Sweden — update on current efforts towards Solvency II

Mar 30 2010 Per Johan Eckerberg and Katarina Rykowska


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In the January 2010 update, we mentioned that the Swedish Financial Supervisory Authority had identified the following five main issues as crucial for the implementation of Solvency II in Sweden:

- The requirements for reporting to the SFSA.
- The extent of public disclosure of information.
- The requirements for untaxed reserves in non-life insurance companies (the "safety reserves") to qualify as tier one capital.
- The "risk-free" interest rate for discounting long-term liabilities.
- The conditions for using internal models for calculating solvency capital requirements.

The January 2010 update also touched upon another subject which is of vital importance to Swedish life insurance companies; the requirements for surplus funds to qualify as tier one capital.


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Summary

This article focuses on one of the main issues that the SFSA identified, i.e., the necessity for certain untaxed reserves — contingency reserves — in non-life insurance companies, generally referred to in Sweden as "safety reserves", to qualify as tier one capital. If the surplus funds are the major source for risk capital in a Swedish life insurance company, then the safety reserve is the most important source of risk capital for a non-life insurance company. Before focusing on the safety reserve topic, however, we would like to briefly summarise the current status of the implementation efforts. In addition to the five main issues that the SFSA has raised, it appears that the Swedish Ministry of Finance has also identified a number of critical

implementation issues. Only one of them is in common with the SFSA issues: the safety reserve. All other issues are additional to those that the SFSA has raised.

Swedish Ministry of Finance implementation initiative

On March 5, 2010, the Swedish Ministry of Finance published instructions for a specifically appointed person who will, most likely together with a committee of experts (together constituting an investigation committee), be in charge of analysing and proposing a suitable procedure for the upcoming implementation of the Solvency II Directive into Swedish law. At the end of March the Swedish Ministry of Finance appointed Daniel Barr as the person in charge of the investigation. Daniel Barr currently holds a position at the Swedish National Debt Office (Sw. Riksgälden) as head of the Bank Support Department. According to the published instructions, the critical areas demanding further investigation include:

- The coordination of Solvency II and Institutions for Occupational Retirement Provision regulations. The Solvency II Directive does not include provisions for issues that fall under the IORP Directive (2003/41/EC). In Sweden, the IORP Directive has been implemented according to the optional model, whereby the IORP Directive's solvency regulations (and not Solvency I) have been made applicable to the part of a life insurance company's activities that falls under the definition of an IORP activity. Determining how the two directives can now be coordinated in a way that enables life insurance companies to comply with both directives may prove rather difficult.

- The principle of proportionality. It will be of major importance to the insurance industry that the legislator finds a way to ensure proportionality by taking proper consideration to the nature, extent and complexity of an insurance operation when applying the Solvency II regulations.

- Entities that fall outside the scope of the Solvency II Directive. The investigation committee will need to specify which entities under Swedish law fall outside the scope of Solvency II and how such entities should be regulated going forward.

- Policyholder protection. As a result of Solvency II, a general prudent person principle will replace the existing specified asset-liability regulations. Measures for ensuring policyholder protection must, therefore, be put forward.

- The future role of the actuary. Solvency II governance principles will result in a new role for Swedish actuaries. The investigation committee will, therefore, need to (re)consider the actuary's liability issues in relation to the insurance company and third parties.

- The safety reserve in non-life insurance companies. As the SFSA has already identified, continued use of safety reserves as tier one capital is of major importance to non-life insurance companies. It is, therefore, necessary to identify whether any regulatory changes are called for to ensure that safety reserves comply with Solvency II tier one requirements.

- Additional capital to SCR. In the Solvency II Directive it is not clear under what circumstances a "pillar two add-on", i.e., an additional capital requirement above the SCR, might be imposed. This should be analysed in detail.

- Supervision of insurance groups. Solvency II will take supervision of insurance groups to a new, international level. Swedish legislation must therefore, introduce provisions that impose liabilities for Swedish legal entities to interact with other European Economic Area authorities. The Solvency II Directive does not include provisions for issues that fall under the Financial Conglomerates Directive (2002/87/EC). It will be necessary to clarify how the two directives should be coordinated to ensure efficient supervision of insurance groups and financial conglomerates that include insurance companies.

- Confidentiality issues. The new supervisory structure and cooperation between supervisory authorities within the EEA will considerably increase the exchange of information. As a result, confidentiality issues will also increase. The investigation committee in charge of proposing the Solvency II implementation measures must consider how confidentiality could be handled in a new supervisory structure.

Financial market legislation should be cost effective. The investigation committee proposing the implementation measures should, therefore, pay special attention to whether administrative costs will be proportionate to the purpose of implementing the directive.

The safety reserve

Allocation

As the law stands at present, Swedish non-life insurance companies are able to make provisions for contingency reserves, which are commonly referred to as the safety reserve. Such a safety reserve must be used to cover losses that derive from factors which are random or otherwise difficult to assess. In other words, the safety reserve is a mechanism for compensation of an insurance result over a longer term than that of general contracts, so that some profits may be used to cover potential future losses due to claims which have not yet occurred or been handled. There may also be damage that has occurred and which the insurance company is liable for, but of which the company is still unaware.

Dissolution

Allocation to a safety reserve is voluntary; however, the possibility to dissolve a safety reserve is more limited. The reserve cannot be discharged as long as there is a surplus in the company. Instead, it may only be used to cover losses (either relating to the insurance operations or financial losses). Any profits which have been allocated to the safety reserve will, therefore, in practice be locked in until there is no other surplus capital available. This means that there are limited possibilities for non-life insurance companies to discharge the reserve to strengthen their own funds. In certain cases the SFSA may grant exemptions from the rules regarding allocation and dissolution.

The SFSA has determined and regulates the maximum amount of provisions. Dissolution of any amount in excess of the safety reserve is mandatory if the permissible reserve amount at the beginning of the year exceeds the maximum amount at the year end. Consequently, dissolution will occur if the scale of operations is reduced. Generally, dissolution of the safety reserve may only be performed to the extent necessary to cover a certain loss. Under extraordinary circumstances, however, the SFSA may grant a greater dissolution than is strictly necessary to cover the loss.

Risk capital

The safety reserve is one of the most important risk capital sources in Swedish non-life insurance. According to a recent report that the Swedish Insurance Federation has published, the safety reserve's proportion of available risk capital in Swedish non-life insurance has varied between 50 and 66 per cent over the past eight years. In 2008, the total equity capital in Swedish non-life insurance amounted to 146bn krona, of which the safety reserves amounted to SKr97bn. A total of 129 non-life insurance companies rendered accounts of safety reserves in 2008. The safety reserve is an especially important source of risk capital for those operators with more limited opportunities of obtaining capital from external sources, such as Swedish mutual insurance companies. In mutual companies, the safety reserve amounted to SKr62bn in 2008, or 69 per cent of the available risk capital.

Consequences

As discussed above, the safety reserve is available to cover all significant risks in the business operations of a non-life insurance company. The safety reserve should, therefore, be classified as tier one capital under the Solvency II Directive. Due to the limitations in respect of dissolution of the reserve, however, certain wordings in the Committee of European Insurance and Occupational Pensions Supervisors' recommendations concerning the capital in an insurance company that may be accounted for as tier one capital could lead to the interpretation that a safety reserve could only qualify as tier three capital.

In the event that safety reserves do not qualify as tier one capital, large capital injections will become necessary. The Swedish Insurance Federation estimates that a capital injection of approximately SKr80bn would be required. For public insurance companies, additional capital could be raised through contributions from shareholders. As regards mutual insurance companies, however, a capital increase could only be achieved by raising premiums significantly. The SFSA, together with the Swedish Insurance Federation, has put a great deal of effort into lobbying other European supervisory authorities to persuade them to support the classification of the safety reserve as tier one capital. As stated above, however, the Swedish government has recently charged Daniel Barr with the task of identifying whether any regulatory changes are warranted to thereby ensure that safety reserves comply with Solvency II tier one capital requirements.

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