Global regulatory dynamics – Opportunities and challenges for Asian insurers

Besides looking at the protection of policyholders, **Mr Clarence Yeung** of **ACR Capital Holdings** says regulators also have the objective of strengthening overall financial stability through more rigorous and 'smarter' capital and risk governance requirements. He explores the impact of these regulatory thrusts for Asian insurers and the advent of Solvency II to the region.

The years following the global financial crisis of 2008-9 have seen a flurry of regulatory initiatives all over the world, mainly directed at the banking sector.

However, the insurance industry was not spared from much heightened regulatory scrutiny: Some draft stipulations of the European Union's repeatedly delayed Solvency II project have been tightened. In addition, previously established Risk-Based Capital (RBC) regimes now place more emphasis on market risks – equity and interest risks in particular – and Enterprise Risk Management.

In other words, these regimes are adopting a more holistic approach to managing asset and liability risk. The Monetary Authority of Singapore and Taiwan's Financial Supervisory Commission are cases in point.

Large global insurance groups potentially face special regulatory requirements should they be deemed systemically important. This implies that the financial crisis has added a second dimension – besides policyholder protection - to regulatory activity: The objective of strengthening overall financial stability through more rigorous and 'smarter' capital and risk governance requirements.

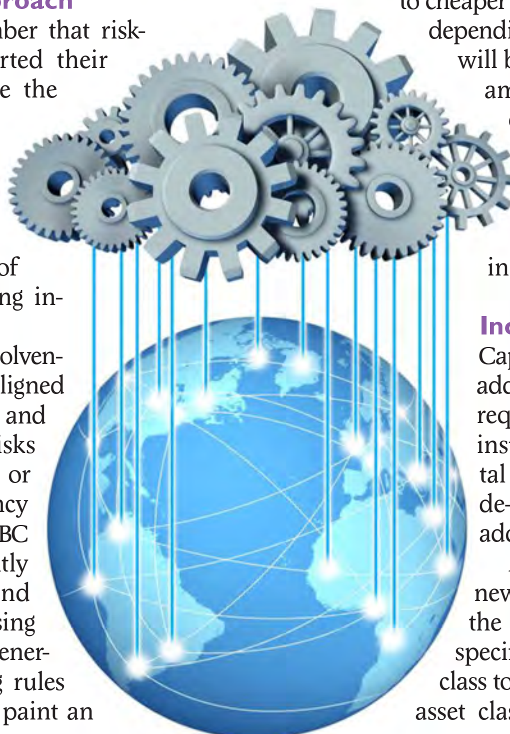
Triumph of the risk-based approach

It is important however to remember that risk-based solvency regimes have started their triumph in insurance long before the financial crisis hit.

In Europe, the Solvency II project was launched in 2003. In the United States, RBC was introduced as early as in 1994 and is widely deemed a success story in terms of protecting customers and preventing insurance company failures.

Under both regimes, underlying solvency capital requirements are closely aligned with the insurer's specific risk profile and explicitly reflect non-insurance risks such as changes to the yield curve or the default of a counterparty. Solvency II is even more ambitious than RBC in that it relies on market-consistently valued assets ('mark-to-market') and liabilities (discounted cash-flows using a risk-free rate), whereas RBC is generally based on statutory accounting rules and therefore does not necessarily paint an economically true and fair picture of a company's balance sheet.

Despite these differences, it is widely believed that solvency regimes based on economic principles and an all-risk approach point the way forward for post-crisis insurance and reinsurance regulatory regimes across the globe.



Modern regulations matter to corporate strategy

Solvency II could further accelerate the adoption of RBC throughout Asia. It can be viewed as a logical step between current static (premium-based) solvency regimes and the fully risk-based and economic framework of Solvency II. Some Asian jurisdictions are monitoring Solvency II developments particularly carefully and may adopt economic risk-based capital rules in the not too distant future.

It is therefore important for Asian insurers to try and gauge the strategic impact of these regulatory dynamics for product development, capital management, asset management and reinsurance purchasing.

Under Solvency II or any future economic and risk-based solvency regime, product pricing will be driven by capital consumption. Risk-sensitive pricing can lead to cheaper or more expensive insurance products, depending on capital intensity. Products which will become more expensive include, for example, with-profit life insurance policies offering long-term guarantees as well as volatile non-life lines of business such as Property Cat. Ultimately, the new regulatory parameters could result in a lower-risk product mix in insurance markets.

Increased capital requirements

Capital management will likely also gain additional importance. As average capital requirements are expected to increase, insurers will have to improve their capital efficiency through measures such as de-risking, enhanced diversification or additional reinsurance purchases.

Arguably, the biggest impact of the new solvency regime can be expected on the asset management side. There will be specific capital charges for each major asset class to reflect market and credit risks. "Risky" asset classes such as equities and high-yield

corporate debt will have to be underpinned by considerably more capital which makes changes to the strategic asset allocation possible.

Insurers will also try to minimise their asset-liability mismatch in order to reduce capital requirements. All in all, an insurer's investment policy in terms of asset allocation and asset duration will have a large impact on capital requirements.

Switzerland may serve as an example in this respect. Since January 2011, the country's insurers have been subject to a Solvency II-style regime. As a result, they have fundamentally reassessed their appetite for market risks, especially interest rate risks.

Under the Swiss methodology, market risks account for more than 60% of solvency capital requirements to be met by life insurers. For non-life insurers, the number is still a high 40%. Traditional underwriting risks, on the other hand, contribute a mere 20% and 50% to life and non-life insurers' solvency capital needs, respectively.

Reinsurance – the risk mitigation and capital management tool

Last but not least, the trend towards economic and risk-based solvency rules will affect reinsurance purchasing decisions: expected capital shortages could boost demand for surplus relief. Reinsurance is expected to be increasingly used as a precise risk mitigation and capital management tool as its impact can be measured more accurately on the basis of economic capital models.

Cedants may also place more emphasis on counterparty credit risks – which carry capital surcharges under Solvency II – and a well-diversified panel of reinsurers.

The Asian perspective

Solvency II-type regimes in Asia would certainly create winner and losers. Winners would be the fastest at boosting their capital efficiency and capturing the competitive benefits of steering a company based on an economic and holistic approach to risks. Responding to regulatory changes pro-actively will be crucial.

Also, insurers with a diversified portfolio would benefit from a capital perspective. Laggards might disappear from the marketplace as they lose out in terms of capital strength and sophistication. Niche players and mono-line businesses could come under particular pressure as they would not benefit from any diversification credit for their capital requirements.

In general, consolidation is set to gather pace, not just because of heightened capital requirements but also as a consequence of stricter and more onerous and resource-intensive regulations concerning internal risk management, governance and disclosure. Further, the market may be shaken up by the withdrawal of certain players from capital-intensive lines of business, such as guarantee-based life insurance, property catastrophe insurance and specialty lines insurance.

Underwriting and pricing will be driven by cost of capital

Under a Solvency II-style framework, Asian insurers' underwriting and pricing decisions would be largely driven by the cost of capital.

Players with adequate actuarial capabilities would therefore enjoy a significant competitive advantage arising from superior pricing skills. Investment risks would increasingly be passed back to policyholders, a lesson learned from Switzerland as well as from the UK for example, where insurers are preparing for Solvency II.

This also presents a challenge for life insurers as one of their key competitive advantages over banks would erode. In the non-life business however, the impact of regulatory change should be less pronounced. For example, motor business, which dominates most Asian insurance markets, is not expected to face higher regulatory capital charges given its limited volatility and the natural diversification inherent in most large motor portfolios ('law of large numbers').

Underwriting profitability becomes a strategic imperative

Particular challenges would need to be addressed on the asset management side. Asian insurers historically tend to assume more investment risks than their European counterparts.

Under an economic risk-based solvency capital regime, they would probably have to de-risk the asset side of their balance sheet as equities and other 'high-risk' asset classes will require considerably more capital. In Europe for example, some executives feel that equity ratios in excess of 5% will become 'unaffordable' from an economic and capital efficiency point of view. Given the much smaller scope for investment income for both regulatory and market reasons (ultra-low interest rates), underwriting profitability develops into a strategic imperative.

Asian insurers are expected to purchase more reinsurance to respond to higher regulatory capital requirements. Non-proportional reinsurance, in particular, would likely become more attractive as it directly and effectively addresses volatile and highly capital-intensive, low-frequency high-severity exposures. This would go hand in hand with a more analytical and quantitative approach to purchasing reinsurance. In addition, Asian insurers may further broaden and diversify their panel of reinsurers to limit credit risk and associated capital charges.

Regulatory change as a catalyst for improved corporate performance

Dealing with the new global regulatory paradigm presents Asian insurers with potential additional challenges such as heightened capital and compliance requirements.

However, companies should not lose sight of significant opportunities arising from the regulatory change. A risk-based market-consistent solvency regime, complemented by sophisticated risk management and comprehensive disclosure requirements offers a potentially rich tool-box for improved competitiveness.

Under such regimes, insurers have the option of using an internal model (as an alternative to a standard formula designed by regulators) to calculate capital levels. These models may go a long way in better aligning available capital with corporate risk profiles and in developing smarter approaches to pricing, asset management and reinsurance purchasing. All in all, proactively embracing the new regulatory realities may help Asian insurers unearth the hidden potential for improved competitiveness and performance.

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