Aktuaari yhdistys

What challenges do we face if trying to implement insurance guarantee schemes and recovery & resolution framework - Case study from Finland

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What was this all about?

- The Actuarial society of Finland published a working paper on 2020 studying the different ways how EIOPA's proposals around IGS and recovery & resolution frameworks (2019) could potentially be implemented into Finnish insurance legislation and industry. This study was made in co-operation with Finnish FSA.
- The aim was to look EIOPA's ideas more closely against the Finnish framework but also to start a debate on what are big issues and questions in such attempt and also what seems to work already
- Finnish insurance industry is developed and works really well and is partly linked to the Nordic market but less to wider Europe nor globally. Finland has a long history on maintaining a quite strong (national) insurance legislation but also market practices that ensure efficient policyholder protection. On the other hand, Finnish population is rather small which doesn't allow for giant financial groups to exist and also both the industry and the NSA might not be that well-resourced that they could.
- There were some clear findings from the study which certainly have helped on the planning and have given better understanding on this bit new and complicated topic.
- After this study European commission has dropped IGS out of the scope in their IRRD-directive proposal but many of the results are still highly relevant to study in a national level.

6 issues to deal with

Minimum or maximum harmonization?

- Minimum harmonization seems to be the only possible solution to avoid difficult national insurance product line specific solutions and settlements. E.g. the role of statutory insurance lines, pension regime and its voluntary part, needed level of protection etc.

Home- or host country principle?

- Home country principle means that in case of insolvency, all policyholder, independent of their country, would be covered in similar ways depending on the insurers home country regulations. This principle seems to be problematic as national needs differ, cross border supervision gets more difficult and also creates issues if an insurer with large cross border operations ends up into insolvency
- Host country in the other hand means that every insurer operating in the same country needs to apply with that country regulations in similar ways. So all policyholders in the same country would be protected independent of where they buy their insurance cover.
- From policyholder's perspective there should be a possibility to deal with the home country authorities and even hold claims towards it.

Deal with risk- and savings products separately

- With savings products policyholder can more easily change to alternative (non-insurance) ways of savings which requires some quite tailored solutions. The same is not possible with risk insurance. Also the needed cover might differ a lot as there might be quite large savings amounts per policyholder.

Pre or post funding?

- With pre funding there's a fundamental problem with setting the premium accurately to avoid over prudency. With savings insurance this could be very difficult.
- Prefunding also requires authorities and national governance structure. Also accounting rules (and IFRS) would cause a number of new issues to deal with.

Separate authority for IGS and R&R?

- There might be a lot of ways national legislations deals with resolution already and there most likely differ through EU; what are the supervisory tools, how courts work and when, how portfolio transfers and run-off's are already regulated (and is there any experience) and what are the existing cross-country processes

How to deal with contagion risk

- This might have a significant impact on how the systemic nature is recognized but also different risks might require different tools, funding or supervisory processes

Finnish non-life industry

- There's an existing IGS-type of framework in three statutory insurance lines; worker's compensation, motor liability and patient insurance and pools to manage all this:
  - In case of insolvency other insurance providers (for the same line) will take care of the loss collectively
  - There's will be an annual premium to secure the policyholders which is max 2% of the annual total insurance premium (for the same line)
  - Portfolio transfer is the preferred option in the regulation and if not possible then the pools takes the control.
  - Host principle is applied with a post funding structure that covers 100% of the losses
  - These three LoB's cover roughly 80% of the non-life liabilities
- These regulations are used only for insurance companies operating in Finland.
- There's a freedom to close the non-statutory LoB's which allows insurers to adjust their business in case of poor profitability

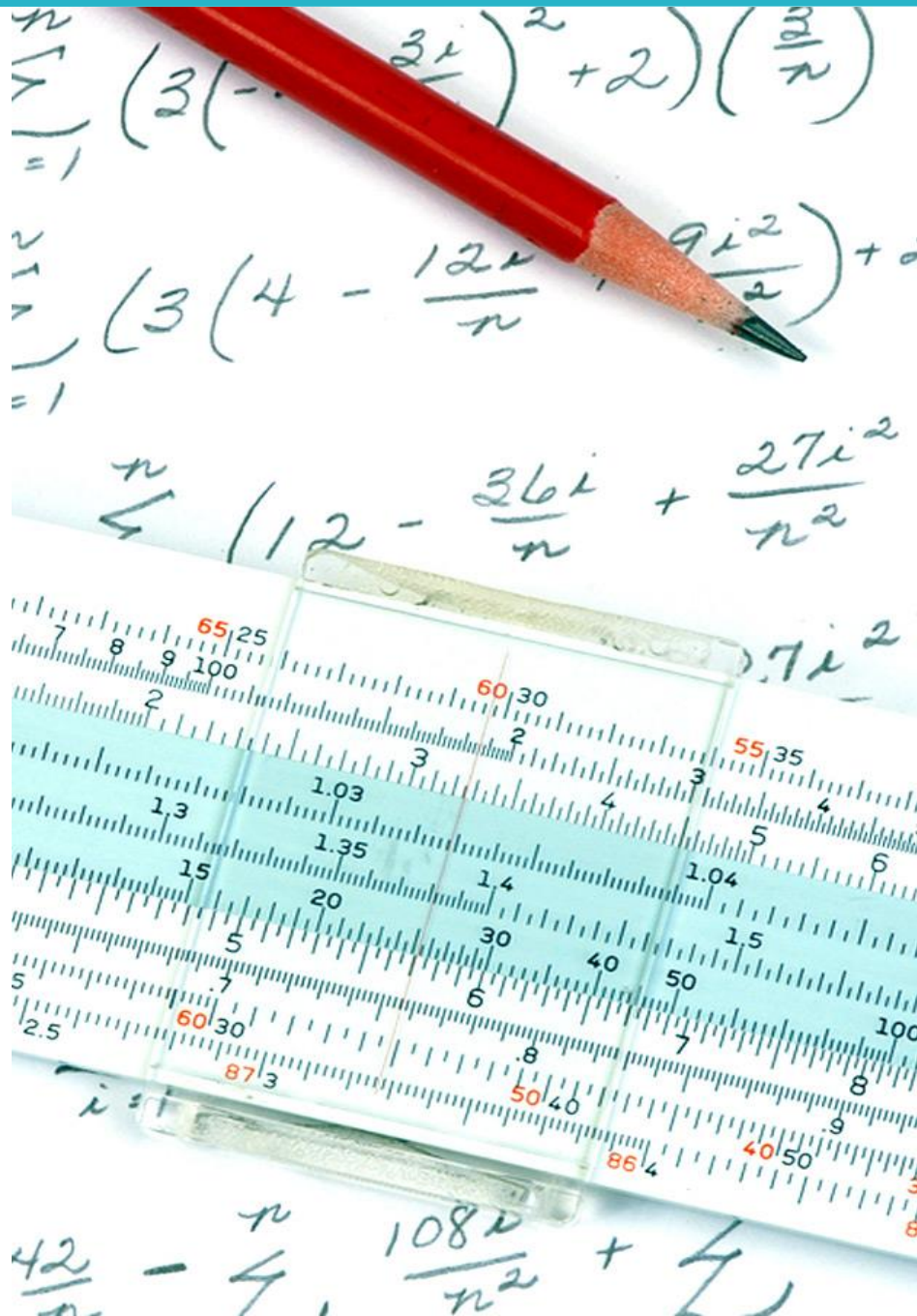
What are the specific questions for life insurance

Life insurers have still a lot of guaranteed rate products with rather high guarantees. Also existing Solvency II transitional measures sets requirements for increasing capital. This increases the need to take market risk and thus increases the own fund volatility. Anyway there's a tool pack for run-off situations which can be used to avoid liquidation:

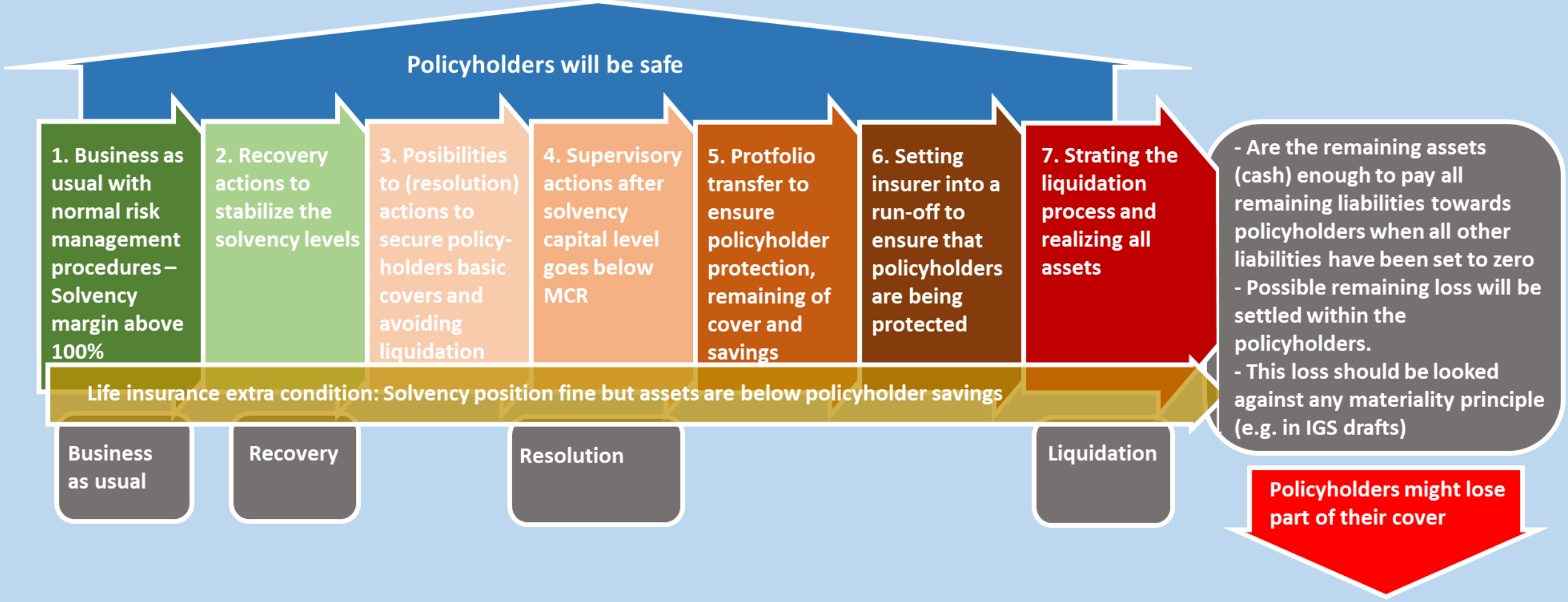
- Existing benefits (from history) can be used to strengthen insurers own funds
- In solvency II the risk margin should bring also some relief when capital is freed up. Also any gone concern types of changes in the calculations might help also
- There's a prudency principle in Finnish legislation that requires that future business is slightly positive
- It might be possible to lower guarantees and change some of the product terms to secure a smooth run-off.

By the Finnish insurance regulation asset values needs to be always above the amount of the savings (withdraw value). This would create a deposit guarantee - type of situation to life insurance:

- What would be the coverage and specially if the back book would be covered also?
- If there was a additional premium to be applied this would have an impact to annual fees, governance and also in national level



Case Finland: The policyholders risk of losing any of their cover in insurers insolvency



Calculation exercise - what would be an additional IGS premium for a life insurer?

- For an life insurer with a 150% solvency the probability of default (no capital left) for 1-year seems to be low; 0,01% to 0,04% depending on the distribution. Results that are somewhat aligned with this can be found from both rating agencies and EIOPA's stress test publications
- Expected shortfall is used to get an estimation of the amount of loss after all capital have been lost.
- The annual premium is calculated by giving the loss probability weight to the expected shortfall. The IGS premium seems to stay in a very low level. Anyway it should be noted that both systemic risk events and different levels of prudency would grow this premium

	Väinämöinen Life Insurance (in € million)	**Year X**
a	Assets (market value)	2 000
b	Solvency capital	450
c	Liabilities	1 550
d	Solvency capital requirement (SCR)	300
e	*- Solvency margin*	*150 %*
f	Minimum capital reguirement (MCR)	90
g	Policiholders in total	100 000

	Policyholder loss * (in liquidation)**	**Normal Distribution**	**Log-Normal Distribution**	**T-Distribution**
1	Assets expected value (1-year return covers only expenses)	2 000	2 000	2 000
2	Standard deviation (calibrated so that SCR equals VaR 99,5)	120	111	106
3	Probability of loss (no capital) using this standard deviation	0,01 %	0,01 %	0,04 %
4	Expected shortfall	-30	-36	-72
5	*Expected shortfall per Liabilities [4/c]*	*-2,0 %*	*-2,3 %*	*-4,6 %*
6	*Expected shortfall allocated to policyholders [4/g] in one €*	*-300*	*-400*	*-700*
7	Additional 'IGS' annual premium for the insurer (total expected loss in one € and without any systemic risk premium) [3*4]	**-3 000**	**-4 000**	**-29 000**

***) All values have been estimated by using monte carlo simulation thus are not accurate values of the underlying probability distributions. Premium estimate (in 7) has been made using the upper limit probability of loss, not the accurate lower probabilities

Main findings from the study

- Solvency II framework has substantially improved the risk management practices amongst European insurers and thus reduced significantly reduced the default risk and therefore increased policyholder protection. This all has also resulted to lower needs for any additional insurance guarantee schemes (IGS).
- Home principle fits poorly as a single principle for harmonising any IGS framework.
- Pre-funding seems not to work for life insurance (and personal pension) savings.
- There needs to be different principles for risk- and savings based insurance products. This should also be taken into account in any harmonization attempts
- Establishing separate agencies for recovery & resolution and IGS purposes seems to be unnecessary, at least in the Finnish context.
- In Finland, the exisiting framework on the statutory lines of insurance (workers comp, motor liability, etc.) that already are covered by national IGS-type of pools should continue and not be changed in any EU wide harmonization
- In finland, the biggest needs from a policyholder protection perspective for additional rules might stem from cross-country cases if the supervisory powers and unclear or insufficient. Therefore, some of the ideas in the proposed recovery & resolution plans might be needed but clear prioritization needs to be done. IGS won’t be needed if R&R is working enough well!

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Thank you, any comments or questions?