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Part 2: Integrated Insurance Supervision

SST as an Instrument for the Determination of the Economic Capital Need

Speech by René Schnieper
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The Swiss Solvency Test (SST) has established itself as an important supervision tool for FOPI. It enables both an evaluation of the various balance sheet items on a market-consistent basis as well as a risk-based quantification of the capital needs. The SST thereby permits an analysis of the solvency of the individual companies on an economic basis and is harmonized with the principles of Solvency II – the analogous project undertaken by the EU. At the same time, the SST is a component of the described integrated supervision model of FOPI, which serves to obtain a comprehensive picture of the supervised companies that goes beyond the solvency analysis.

Findings from the 2006 SST field test

The third run of the SST field test was for the first time mandatory in the reporting year for eight life insurers with a premium volume of more than CHF 1 billion and for nine non-life insurers with a premium volume of more than CHF 500 million. Additionally, numerous other undertakings took part on a voluntary basis, so that a total of 47 companies were included in the 2006 field test.

The field test once again confirmed that the main risk of life insurers consists in the market risk. This constitutes 50% to 80% of the capital needs. The largest component of the market risk in turn is the interest rate risk.

In the case of non-life insurers, the picture is more heterogeneous. Market risks are also significant, but the insurance risks are dominant here. Overall, the non-life insurers have good capitalization and the life insurers have sufficient capitalization. In a very few number of cases, FOPI took protective measures. Undertakings that have currently not achieved full solvency have until 2011, however, to build up their solvency accordingly – either by increasing their capital or reducing their risks. The latter can be achieved, for instance, through better asset/liability matching.

Effects of the SST on the investment activity of insurance undertakings

On various occasions, concerns have been expressed that the introduction of the SST would lead to a massive sale of shares and real estate by insurance companies, such that the share prices and real estate prices might come under pressure. Aside from the fact that it is not FOPI's responsibility to manage share prices or real estate prices, these concerns have proven to be unfounded, due to the relative weight of share and real estate inventories on the part of insurance undertakings. As of the end of 2005, the share inventory of life and non-life insurers amounted to approximately CHF 33 billion, not taking investments in affiliated undertakings into account. At the same time, the Swiss Performance Index (SPI) encompassed shares in the amount of CHF 1,175 billion. Under the unrealistic but conservative assumption that insurance undertakings only invest in SPI values, their market share therefore amounts to less than 3%.

As of the end of 2005, the value of real estate property of life and non-life insurers amounted to approximately CHF 35 billion. By comparison: 19 cantonal building insurers belonging to the VKF (Association of Cantonal Fire Insurers) insure values totalling CHF 1,700 billion. The VKF estimates that this amounts to more than 80% of the total Swiss real estate inventory. This inventory therefore amounts to nearly CHF 2,000 billion. The market share of insurance undertakings thus represents less than 2%, under the conservative assumption that the real estate inventories of insurers have been balanced at their insured value.

Looking at the inventory of fixed-interest securities of the insurance undertakings as of the end of 2005, however, an amount of CHF 184 billion stands in relation to a market value of CHF 486 billion for the bonds traded on the SWX. Furthermore if one takes into account that undertakings with better asset/liability matching which do not want to assume additional credit risks demand especially illiquid government bonds, then a flattening of the interest rate structure on the domestic capital market can be expected. This conclusion is also reached by a study done by the University of St. Gallen published in December 2006. The study forecasts increased issue activity for long-term bonds and concludes that this will again lead to a long-term rise in the interest rate curve.

Future challenges

The focus of the immediate tasks of FOPI is on verification and evaluation of the internal models of insurance undertakings. We would like to recall that companies whose risks are not adequately reproduced by the standard model have the obligation to develop and apply an internal model. This is especially true of reinsurers, insurance groups, and conglomerates, as well as for the subsidiaries of Swiss undertakings abroad. Of note in this connection is also the fact that the group model may not rest on a consolidated basis, but rather must reproduce the group structure and the relationships between the undertakings in the group.

A further challenge consists in minimizing the existing contrasts between the economic and statutory perspective. But also existing contradictions between risk-based and principle-based supervision on the one hand and the customary rule-based approach on the other hand must be eliminated as soon as possible. Both examples constitute important preconditions for the establishment and implementation of integrated supervision.

New Investment Directives for Tied Assets

Speech by Markus Geissbühler
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Tied assets as a component of integrated supervision

Experiences of the recent past have pointed the way in two respects for the new supervisory regime relating to financial investments in force since 2006: On the one hand, the goal was to get a better grip on the solvency problems of insurance undertakings manifesting themselves in the wake of the stock market downturn in 2001 and 2002. On the other hand, a substantial need for supervisory action with respect to the quality of financial investments in general became apparent.

The examples show that a significant need for new, timely supervisory provisions existed with respect to financial investments. The focus of these efforts has been and continues to be on tied assets, which play a central role in securing the demands of policyholders.

The protection mechanisms relating to tied assets provide that a 100% cover must be ensured at all times. The assets deposited in the tied assets of Swiss private insurers are correspondingly high. At the end of 2006, they amounted to about CHF 292 billion.

The new investment directives for tied assets

In the new investment directives that entered into force on 1 September 2006, FOPI defined specific qualitative demands on the tied assets, in order to protect the interests of policyholders effectively with respect to the financial investments. All rules concerning financial investments are now included in one directive. The following changes should be emphasized with respect to the monitoring of financial investments:

By opening the investment universe, FOPI permits a risk-aware use of newer, more complex investment instruments. For instance, hedging transactions on technical provisions, such as synthetic bonds or swaptions, are now allowable, in order to better manage the risks arising from long-term interest rate obligations. At the same time, investments in alternative products such as hedge funds, private equity funds, or commodity certificates and the use of structured products are now possible.

At the same time, FOPI has defined uniform quality criteria. Accordingly, investment activities must be carried out in the framework of an investment strategy that has been clearly defined by the insurance undertaking. This strategy must be appropriate to the type and complexity of the offered insurance business and the underlying financial situation of the insurance undertaking. A condition in this regard is that the insurance undertaking has the necessary expertise and can fall back on processes and systems that are absolutely necessary for the professional selection, management, and control of the investments made.

A further aspect of the uniform quality criteria concerns the credit risks. The investment directives demand a systematic quantification of the credit risk and a valuation of all bond issues and receivables. As you can see in the following overall overview of the market, the tied assets are predominantly invested in products with very high ratings:

AAA	AA	A	BBB	BB to B	C	non-rated
20%	30%	30%	15%			5%

The new investment directives focus in particular on operational risks such as realizability, evaluability, know-how, processes and systems, legal environment, and transparency. They demand that private insurers manage the operational risks professionally and with knowledge of the associated effects and mechanisms.

Finally, the new investment directives require that the insurance undertakings submit a report on the effective risk exposures for each investment category.

First consequences

Initial reactions to the introduction of the new investment directives show that the changes are having the desired effect: In particular, the new directives have created a better understanding in the financial market for the special legal status of tied assets. This has led to the renegotiation of some contracts with financial service providers, taking these parameters into account. Investment undertakings thus appear to be making use of the new investment possibilities. FOPI therefore expects that in particular the share of alternative investments will rise noticeably in the next two years.

At the same time, the insurance companies have identified the investments whose quality no longer satisfies the new directives. Disinvestment plans to this effect are currently being set up. We now know that approximately 1 to 2% of the total investments do not comply with the new quality requirements, so that they must be drawn from the tied assets during the transitional period until the end of 2008. These are primarily group loans, not listed holdings and real estate investments with special uses.

In the area of operational risks, the new demands have in part triggered changes within the insurance undertakings: For instance, some completely new processes have been implemented, and new expert staff have been hired.

Outlook

Various advantages arise for the policyholders: On the one hand, the opening of the investment universe allows better returns to be generated; on the other hand, the primary need for preserving capital is better taken into account. Consequently, supervision by FOPI focuses on a complete quantitative assessment of the investment risks, taking the operational risks into account.

As communicated upon introduction of the investment directives in the autumn of 2006, FOPI will always react quickly to important market changes and new tendencies and will carry out necessary amendments to the investment directives within an appropriate time period.

The Role of Life Insurers in the Occupational Pensions Business

Speech by Manfred Hüsler
Deputy Director, Federal Office of Private Insurance

We would now like to turn our attention to a field of activity of FOPI that is still strongly characterized by the traditional supervision methodology, but with respect to which the participating insurance companies must at the same time fulfil the SST and the demands on tied assets: Life insurance in the area of occupational pensions.

In recent months, public attention has again increasingly focused on the services rendered by insurance undertakings in the field of occupational pensions. Allow me therefore to first of all present a few facts that constitute a necessary precondition for a serious treatment of this important topic:

Only one fifth of the pension assets are even reinsured by the insurance undertakings anyway. This means that of the approximately CHF 600 billion invested in occupational pensions, 130 billion are managed by life insurers on behalf of the reinsured pension schemes.

For the first time, private Swiss life insurers had to present complete annual accounts for occupational pensions in 2005, which were published by FOPI – as an overall overview – at the end of 2006. They are therefore not yet suitable for a conclusive assessment of the associated impact.

The fact is therefore significant that FOPI has been unable to grant a licence to any new providers for this business segment since the introduction of the Occupational Pensions Act in 1985. Rather, the number of life insurers working within the scope of the Occupational Pensions Act has successively fallen to only 13 undertakings today. It is thus certainly not the case that this field of business has been overly attractive.

Parameters and functioning of the pension plan administrators

Occupational pensions are administered by pension schemes, i.e. by legally autonomous entities which are fully subject to the Federal Law on Occupational Old Age, Survivors', and Invalidity Pension Funds (BVG) and the corresponding supervisory authorities. This can be called the first level of the 2nd pillar system.

Only the private insurance undertakings operating at a second level which assume – in whole or in part – risks and capital management on behalf of the pension schemes by way of reinsurance are subject to the Insurance Supervision Act and therefore to supervision by FOPI. Pension schemes thus freely decide whether to bear their risks themselves or to have them reinsured by an insurer. As profit-oriented undertakings, the insurers operate their Occupational Pensions Act business in the competitive framework desired by policy.

A key distinction in comparison with the pension schemes is that insurance undertakings guarantee their benefits and must bear losses arising from the pension business themselves (e.g. CHF 2.4 billion in 2002). They are therefore rightfully subject to the strict licensing and operating conditions set out in the Insurance Supervision Act. This is in contrast to the registered pension schemes under the Occupational Pensions Act, where insufficient coverage is possible and any reorganization must be borne by employers and policyholders.

Handling of the minimum quota (article 147 of the Supervision Ordinance)

The introduction of a so-called minimum quota associated with the entry into law of the 1st revision of the Occupational Pensions Act on 1 April 2004 arose at the time from the experiences of neighbouring foreign countries, where incidentally the so-called earnings-based method is applied without exception.

For the occupational pension business, Switzerland deliberately introduced stricter regulations than those applicable to life insurance in our neighbouring countries. Unlike foreign regulations, the minimum distribution rate not only encompasses the savings component – i.e. earnings on savings capital – but also the cost and risk process. This ensures that the insurer cannot increase its share via higher cost or risk premiums to the detriment of the insured parties. It should also not be forgotten that the minimum distribution rate is applied in addition to the minimum interest rate under the Occupational Pensions Act, which itself already ensures a minimum distribution to the insured parties. At issue is the distribution of earnings in addition to the minimum interest paid under the Occupational Pensions Act. Moreover, a profit-based calculation of the minimum quota is used if the interest rates are high.

High regulatory demands

The current regulatory solvency requirements (Solvency I) and the future solvency requirements strengthened after the crisis in 2001/2002 (Swiss Solvency Test, SST) at the same time entail that the mechanism of a minimum quota must be designed in such a way that an insurance undertaking is actually able to make the resources available to cover the legal solvency requirements. In addition, 100% of the claims of insured parties must be able to be covered at all times. The system of the minimum distribution rate must be designed such that the insured parties can enjoy surplus allocations that are as high as possible. At the same time, it must be ensured that the insurance undertakings are able to build up and pay interest on the legally required solvency capital.

In its response of 9 March 2007 to a parliamentary motion of the Social Democratic Party, the Federal Council emphasized that the current regulations governing the earnings-based method adequately take into account the clearly strict regulatory requirements of the insurance undertakings operating in the pension market. The current system continues to allow pension products with guarantees to be offered on the market and the promised benefits to be permanently met, i.e. any losses must be borne by the insurance undertaking and its shareholders, but not by the employers and insured parties. On the basis of the brief experience with the system so far, the Federal Council has also rejected a proposal to relax the 90% rule.

New transparency requirements show effect

Transparency in relation to the insured parties must primarily be ensured by the pension schemes themselves, not by the insurance undertakings. The primary task of insurance supervision is therefore to ensure that the insurance undertakings meet their transparency obligations in relation to the pension schemes within the legal framework, so that the pension schemes can in turn fulfil their legal information requirements in relation to the insured parties. FOPI has thus required the insurance undertakings to prepare their figures relevant to the Occupational Pensions Act in a timely manner and in the envisaged form for the pension schemes.

FOPI also monitors, in addition to the external audit office, whether the annual accounts have been properly prepared and whether the insurers have complied with the minimum distribution within the scope stipulated by ordinance. Moreover, FOPI undertakes to prepare the figures verified by the supervisory authority and the audit companies in a comprehensive manner. By publishing this overview, providers should be able to position themselves competitively with respect to distribution rate, risk premiums, and costs.

It is a positive development that the mechanisms introduced with the new transparency requirements have now begun to show effect. On the one hand, the IT investments associated with the compilation of transparent annual accounts have now been made; on the other hand, an increase in competition can be seen. Various requests for premium reductions have been approved or are currently being reviewed by FOPI for 2007 and also already for 2008.

Based on its experiences with the first annual accounts in 2005, FOPI is planning various optimizations for the 2006 business year. For instance, the instructions for filling out the annual accounts will be replaced by an expanded directive. Additionally, a directive for the audit of the annual accounts by the external audit office has entered into force. Further improvements concern disclosure. For instance, the savings, risk, and cost process will be presented in a clearer form for each provider, enabling an easier comparison.