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Solvency II an opportunity or challenge for insurance industry in Kosovo

Authors: **Berat BEGU**, Central Bank of the Republic of Kosovo, beratbegu@aol.com, **Erdin MALOKU**, Central Bank of the Republic of Kosovo, erdinmaloku@bqk-kos.org

The purpose of this assignment is to provide a research that will be used further during the dissertation. The research is focused at benefits of the Solvency II and possibilities that would follow its implementation in the insurance industry in Kosovo.
This assignment will briefly explain how it is can be applied on to the Solvency I regime that exists in the insurance industry in Kosovo and potential for the insurance industry of Kosovo when Solvency II is implemented. For both of these methods of the Solvency I and II we tried to offer proper solutions.
For this research we prepared a questionnaire for the top managers of the insurance companies and experts in this field. The questions focused on their perspective of the implementations of Solvency II on the insurance industry in Kosovo. We also have interviewed the director of insurance supervision at the Central Bank of Kosovo (CBK). The responses to the questionnaire are summarized in the following part of this research.

Keywords: *solvency, insurance industry, CBK*

Introduction

The insurance industry plays a crucial role in domestic and global economies. The role of the insurance industry within the financial system expands and changes in response to a wide range of social, financial and economic developments. Insurance companies are of great importance to the economy of a country. They are moving from a system of direct supervisory control to a more deregulated environment. This step requires new systems of risk control and risk management. Their soundness has a clear impact on the financial market. The key benchmark of an insurance company is its solvency or its financial strength. It is important that insurance companies remain in sound financial condition in order to ensure the smooth functioning of insurance markets and the protection of policyholders. The maintenance of sound financial positions, adequate levels of capital and reserves for insurance companies plays a large part in achieving the objectives of supervisory frameworks.

Concepts of Solvency

The solvency margin is a buffer in a company's assets, which covering its liabilities. For the supervisor, this is important that policyholders are protected, but it is also important to ensure the stability on the financial markets. In view of this, the definition of the solvency margin (SM) is given by Pen-Tikäinen (1952).

The solvency margin, (SM), is the difference between assets, A, and liabilities, L; SM = A – L

In insurance industry in Kosovo we have put some restrictions on the assets, e.g., (Receivables are not recognized as assets in calculating of the Solvency Margin) so that assets should be of good quality, this definition could be called the available solvency margin (ASM), Benjamin (1977). Other essential element in assessing the financial soundness of an insurer is the level of its capital relative to its risk profile, in other words, its capital adequacy. However, capital adequacy is only part of the story. Another critical element is the adequacy of provisions for claims that are expected to be made. These provisions may be called:

(i) Insurance liabilities
(ii) Actuarial liabilities
(iii) Policy reserves

(iv) Policy liabilities
(v) Actuarial reserves
(vi) Technical provisions

Determining the appropriate level of capital has been the subject of much study in insurance industry. In Europe, a significant review of insurance company solvency requirements is under way. It is known as Solvency II.

Research objectives

The original EU-wide insurance supervisory and solvency requirements date from the 1970s. The 1973 directive required members of the European Economic Community (EEC) to set minimum capital standards for insurance companies in their jurisdictions. With the passage of time and significant development of the insurance industry, the supervisory elements of EU-wide requirements became outdated. As a result, an initiative was started to revise the insurance supervision regulations in the late 1990s which resulted in limited reform in 2002, this became known as a Solvency I.

However, it was recognized that a more fundamental review was needed, and a second phase, known as Solvency II, was undertaken, with an implementation target of 2012.

Research background

Research in this case is intended to collect the information and to analyze the current situation of the business environment on the insurances industry in Kosovo. Based on existing information the insurance industry in Kosovo is one of the lowest levels in Europe, i.e. just 5 -7 Euro per capita, this is result; (Annual Report of Central Bank of Republic of Kosovo 2010)

- The Insurance Industry in Kosovo is a new it started in 2001, when the first insurance company was licensed;
- There is lack of insurance culture and heritage;

- The limited restrictions through a low level of legislation has enabled the initial development of the insurance industry to Kosovo;
- Today approximately 90% of all national wealth remains uninsured;
- 80% of the insurance companies' portfolios of gross written premiums consist of compulsory Third Party Liability insurances.

Kosovo as a country in transition it has made some slow steps to develop of the insurance industry. The development has only in one direction; i.e. the number of companies has increased but the appropriate level of services and elements that characterize a modern insurance industry have not improved.

Table 1: Licensing activity of insurance companies in Kosovo

Description	2002	2003	2004	2005	2006	2007	2008	2009	2010
Prior Licensed	0	8	8	8	8	9	9	11	11
Licensed	8	1	2	1	1	0	2	0	0
Canceled	0	-1	-2	-1	0	0	0	0	0
Total	8	8	8	8	9	9	11	11	11

Source: Central Bank of the Republic of Kosovo

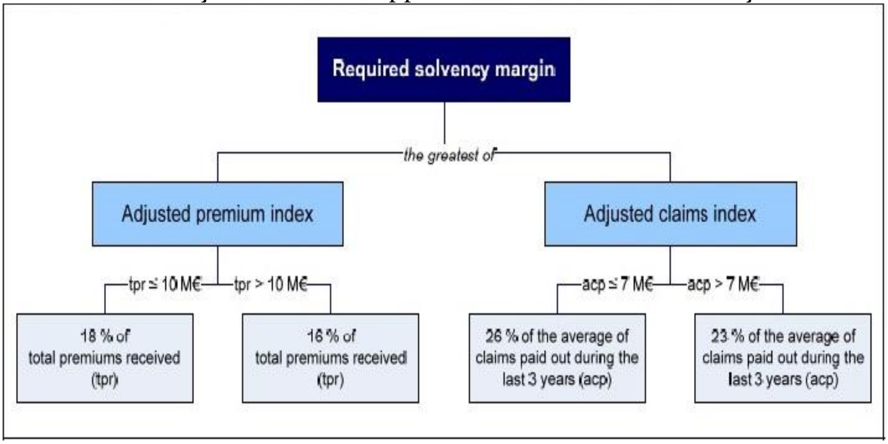
In 2010 the Gross Written Premiums were 70 million euro, comprised of;

- 51 million euro have been of the compulsory motor liability insurance, and just
- 19 million euro has been property insurance which can be considered a very small increase and no substantial value on the conditions and possibilities of our country.

Research process

Solvency I and its implementation in the insurance industry in Kosovo is based on UNMIK Regulation 2001/25, in the past we have use this model for calculation of Solvency Margin for non-life insurance company, known as Solvency I, presented as table below. (Central Bank of the Republic of Kosovo)

Table 2: Solvency I - the model applied in the insurance industry in Kosovo



Source: Directive 2002/13/EC

- 18% of total premiums received during the financial year up to 10 million euros, and
- 16% of total premiums received during the financial year in excess of 10 million euros,

And the adjusted claims index is:

- 26% of the average of claims paid out during the last 3 years up to 7 million euros, and
- 23% of the average of claims paid out during the last 3 years in excess of 7 million euros, (Directive 2002/13/EC)

Research that relate with weaknesses of Solvency I

Solvency I is a simple framework that is minimally risk sensitive and relies on a small number of indicators that are only vaguely related to insurers' risks.

A number of key risks, including market, credit and operational risk, are not explicitly captured under the Solvency I regime. The regime does not contain meaningful qualitative requirements relating to risk management and governance, and does not require supervisors to conduct regular reviews of these qualitative aspects. The lack of risk sensitivity does not provide incentives for insurers to improve and invest in risk management.

Regimes, such as Solvency I, which have used factor-based regulatory capital requirements, have not been very effective in identifying insurers that become financially weak. This means that insurance supervisors have had little time to intervene and rectify the situation, if an insurance company's financial position deteriorates or its risk profile increases.

The weaknesses the identified of Solvency I are summarized as following:

- It does not provide risk sensitive approach
- Supervisors do not have to conduct regular reviews of these qualitative aspects of an insurance company's business.
- No investments in risk management processes and policies by the insurance company
- No timely intervention by supervisors
- Very few requirements for risk management and corporate governance,
- The Solvency I regime does not align the capital requirements of an insurance company with insurers' risk profiles
- Solvency 1 does not help to protect the industry from any deterioration of market and financial risk, (G. Lekatis, President of the Solvency ii Association).

The shortcomings of the EU insurance solvency requirements led a number of countries to undertake updates of their regulatory frameworks. For instance, the United Kingdom developed and adopted its Individual Capital Assessment Standards (ICAS), Switzerland, the Swiss Solvency Test (SST) and the Netherlands, the Financial Assessment Framework (FTK). These countries' updated requirements are consistent with the concepts and approaches proposed for the new EU insurance solvency regime.

Solvency II is an opportunity to improve insurance regulation by introducing:

- More timely intervention by supervisors
- A risk-based system
- An integrated approach for insurance provisions and capital requirements
- A comprehensive framework for risk management
- Capital requirements that are defined by a standard approach or internal model
- Recognition of diversification and risk mitigation.
- Greater regional cooperation between regulators

Research related to the benefits of Solvency II

"Solvency II is not just about Capital. It is a change of behavior (Th. Steffen, Chairman of CEIOPS)

The EU Solvency II project will introduce a new solvency regime for life and non-life insurers and reinsurers in Europe. Solvency II will be a risk-sensitive approach to assessing solvency that is intended to better take into account the risks faced by insurers than the current EU solvency regime.

Solvency II is being designed to reflect the economic risks facing insurers and reinsurers by considering both asset- and liability-side risks and the interactions within and between those risks.

Risk-sensitive solvency requirements will align the capital held by insurers to their risk profile. It is intended to improve the financial soundness of insurers and reinsurers, resulting in better protection for policyholders, including in difficult periods. In addition, the new regime aims to promote more efficient supervision.

Solvency II will substantially change the philosophy of the current framework relative to group supervision. While the current approach to group supervision is merely supplementary to the solo supervision of insurers, Solvency II will be a more integrated approach. Solvency II risk measure will be based on a Value at Risk (VaR) level of 9.5% which is equivalent to a 0.5% target default probability, and specifies a time horizon of one year.

Three - pillars main of Solvency II

1. Pillar 1 will focus on the quantitative aspects of solvency and how to calculate the capital requirements.
2. Pillar 2 will focus on qualitative measures (including the supervisory review process) and allow for additional capital requirements to supplement those calculated under Pillar 1.
3. Pillar 3 will consist of disclosure requirements.

It is evident that meeting the requirements of Solvency II demands a far-reaching program. The Directive is about to be ratified and now is the time to drive the program forward. The challenge is how to implement such extensive change whilst maintaining ongoing business operations Solvency II is being developed in an iterative manner following the Lamfalussy approach. The target of implementation date for Solvency II is 2012.

The main objectives of Solvency II are?

- To deepen the integration of the EU insurance market
- To enhance the protection of policyholders and beneficiaries
- To improve the competitiveness of EU insurers and reinsurers
- To promote better regulation
- Improve the risk management of EU insurers and reinsurers
- Advance supervisory convergence and co-operation
- Encourage cross-sectorial consistency–no regulatory arbitrage
- Promote international convergence
- Increase transparency.

Research that relate with potential implementation of Solvency II in Kosovo

During the interviews with supervisors, managers of insurance companies, experts in this field including heads of department Insurance Supervision of Central Bank of Kosovo (CBK), conclude that;

Solvency II will affect the capital levels and limited amount of capital to invest in industry,

To improve the recognition of diversification and risk mitigation in the capital requirements for each insurance company.

- Solvency II will affect the amounts of reinsurance that insurance companies have agreement,
- Solvency II will affect the increase pricing of premiums
- Solvency II will lower the total capital requirement for insurance companies
- Insurance companies only selling products that they have expertise in
- Limited capability of board of directors to manage risk
- The ability of the CBK to provide effective supervision that protects policy holders right and financial position

In Solvency II, the aim is to develop a coherent framework with consistent solvency measures across all types of business. The framework will also take into account the quality of risk management as well as the accuracy of risk assessment.

To explain how the Solvency II will affect risk management in the Insurance Industry in Kosovo and whether these changes can result as opportunities for insurance companies Kosovo, we set up these hypotheses;

Conclusion and Hypotheses

These hypotheses we considered were tested during the research and interviews conducted with managers of insurances companies. Although the interviewees did not all give similar answers to the same question we were able to come to the following common conclusion that:

- There is no definition of best estimate of technical provisions and this is a major obstacle in implementation of the Solvency II project.
- Poor quality data is the main obstacle for Insurance Companies in Kosovo due to the lack of good of the lack of an information centers and sufficient databases.
- If we start implementing Solvency II, the CBK will require more than 1 year to control just the Pillar 1 requirements of capital and the required level of technical provisions. None of the existing

Insurance companies in Kosovo will meet these requirements from the beginning

- The most complicated problem that will CBK will face is finding the balance between, on one hand, that the Insurance Companies should be allowed to use their own internal models and on the other hand, ensuring a level playing field from a competitive perspective
- The internal models in Solvency II are more loosely defined, making supervision more complicated
- The progress with the preparation for Solvency II is different between companies and depends whether company has enthusiasts and an expert among its employees for implementing of Solvency II.
- Kosovo insurance companies need to have more differentiated pricing of premiums in order to stay competitive. Insufficient price differentiation is harmful to insurance companies and their consumers in the long run.
- Reinsurance may become more expensive due to higher demands on capital reserves in reinsurance companies and it could impair the operation of insurance companies in Kosovo.

It is therefore not very surprising if conclude that the Insurance industry in Kosovo is characterized by a general wait-and-see mentality towards Solvency II. So far, the details, requirements and implications of Solvency II are far too uncertain for the insurance companies of Kosovo to throw themselves into large-scale implementation projects, as is Solvency II. The Solvency II should be based on a standard approach or a standard internal model. In other words, the aim is that CBK preliminarily should find or create an internal model for Solvency II that would describe how Kosovo insurance companies should comply with Solvency II in the best possible way, but all this should happen after year 2012.

Solvency II should cover all relevant kinds of risk and should be able to supervise and improve internal risk management systems on an international level.

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