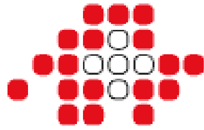

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Reinforcing risk-based supervision

Speech by Herbert Lüthy
Director, Federal Office of Private Insurance

Ladies and Gentlemen,

The rules currently applicable to the calculation of solvency, i.e. the equity capital of an insurance institution, are based on the so-called "Solvency I" process of the EU. Switzerland implemented these rules through amendments to the old ISL. These Solvency I principles will continue to apply and have been integrated into the new ISL.

At the same time, it is undisputed both within the EU and in Switzerland that the definitions for calculating solvency in accordance with Solvency I do not suffice. They are insufficiently differentiated and, in particular, do not take into account the risk profile of the insurance portfolio. The corresponding capital deposit requirements therefore also do not reflect the risk-oriented capital need. International rating agencies have thus long consulted risk-based measures in order to evaluate the financial strength of insurance companies. How necessary such an approach is was demonstrated to the broader public in a dramatic way when the stock markets collapsed (approximately March 2000 to March 2002): Many insurance companies worldwide ran into severe difficulties, since their equalisation funds had not adequately taken the capital risk into account.

The discussions in this regard are being conducted in the EU under the name "Solvency II" – in a certain analogy to Basel II in the field of bank supervision. At the same time, important differences between insurance companies and banks must be taken into account. In the case of insurance, the dependencies between risk concentrations, risk aggregations, and risk diversifications play a significantly greater role. In addition, insurance supervision is in general also subject to the desire of politics and society that insurers take on components of the social security net.

The questions to be dealt with are accordingly complex. The Solvency II discussion has already led to very good, generally accepted principles, but has not yet led to any concrete implementation. As always, the devil is in the details, and it should therefore be expected that much work remains to be undertaken in the EU until the Solvency II rules can be adopted as general directives and attain the force of law in the EU States. This will likely not be the case before 2008 and could even take until 2010 or longer. Switzerland does not want to and cannot wait that long.

The situation in Switzerland: new ISL and new Supervision Ordinance

The principles of Solvency II that are already available, the pilot projects undertaken in Switzerland, and the risk-based models used in other countries (such as Australia, the United Kingdom, Canada and the United States) show that the consideration of risk in calculating necessary capital resources not only results in many differentiated solutions, but also deepens the understanding of the risk situation of an insurance company.

This circumstance is not only of utmost importance for supervision, but also – and this is probably even more crucial – for the companies themselves. FOPI therefore took up the principles of Solvency II and staked out the goal of elaborating the corresponding application and implementation of risk-based solvency supervision even before entry into force of the new ISL. Such a large and ambitious goal was only achievable with the support of all affected stakeholders in Switzerland (and some stakeholders abroad) who possessed the relevant know-how.

In the spring of 2003, FOPI launched a project that was supported by specialists from the insurance industry, management consultant companies, and universities. The project succeeded in elaborating the appropriate applications and mathematical models by the summer of 2004 to the extent that a first field test with ten selected insurance companies could be undertaken. The Swiss variant of risk-based supervision, named Swiss Solvency Test (SST), has also attracted great attention abroad.

On this occasion, I will refrain from again providing an in-depth presentation of the functionality of the SST. I would like to refer to the relevant chapter in the Annual Report, but primarily also to the "White Paper on the Swiss Solvency Test". Both documents are contained in the distributed documents and can also be found on our website.

Insights of the SST field test

Initially, the main result of the 2004 field test was that it could even be conducted. Although this may sound trite, it was of fundamental importance to FOPI. In addition, it was shown that SST demonstrates a favourable cost/benefit ratio for insurance institutions as well, and that it leads to realistic and plausible figures. The results of the field test helped further develop SST, so that a new field test can be conducted in the early summer of 2005, this time with 45 insurance companies.

It is still too early to communicate concrete results of the SST in the sense of a general market evaluation. Nevertheless, the economic perspective of the SST already makes clear that the dominating risks for many insurance companies are to be found in the area of financial risks. In contrast, actuarial risks are of primary importance for non-life insurers, although even there, financial risks carry unexpectedly high significance. A further general insight is the high significance of diversification effects.

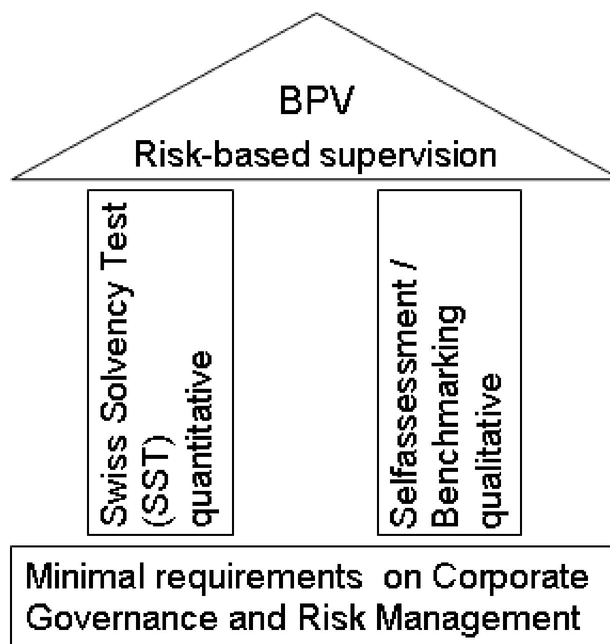
SST therefore creates a considerably better understanding of the risks entered into and the necessary capital resources, both for supervision and for the companies themselves. But why doesn't FOPI wait for the corresponding Solvency II rules of the EU? The answer is simple: An introduction of SST as soon as possible not only will increase the effectiveness of supervision, as is demanded in any event by the legislative power with the new ISL. Due to the more in-depth knowledge of their own risk structure, it will also help affected insurance institutions achieve a competitive advantage over companies that do not have this knowledge. Not only the large insurance companies benefit from this knowledge, but smaller companies in particular as well, for whom the SST provides a risk model including the corresponding parameters for free, so to speak, a model which also gives them an incentive for ongoing self-supervision. For small to mid-size insurers, it would be very expensive to develop a risk measurement system of their own equivalent to the SST.

The SST will be introduced simultaneously with the entry into force of the revised Insurance Supervision Act (ISL), scheduled for 1 January 2006. Transition periods are provided for the adjustment of equity capital requirements to the results of the SST for each individual insurance company and especially for the calculation of the necessary values, such as the market-oriented evaluation of assets and liabilities and the amount of the necessary risk-bearing capital.

Risk-based supervision

In addition to the central questions of reserves and solvency, the new law establishes a further dimension of supervision, which has already been incorporated conceptually into the SST: the increased attention of supervision to the qualitative review of the various risks.

These models, complementing the SST, are therefore deliberately embedded in an overall concept of comprehensive assessment of the general risk management of the companies. The future prudential supervision of FOPI can thus be illustrated as follows:



Here the SST primarily monitors the *quantitative* aspects of the insurers and is meant to motivate the individual companies – as it should be – to ongoing self-supervision.

The model developed by FOPI towards qualitatively oriented supervision envisages drawing up a risk inventory with the insurance industry in an initial phase and defining the risk-relevant parameters and submodels. The focus here is on the organisational processes and thus the qualitative aspects of the overall organisation of an insurance company. The Information Technology submodel has already been initialised as an FOPI pilot project which is now also being tested with the companies and will then, if necessary, undergo appropriate adjustments. The entire process of introducing comprehensive prudential supervision will continue for several years, however. The goal is to launch the individual submodels as pilot projects and to test them with the companies, before phasing them into operation.

The key idea behind this model is self-supervision and self-assessment based on relevant requirements of the supervisory authority. The authorities will only intervene if the self-assessment leads to odd or strikingly different results compared with the general benchmark values based on experience.

In light of the prevailing cost-cutting pressures and the discussions concerning alleged over-regulation, allow me to make the following concluding remarks: The FOPI model for prudential

supervision that fulfils the highest standards both quantitatively and qualitatively is a cost-effective model. The aim is not to establish new ordinances and expensive regulations, but rather a risk-based philosophy that is essentially based on principles. Supervision provides outer boundaries and promotes self-regulation processes. Given increasingly severe international competition, this model not only provides valuable insights to individual companies, but also enables FOPI to fulfil its mandate, which has become even more extensive through the new ISL, in an efficient and nevertheless very effective manner. At the same time, activities of a formal nature that are no longer needed thanks to the reorientation toward prudential, forward-looking supervision can be reduced. Nevertheless, even a basically efficient and effective supervisory structure entails that the responsible authority must have sufficient quantitative and qualitative resources at its disposal to fulfil its legislative mandate with the necessary independence and stringency.