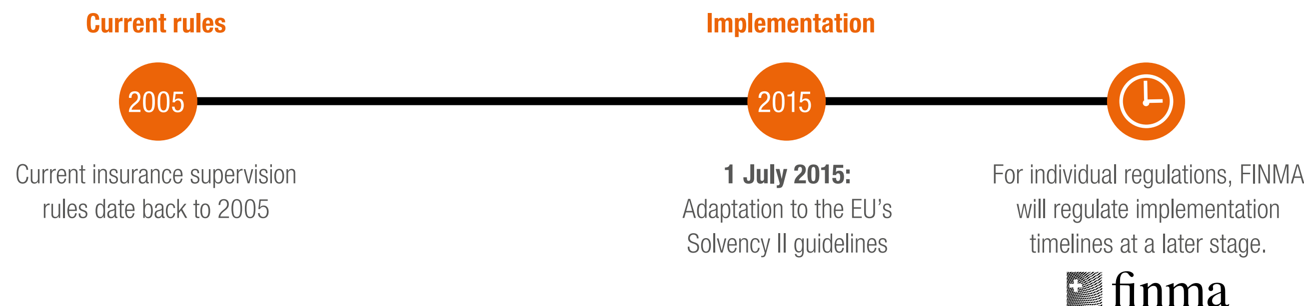
*Opinion paper*

# MEGATREND FINANCIAL CENTRE

*Insurance industry – May 2015*

# Revision of insurance supervision legislation: overview of key factors

Current insurance supervision rules date back to 2005. Countless new regulations have since been created worldwide, which is why Switzerland must adapt its regulations to meet international standards. A key aspect of the revision is the adaptation of Swiss standards to the requirements of the EU's Solvency II guidelines that take effect in 2016. The revision's aim is to ensure that Swiss insurance companies have the same opportunities as their European competitors. The new regulations are to be introduced in Switzerland with effect from 1 July 2015. The Swiss Financial Market Supervisory Authority (FINMA) will determine the implementation dates of their individual aspects. The key changes affect the following points:



Changes in the area of corporate governance

Equivalence with the EU's Solvency II guidelines

The introduction of standard models in the Swiss Solvency Test (SST)

# Changes in the area of corporate governance

There will be a major change in the area of corporate governance:

- The board of directors as a corporate body is already required to possess sufficient expertise to carry out its function. In future, every member of a board of directors must have specialist knowledge of their field.
- Furthermore, a member of a board of directors will no longer be able to hold an operational function.

➜ *The industry is vehemently fighting this change. There is a risk that insurance companies will find too few suitable board members and that the same individuals will be candidates for multiple boards. This will result in a concentration of knowledge and influence, thereby increasing risk.*

- In addition, two different functions must now be created for internal audit and the responsible actuary.
- A separation of risk management and compliance in groups and individual companies must be completed within three years. Group risk management will be responsible for overall risk management, while these functions in individual companies will bear responsibility at their level.
- A further change affects the transaction area, such as acquisitions or disposals of blocks of business, sales or purchases of an insurance company. In the past, the supervisory authorities had to be informed after a transaction was agreed. Now the authorities must be informed as soon as there is any intention of agreeing to a transaction. This will enable FINMA to intervene at an early stage should something stand in the way of the transaction.

## ASSESSMENT

Corporate governance guidelines are a controversial topic of debate. While they are consistent with developing best practice across the global insurance industry, there is a limited pool of individuals with sufficient expertise who do not currently hold operational positions in Switzerland. Supervisory practice will have to be developed in this area.

# Equivalence with the EU's Solvency II guidelines

In order to achieve equivalence with Solvency II, an own risk and solvency assessment (ORSA) is being introduced. This process is part of a firm's risk management and is to be integrated into its business planning and strategy. The annual ORSA report provided to FINMA documents the highlights of this process and at a minimum comprises:

- The company's risk profile, including current and future risks.
- An estimate of overall solvency needs, including any risks not captured in the SST.
- Compliance with technical provisions and the requirements of tied assets.
- A demonstration of appropriate and effective risk management.

➜ *The ORSA must be understood and owned by a company's senior management. Solvency figures will have to be taken into consideration in decision making. The introduction of the ORSA is complex, as it may require new processes, data collection and a potential change in corporate culture, such as embedding risk management in the strategic decision-making process. Swiss insurance companies that are active in the EU are familiar with the concept as it is a Solvency II requirement. It might be a challenge for other insurance companies, both large domestic providers and small industrial insurers. However, some companies have found ways to leverage the ORSA process to create value for their organisation.*

Liquidity management is to be adapted. FINMA will define the specific details in a circular on this topic.

➜ *The introduction of liquidity management also affects the processes within a company. Large insurance companies already have them in place, and the requirements will be expanded to include small companies.*

In addition to business, financial and sustainability reports, a solvency report is now also required. It will be disclosed publicly and comprise details about:

- Business activities
- Business result
- Risk profile
- Methodology
- Capital management
- Solvency

➜ *This new requirement in turn requires new processes, new software tools and, most likely, additional staff. The solvency report involves additional work and expense, but also has the advantage of disclosing the solvency ratio, which could be used as a key communication tool by insurance companies.*

In addition, separate and independent risk management and compliance functions must be created under the new regulation.

➜ *Small insurers may need to create new functions to comply with the provision, since these were often combined in the past. This is likely to increase costs. An important aspect of implementing the new requirements will be considering how to use the information and new processes to create value.*

In the past, captive reinsurance companies were not required to perform Swiss Solvency Test calculations. However, this will now also become obligatory for captives. The transitional period will be determined by FINMA.

➜ *For the first time, captives will need to apply standard models for the solvency test developed by FINMA. While this will require the corresponding data to be prepared and processes to be set up, it will ensure consistency with the EU and increase transparency.*

The adaptation of Swiss solvency regulations renders additional reporting pursuant to Solvency I unnecessary.

➜ *The change affects all insurance companies with the exception of non-life insurers active in the EU, which must continue to issue a Solvency I report in order to comply with EU state treaty provisions. It is likely that the treaty provisions. It is likely that the treaty will be amended with effect from 1 January 2016. Thereafter, Solvency I will also become obsolete for non-life insurers that are active in the EU.*

A group-wide solvency test can now be carried out in two ways:

- The preferred method in the ordinance is an SST based on the consolidated financial statements. Clusters may be formed subject to FINMA's approval, for example, by geographical criteria or type of business, and form the basis for the solvency test.
- It is also possible to carry out a "granular group SST" that considers all entities and intra-group transactions.

An insurance group meets the solvency requirements if it complies:

- with the consolidated group SST or
- with a granular group SST approved by FINMA

➜ *The granular group Swiss Solvency Test is more demanding than Solvency II as it is more complex and requires more modelling work. However, it captures information and assumptions specific to the group better than the EU model.*

## ASSESSMENT

For small and medium-sized insurance companies, the revision is likely to involve a great deal of additional cost and effort, as the corresponding processes are not yet in place. Moreover, the new processes will have a direct impact on their day-to-day business. The new requirements might also require some insurers to make a change in their corporate culture.

Insurers who as yet have no experience with the new regulations should familiarise themselves with them at an early stage, look to insurance companies in the EU to learn from their experience, and plan sufficient time and resources for the introduction of the regulations.

# The introduction of standard models in the Swiss Solvency Test (SST)

As part of the revision of the insurance ordinance, standard models for all insurers will be introduced for the Swiss Solvency Test (SST). The existing internal models will no longer be required as they make comparisons among insurers difficult and result in a very complex FINMA approval process.

- Standard models now apply to all insurance companies that do not already have a (partial) internal model approved by FINMA. In addition, the supervisory authorities will develop further standard models that cover the typical risks of the corresponding insurance sector.
- FINMA will determine a transitional phase for the switch from an internal to a standard model.

## ASSESSMENT

The move to standard models for many companies is bound to be controversial and involve protracted discussions between the regulator and the industry. These will be based on a cost-benefit analysis of the cost and complexity of internal models and on the ability of the underlying company or group to tailor an internal model to its specific risk profile. While internal models have identified some areas in need of additional capital, they have generally resulted in lower capital requirements compared to the standard model. It should be noted that FINMA is not the only regulator to raise the challenges arising from regulating through multiple complex internal models.

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