The insurance market and Solvency 2 - Level 1 (The Framework Directive)

It does sound like a good idea at first glance. Solvency 2 is supposed to replace the 13 current insurance laws in the EU. It is supposed to minimize the risk of insolvency and to change the focus from a liability to a balance sheet one. Of course, some companies will be exempt from the directive, but it is not an easy task or goal, to become an exempt entity; the upper limit is set at 5 MEUR in gross premium revenues (or gross technical provisions above 25 MEUR).

National supervisory authorities are mentioned in article 36, where it is written that they should have tools available for detecting whether a firm is compliant or not. It is further mentioned in article 86 that the supervisory authorities have the responsibility to determine which methods of calculation the firms are to use. It would be interesting to know why certain tools are chosen, regarding both theoretical as well as practical assumptions.

Article 44 raises risk management issues; more specifically, strategies, processes and reporting are mentioned. The operative risk is defined as including legal risks, excluding strategic and reputational risk. The operative risk will probably not be something that will receive much attention, but it is important to ask oneself if the current definition is wise. This aspect could be said to be discussed in the text concerning the importance of well functioning corporate governance, in order to ascertain the well functioning management of insurance companies. The following is mentioned in the definition of corporate governance system: risk management functions, the function for regulatory compliance, the internal auditing function and the actuary function.

It is mentioned in the introduction to the directive that the standard formula for solvency is aimed at reflecting the risk profile of the majority of insurance firms. It is further stated however that each company should evaluate its own solvency needs and integrate this in their risk profile. I want to further extend that recommendation to include the internal risk management overall, in particular the parts relating to terms and conditions, as well as premiums and the way with which they are set.

Yet another interesting aspect is that the directive mentions that firms are to be prepared for unforeseen events. Should the focus then be on predictive models (which this author is against), or preventive mechanisms? More on this can be found in the Level 2 directive, on implementation. One can however see in Level 1 what is envisioned regarding this question. What worries and bothers this author is the view on what is perceived as good risk management in the framework directive. The directive mentions that the firms “with a minimum of 99.5% should be able to abide by their obligations towards insurance holders and beneficiaries during the following period of 12 months”. Of course, the VaR (Value-at-Risk) measure is referred to. An exposé around the problem of using this measure is the material of another article. It is however worrisome that the authors of the directive have not gotten any further in their analysis of available methods and models that better capture the risk of default for the firms involved. What irritates one the most is the text that follows:

“If company specific parameters make it possible to better catch the company’s real underwriting risk profile, these should be allowed given that the parameters have been derived using a standardized method”. The part about standardized methods is important; who decides which method to “standardize”? On what grounds?

There is much more to discuss regarding Solvency 2’s framework directive. Most of us have already realized that Solvency 2 will have a doubtful effect on staving off future crisis for individual companies.

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