



FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

FSI Round Table on Risk Assessment and Capital Adequacy in the Insurance Sector

Basel, Switzerland, 24 March 2003

Annotated Agenda

Background

The last decades of the twentieth century were a period of dramatic change in financial engineering, financial innovation and risk management practices. Enterprise-wide risk management has been evolving as financial theory has advanced, new technology has made modelling of risk more feasible and innovation has fostered better ways to mitigate risk.

Although risk management has become more quantitative, considerable management judgement must be applied to the risk management process. This is particularly the case with respect to the low probability, high severity risks that can severely damage or even ruin a company.

Risk measures are important inputs into risk management decisions, including the appropriate pricing of products. The historic pattern has been that underwriting and investment results have been negatively correlated. Strong investment performance has generated increased capacity, leading to increased competition and lower rates. With the recent convergence of poor underwriting and investment results, however, and with higher exposure levels, better risk assessment and management is increasingly important.

Capital or solvency regulations are important tools in insurance supervision. Due to the lack of international standards, regulations differ across jurisdictions in this area. There are presently two primary models, the US risk-based capital model, which is also followed in similar form in other countries, and the model used in the European Union. There are several differences between the two models. One of topical interest is that there are explicit capital requirements in the RBC model for investment-related risks, while the model used in the EU is based more on qualitative rather than quantitative rules, focussing exclusively on the assets corresponding to the technical provisions. This has had an impact on the composition of companies' investment portfolios and differences can be significant, depending on the applicable solvency regime.

Important work is going on within the International Association of Insurance Supervisors (IAIS) to develop international standards. There are many arguments in favour of finding a common approach to measuring risks and determining required capital, but there are also many obstacles and the IAIS has still some way to go. There are also other international standard-setting activities or studies that can have an important impact in the future, e.g. those of the European Commission, the International Actuarial Association (IAA) and the International Accounting Standards Board (IASB).

The Basel Committee on Banking Supervision has recently introduced a proposal for a new framework intended to align regulatory capital requirements more closely with underlying risk and to provide banks and their supervisors with several options for the

assessment of capital adequacy. Although these rules concern the banking sector, some supervisors will also apply various aspects of them to the insurance sector.

Focusing on these topics, the Round Table will strive to facilitate discussions among the participants. We believe that there is wealth of experience and knowledge to be shared among supervisors and those impacted by these regulations. This sharing can help to advance the techniques of assessing risk and setting an adequate level of capital.

Proposed disposition of the discussions

14.00 **Opening Remarks**

Ms Gunilla Löfvendahl Briatte, Financial Stability Institute

Mr Martin Roberts, Facilitator of the Round Table and Chairman of the IAS Technical Committee

14.15 **Can we expect uniform international standards for risk assessment and capital adequacy for the insurance sector in the near future?**

What are the possible obstacles and what are the attitudes and expectations of the supervisors and market participants in this area?

15.00 **Some international observers believe the insurance sector to be the most vulnerable area within financial services. Do you share this concern and, if so, what could be done to address this vulnerability?**

The IMF is one of those that has, in its Global Financial Stability Report, criticised insurers for not keeping pace with their involvement in the financial markets and for not managing their market and credit risks properly. Insurers are said to apply adapted insurance pricing methodologies, using traditional actuarial-type techniques to manage credit risk, which is considered to be inadequate and dangerous.

15.45 **The insurance industry has made big losses recently. Is this due to inadequate risk management?**

Would a different solvency regime and stricter regulations on corporate governance have made a difference?

The European Commission has commissioned the so-called Solvency II project, which is a review of the current regime in the light of recent development in insurance, risk management, finance techniques, financial reporting, etc. One of the key objectives is to establish a solvency system that addresses the true risks of an insurance company.

To inform the debate on revision of insurance regulation within the EU, a working group of supervisors from 15 European countries dissected recent experiences of failed insurance companies or companies with a critical solvency situation across the life and non-life sectors since 1996. One of the conclusions from this study was that management problems appeared to be the root cause of every failure or near failure.

16.30 **Work going on within the Basel Committee proposes a more risk-sensitive approach to the determination of regulatory capital and a greater freedom for banks in measuring the risks. Is this a possible, or even desirable, model for the insurance sector?**

Are judgement-based approaches a threat to ensuring a consistent application of international standards and, therefore, is a simpler, albeit less accurate approach preferable?

The Basel Committee is proposing a so-called three pillar approach, where pillar one represents the minimum capital requirements, pillar two the supervisory review process and pillar three the disclosure to market participants.

Banks with more advanced risk management capabilities, which can meet rigorous supervisory standards, will be able to make use of an internal ratings-based approach. With this system the supervisor needs to ensure that the bank has sound internal processes in place to assess the adequacy of its capital and set targets for capital that are commensurate with the bank's specific risk profile and control environment. This internal process would then be subject to supervisory review and intervention where appropriate.

17.15 **Can the supervisory community keep up with the innovations and the progress in risk management techniques in order to supervise insurers effectively?**

Is there a real danger of differences in supervisory sophistication and thus legal arbitrage?

18.00 **End of Round Table**