State conducts operations in a given country (so-called host country), that country as a Member State must assure the possibility of conducting control at site of the company by the body of supervision from the country of the domicile of that company. Bodies of supervision of the host country may participate in such control activities after being notified by the body competent for the domicile of the company. If the bodies of supervision of the host Member State establish that the insurance or reinsurance company possessing a branch or conducting operations within the

frameworks of free provision of services does not observe the regulations effective in the Member State then it has the right to demand remedying such noncompliance. If the company does not undertake the necessary action, the body of supervision of the given Member State shall notify about the fact the body of supervision in the Member State of domicile of that company. In that case such bodies of supervision must, without undue delay, undertake appropriate measures to assure remedying the noncompliance by the insurance or reinsurance company informing about that the supervision body of the host Member State. In the extreme situation, when despite the measures implemented by the Member State of the domicile of the company or in the situation when in that state those measures prove insufficient or are not available and the company continues violating the legal regulations effective in the host Member State, bodies of supervision of that state may implement appropriate measures to prevent further noncompliance including imposing a penalty on the company. However, the intent of taking such a decision must earlier be notified to the body of supervision in the Member State of domicile of the company. Stabilization of the financial results of its operations is one of the functions of reinsurance in the insurance companies (GASTEL 2004, p. 2), which is also immensely important from the perspective of the bodies of supervision and as a consequence they must possess instruments of effective intervention in case the companies do not satisfy the applicable requirements.

Domestic reinsurance companies in Poland in case of which the principles of operating their reinsurance business are regulated in the newly added section III in the amended Act on the insurance activity (Act... 2003), that came into force on the 18th of June 2009 may operate only in the form of a joint stock company or mutual reinsurance company or in the form of the European company. Reinsurance company that takes over the risk transferred by its members on the principle of mutuality is a mutual reinsurance company. The reinsurance premium is set at the level that should at least assure performance of all the liabilities from the reinsurance contracts made and coverage of the reinsurance operations performance costs from the technical-insurance provisions. The company capital of a domestic reinsurance company may not be lower than the level of the minimum guaranty capital required for the types of reinsurance covered by the scope of business of the domestic reinsurance company that is in the life insurance field or the field of other personal and property insurance or to the extent covering those types of insurance jointly. If the reinsurance company conducts reinsurance business covering the joint range of insurance the reinsurance solvency margin is equal to the sum of solvency margin of reinsurance company for the life insurance operations and the solvency margin of reinsurance company for the other personal and property insurance. The minimum level of the guaranty capital, however, may

not be lower than the minimum level of guaranty capital of reinsurance company for reinsurance of life insurance or the minimum level of guaranty capital of reinsurance company for reinsurance of other personal and property insurances. The minimum guaranty capital level for the reinsurance company may not be lower than the equivalent of EUR 3 million in Polish Zlotys.

Foreign reinsurance companies from the European Union Member States may operate in the territory of Poland on the base of the principle of free provision of services or through a branch. Performance of reinsurance operations in the territory of Poland by foreign reinsurance companies domiciled in countries that are not Member States of the European Union may be performed by the main branch or directly from the territory of the country in which the company is domiciled if an agreement was made with that country according to article 50 of the Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance (concerns agreements that in particular aim at assuring, on conditions of equivalence, the prudential regulation, effective access to the market to reinsurance companies in the territory of each of the agreeing Parties as well as securing mutual acceptance of the principles and practices of reinsurance supervision; additionally those agreements aim also at securing for the competent bodies of the EU Member States access to the information necessary for supervision of reinsurance companies domiciled in the territory of the EU that operate in the territories of third countries). Initiation of reinsurance activities by the main branch requires obtaining a license from the body of supervision of the host country. Additionally, the main branch of a foreign reinsurance company is required to possess in the territory of the Republic of Poland own funds to the amount not lower than the solvency margin and not lower than the guaranty capital.

Reinsurance companies operating in the Polish market are required to collect statistical data for the purpose of establishing on its base the reinsurance premiums and the technical-insurance provisions. The reinsurance premiums must be set at the level that should at least assure performance of all liabilities from reinsurance contracts made and cover the costs of performance of reinsurance activities. The assets representing coverage of the technical-insurance provisions must be invested by the reinsurance company in a way assuring sufficiency, liquidity, security, quality, profitability and maturity of the assets to the level of due liabilities. Additionally, the assets covering the technical – insurance provisions should be diversified and appropriately scattered to allow appropriate reaction by the reinsurance company to changes in the economic environment, in particular the development of the situation in the financial and real property markets or appearance of catastrophic events. The possibility of investing the assets in the derivative instruments on condition, however, that they would contribute to decreasing the investment

risk involved in other assets representing the coverage for the technical – insurance provisions represents an important solution for reinsurance companies.

Own assessment of risk and solvency

Within the frameworks of the information provided for the purpose of supervision the insurance and reinsurance companies must monitor and conduct own evaluation of the risk and solvency. That evaluation encompasses the major needs in the area of solvency considering the specific risk profile, the approved risk tolerance limit and company operational strategy. The company must possess developed procedures that are adequate to the character, scale and complexity of risks specific for its operations allowing it appropriate determination and evaluation of the short- and long-term risks that it is or may be exposed to. The methods applied for that evaluation must be presented by the company to the supervising body for review. Continuous compliance with capital requirements and requirements concerning technical – insurance provisions is also required. Additionally, the evaluation encompasses significance of the deviation of the risk profile for a specific company from the assumptions that are the base for the capital solvency requirement computed according to the standard formula (or according to the partial or full internal model of the company). In an internal model is applied, the evaluation is conducted together with recalibration transforming the internal data on the risk into the measure of risk and calibration of the capital solvency requirement. Own risk and solvency assessment represents an integral part of the operational strategy and is continually considered in taking strategic decisions by the company. It must also be performed each time when significant changes in the insurance or reinsurance company risk profile occur. It should also be highlighted that own risk and solvency evaluation does not serve computation of the capital requirement.

Publication of information, information for the CEIOPS

Member States impose on insurance and reinsurance companies the requirement of yearly publication of the reports on their solvency and financial standing. Such a report shall contain, among others, the following information:

- description of company operations and results,
- description of the management system and evaluation of its adequacy to the company risk profile,

- description – separate for each risk category – of risk exposure (premium written on own share for the following year), risk concentration, risk mitigation and sensitivity to risk,
- description concerning the bases and methods applied for valuation of the assets and technical-insurance provisions and other liabilities,
- capital management description (contains at least the structure and amount of own means as well as their quality, amount of the capital solvency requirement and minimum capital requirement, etc.),
- analysis of all the important changes from the preceding reporting period and explanation of any significant differences in the value of such components in the financial statements.

Bodies of supervision allow insurance and reinsurance companies withholding some information. This applies, e.g. the situation where as a result of publication of such information competitors of the company could obtain significant undue benefits or if there are commitments to the insuring or other relations with the partners requiring the company to maintain secrecy or confidentiality.

European Union Member States impose on the bodies of supervision the requirement of yearly information to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) on, among others, the capital surcharge that as a consequence of the supervision process is established by the body of supervision finding that the insurance or reinsurance company risk profile diverges significantly from the assumptions forming the base for the capital solvency requirement computed by applying the standard formula. The Directive provides for publication by CEIOPS of such information either in aggregated format for all the countries together in the form of the total distribution of capital surcharges computed as percentage of the capital solvency requirement for all insurance and reinsurance companies or for each Member State separately or for each case revealed. It is the task of the CEIOPS to provide the above information to the European Parliament, Council and Commission together with the report presenting the degree of cohesion in the field of supervision among the bodies of supervision of individual Member States in relation to the capital surcharges.

Conclusion

Organizational changes will most probably be the most difficult component in Solvency II implementation. The Directive means not only a new way of computing capitals in the insurance and reinsurance companies but also a change of their behavior in the decision taking process (STEFFEN 2010). The

scope of necessary changes depends on the requirements formulated by the supervision body. Satisfying the regulation requirements by the companies will be beneficial not only for the insuring and the beneficiaries but also for the companies themselves from the business perspective. Mechanisms described in Solvency II can be used for better effectiveness management of the companies, which may be a chance for gaining competitive advantage. Almost one third of the insurance companies that started implementing Solvency II requirements voluntarily without pressure from the regulators or the capital group they belong to also see it that way (Solvency II 2010). Adjustment activities also concern the issues of outsourcing in insurance and reinsurance business (CZUBLUN 2010, p. 32). New regulations allow, in a long-term perspective, taking strategic decisions on the base of a model reflecting the real risks better. That is why the role of the bodies of supervision in the implementation of the Directive requirements is immensely important for all insurance and reinsurance services market participants. For companies, own solvency and risk evaluation represents a tool allowing a more effective linking between the regulation requirements with own operational strategy. For the beneficiaries (the insured) it represents higher certainty of obtaining the insurance benefit; for the insurance companies a higher certainty of obtaining the reinsurance benefit. As a consequence, compliance with the regulation requirements from the perspective of the body of supervision represents also an opportunity to build a tool supporting the process of taking strategic decisions by the company, while the measures (such as damages ratio, operational costs ratio, operational ratio, premium ratio) (WILLIAMS et al. 2002, pp. 422–425), which are important from the perspective of the body of supervision even over the period of twelve months may become components of a strategy built for a much longer period on the base of the internal evaluation of what is the important risk now and what might represent a risk in the future for both the companies and for their beneficiaries.

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