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Squaring a circle

Karel Van Hulle looks at the hurdles in the way of creating an international capital standard for insurers

Insurance is complex. Accountants have been struggling for decades with the difficulty of translating the insurance business model into sensible financial reporting. Likewise, insurance supervisors have had their problems with the development of a risk-based solvency capital regime. Nevertheless, there is no obvious reason why the insurance industry should remain the only major economic sector without an agreed international capital and/or accounting standard.

While the International Accounting Standards Board (IASB) seems now close to finalising its long-awaited international accounting standard for insurance, it is still uncertain whether it will be possible to develop a truly international solvency capital standard.

Although the insurance industry was not responsible for the last financial crisis, it was impossible to disregard insurance when developing new regulatory requirements at global level. The Financial Stability Board (FSB) wanted a level playing field between banking and insurance regulation in order to avoid regulatory arbitrage.

Furthermore, once it was agreed that there could also be global systemically important insurers (G-SIIs), it became necessary to define the additional capital that these insurers need to hold in order to distinguish them from other insurers. How to do this in the absence of an internationally-agreed capital standard was the question.

One standard …

In October 2013, the IAIS announced its plan to develop an insurance capital standard (ICS) that will ultimately apply to all internationally active insurance groups (IAIGs), which include the G-SIIs. An ambitious work programme was agreed, with a target date of 2019. First, a basic capital standard (BCR) was developed for G-SIIs as a base for the additional capital that they need to hold (higher loss absorbency or HLA). This BCR will ultimately be replaced by the ICS.

The development of the ICS is greatly helped by the fact that many insurance supervisors now agree that a risk-based solvency capital regime is also needed for insurance. This has led to important reforms in many parts of the world. However, while there is agreement that this solvency reform should follow the three-pillar approach — Pillar 1 (quantitative requirements), Pillar 2 (qualitative requirements) and Pillar 3 (public disclosure and supervisory reporting) — that was introduced in the banking sector, there is still a lot of disagreement on the quantitative part dealing with capital.

The disagreement relates to issues such as the valuation of assets and liabilities in the solvency balance sheet, the risks to be included in the standard formula, the definition and quality of own funds and the possibility to use an internal model. The ICS will therefore have to come in stages, whereby the last stage should be a truly international capital standard.

… two valuations

It seems impossible to agree from the beginning on one set of rules for the valuation of assets and liabilities in the solvency balance sheet. Although most countries in the world have opted for an approach based on international standards (International Accounting Standards/International Financial Reporting Standards), the US is still unable to sign up to these standards. The ICS will therefore have to use two valuation approaches as a start: one approach using a market-consistent valuation and another approach using historical cost as the basis for valuation.

While using market values creates volatility in the balance sheet, ignoring market risk in the valuation of insurance liabilities and assets can hardly be called a risk-based solvency approach. In my view, it will therefore be unavoidable to move ultimately to a form of market-adjusted valuation for calculating insurance liabilities. The question for the IAIS, the industry and academics is how to do this in a way that captures adequately both the real risks and the long-term nature of insurance.

As long as two valuation approaches continue to exist, the numbers will not be comparable. Comparability can be helped through disclosures that allow interested parties to see the difference between the two approaches. However, experience has shown that the use of different numbers is confusing, as the readers are left to make their own judgement on which of the numbers is the right one. In addition, there can be no level playing field between insurance groups that use different valuation approaches, as the required capital will be different depending on the valuation approach chosen.

Hiden benefits

Nevertheless, the development of the ICS has had important advantages. Insurance supervisors are learning to better understand each other and to speak the same language, even though they might not always agree.

This is particularly relevant for group supervision, where supervisors from different jurisdictions are sitting around the same table. The discussions and the field-testing also bring some order to the different economic capital concepts that are applied by insurers in different parts of the world. They may also at last bring agreement that group solvency is important and that we need to move away from legal-entity reporting as the sole way of reporting within groups.

In terms of implementation of the ICS, things are not easy. For the EU, it is unlikely that changes will be considered before the agreed deadlines for the revision of Solvency II and — given the investment made in its development — any changes are likely to be refinements rather than fundamental. Other countries, such as Australia, Brazil, Canada, China, Japan and Mexico have carried out, or are in the process of developing, similar reforms to create strongly risk-based solutions. It will also be difficult for many of them to fundamentally change their approach. For the US, it is already difficult to agree nationally on who is in charge of developing solvency rules for large insurance groups. It is therefore unlikely that the introduction of an ICS will come without difficulties there.

The ICS therefore cannot be a revolution but must be something that evolves from the reforms that have recently been introduced in many parts of the world. It will not be easy to square the circle.