reinsurance

Give us some uniformity!

Geoffrey Bromley questions the cohesiveness of the newer Capital Adequacy Standards for insurers and puts in a plea for uniformity

Geoffrey Bromley, chairman, Europe and Asia for Guy Carpenter

Measures of capital adequacy have moved from relatively simplistic leverage ratios to more complex, risk-based standards in global regulatory environments. But because these new standards were developed separately, they lack uniformity.

The question is whether we can expect more uniformity to develop in the future. I would argue that while absolute uniformity is not essential to regulate insurance solvency prudently, the integrity of the process gets called into question when the same company is seen as having more-than-adequate capital in one jurisdiction but totally inadequate capital in another.

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Historically, risk-based capital adequacy requirements were first introduced in the US in the early 1990s. This initial initiative was followed by Australia, Canada, the UK, Germany and Japan. In addition, the rating services — notably Standard & Poor's and AM Best — developed their own approaches to risk-based capital standards.

In the US, solvency regulation used to be based on the Insurance Regulatory Information System (IRIS). This system considered nine ratios, including GWP to surplus and NWP to surplus. If a company failed on four or more of these ratios, action by the regulator would be triggered.

Risk-based capital adequacy tests were considered revolutionary in that they took all risks considered in the IRIS tests and converted them to a single number called "required capital". They reflected differences in the mix of business, and took into account risks arising from invested assets, premiums, credit and reserves.

As other countries and organisations developed their risk-based capital standards in relative isolation, there are huge differences between the various nations' and rating agencies' models. All consider invested asset risk, credit risk and premium risk, and all but Japan have a reserve risk component. In Japan, however, loss reserves are not a major liability, but paid losses are taken into account.

AM Best is concerned not just with the quality of reinsurers, but the extent to which insurers rely on reinsurance. For example, a company that ceded 20% would get a higher risk charge for reinsurance than one that ceded 50%.

However, none of the models reflect reinsurance diversification, although the UK has implemented a requirement that an insurer cannot cede more than 20% to an individual reinsurer. In addition, reinsurance recoveries from a single reinsurer cannot exceed the capital of a UK insurer.

Consideration for "accumulation risk" varies, with Australia, Canada, Japan and AM Best including explicit provisions in their risk-based capital models. Standard & Poor's European model does not specifically include accumulation in the capital adequacy calculation for most insurers. With regard to premiums, Australia and Canada apply factors to unearned premium, not NWP, as other countries do.

Having determined the capital required , a regulator then compares the company's actual capital with the risk-based measure. But countries even calculate capital in different ways: for example, there are differences in how capital is reported in financial statements; in some jurisdictions, reserves are discounted; and in some countries, a risk margin is included in the reserve calculation. Sometimes invested assets are reported at market value, others at amortized cost. There are also inconsistencies in how catastrophe reserves — where permitted — are calculated.

Guy Carpenter has developed the Capital Adequacy Projector (CAP), which compares the capital adequacy measures for different regulatory regimes and rating agencies to help clients assess the impact of financial decisions on their capital requirements.

In running our CAP tool for numerous clients, we have been struck by the variations in requirements and the inconsistencies in the weighting of various factors. We must question whether the current multi-flavoured approach to risk-based capital is really a standard (particularly a global standard) when factors can vary so broadly.

The solvency regulation of insurers has come a long way from the highly simplistic systems utilised a mere decade ago. As we look to the future, we can expect even more advances to be made. But critical to this evolution is a respect for the integrity and consistency of the approach across country borders, particularly in a business that is as global as ours.

The current system falters in this consistency test. In my view, these inconsistencies need to be addressed. We do not expect full uniformity from varying measures, but certainly differences should be contained within a reasonable range. re

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