УДК 386:336

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FINANCIAL SECURITY OF INSURANCE COMPANIES IN THE LIGHT OF THE SOLVENCY II DIRECTIVE

ANNOTATION. The article presents the issue of financial security of insurance companies in the light of the Solvency II Directive. The question of minimum capital requirements for conducting operational activities by insurance and reinsurance companies was also discussed.

KEYWORDS: insurance company, financial security, risk management, solvency.

АНОТАЦІЯ. У статті розкрито сутність фінансової безпеки страхових компаній у світлі директиви Solvency II. Також розглянуто питання щодо вимог до мінімального капіталу для проведення оперативної діяльності страхових і перестраховувальних компаній.

КЛЮЧОВІ СЛОВА: страхова компанія, фінансова безпека, управління ризиками, платоспроможність.

АННОТАЦИЯ. В статье раскрыта сущность финансовой безопасности страховых компаний в свете директивы Solvency II. Также рассмотрен вопрос относительно требований к минимальному капиталу для проведения оперативной деятельности страховых и перестраховочных компаний.

КЛЮЧЕВЫЕ СЛОВА: страховая компания, финансовая безопасность, управление рисками, платежеспособность.

Introduction. Financial security of an insurance company is one of the key aspects of its functioning, whereas appropriate management of funds and the risk related to its operation is its principal task. Therefore, the issue of optimizing the operation of insurance companies in the context of risk and capital management is the responsibility of supervisory institutions that have regulated their operation at the national and international level for years now.

Creation of the common European insurance market has contributed to the harmonization of insurance markets in all EU Member States and has imposed new requirements on insurers in the

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field of their financial liquidity. Changes related, among others, to the development of financial markets, concentration of business around international capital groups, unification tendencies or development of risk management techniques compel the adjustment of regulations to changing conditions around. The key initiative in this scope is *Solvency II*, which allows a more optimal risk analysis from the insurer's perspective in order to optimally use the capital. It has also given the possibility to monitor risks that had not been estimated before.

The essence of Solvency II. The work, in progress since 1994, has been undertaken on the EU market to develop uniform rules regulating the financial market of the European Union and to create equal opportunities to entities conducting business activities in this area. Changes introduced on 1 January 2004, resulting from the so-called Muller Report (Solvency I), have enhanced the security of insured entities by increasing the severity of requirements concerning solvency. Consequently, the following goals have been achieved:

- operational model based on constant indices,
- increased authority of supervisory bodies,
- stricter requirements concerning minimum guarantee capital.

Introduction of rules under the name *Solvency I* was an impulse to seek new solutions aimed at developing closer links between capital requirements and risks an insurance company is exposed to — which has been termed *Solvency II*.

Solvency II is there to increase transparency and trust in the entire insurance sector. It is based on the rules of economic assessment of insurance companies in order to maintain balance between the amount of costs incurred by insurers and the high level of security of the insured persons, on the assumption that the objective analysis depends on capital requirements based on risk assessment. Project is based on three pillars — Figure 1. A separate category of risks related to conducting insurance or reinsurance activities has been subjected to each pillar.

Particular pillars of the system include:

- pillar I — quantitative requirements concerning the valuation of assets and liabilities of insurance companies, approaches to calculation of costs of capital components, insurance technical reserves, Minimal Capital Requirement and Solvency Capital Requirement;
- pillar II — qualitative requirements concerning the supervisory process, own risk assessment, risk management system, own resources and group supervision,

• pillar III — concerns the enhancement of transparency of actions performed by insurance companies on the market and establishment of uniform rules as regards insurer's disclosure requirements.

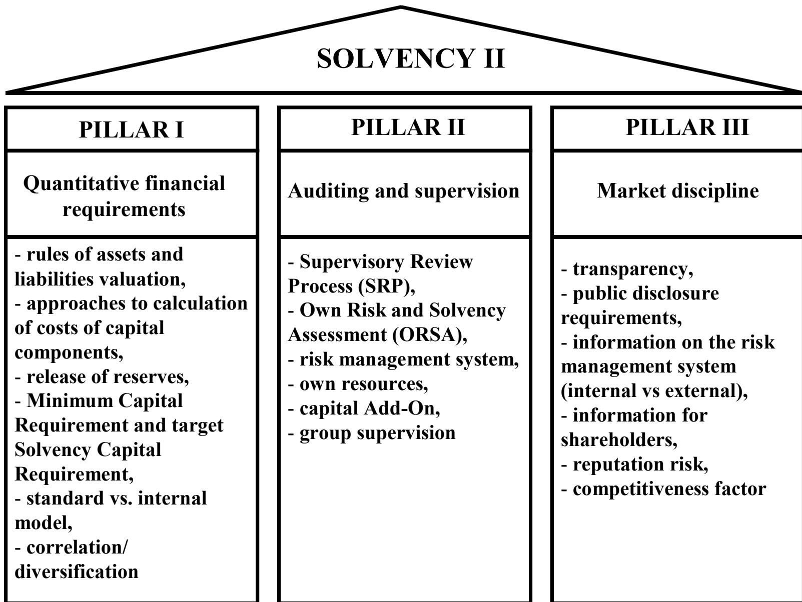

Figure 1. Financial supervision structure under Solvency II [1]

One of the key elements of the *Solvency II* system is the enhanced insurance supervision and the broadest possible legal and systemic harmonization of the insurance market within the territory of the European Union. In the new system, the insurance supervision covers a broad range of obligations and thus should be based on a risk-oriented approach, taking account of the complexity and scale of risks related to insurance and reinsurance activities conducted. Such approach requires that an insurance (reinsurance) company makes an appropriate assessment of own short-term and long-term risk, as well as the quantity of own resources necessary to cover it.

Insurance and reinsurance company management in the light of Solvency II.

Each insurance company is exposed to different types of risk in relation to its operation. Their careful identification is one of the key tasks for insurers. Bearing in mind the main risk, i.e. general insolvency, they should undertake actions aimed at identification of

risks and counteracting their effects. We need to note that the materialization of the main risk involves the materialization of fragmentary risks that could be divided into:

- technical risks — related to a technical operation of an insurance company and resulting from the type of activity conducted,
- investment risks — related to the investment activity of an insurance company,
- operational risks — related to an ongoing business activity of insurers.

Therefore, an insurer should have funds at its disposal to serve as a collateral against the abovementioned risks and constitute a source to cover all financial losses. In this context we need to emphasize that the identification of capital requirements of an insurance company is there to set such an amount of own funds that allows the insurer's solvency according to the scale of activity and exposure to risks.

Apart from capital requirements, insurance risk management is an important element of insurers' security. We also need to stress that «regulations referring to a relevant amount of an insurance company's own funds provide an appropriate execution of tasks an insurance company is responsible for, including those related to insurers, are one of the conditions that guarantee the implementation of the real insurance protection rule» [2, p. 134]. These conditions have been included in the *Solvency II* Directive.

The new system introduces a number of changes that are of significance to the insurer's activity. These are mainly new quantitative and qualitative requirements as regards the approach to the management of risk and capital dedicated to cover it. The proposed qualitative amendments mostly concern the extension of the catalogue of risks to be managed by an insurance company and the methods of their analysis. In compliance with new regulations, apart from managing an actuarial risk, insurers will have to concentrate more on the market and credit risk management.

The management system specified in the new Directive requires the meeting of seven requirements that are crucial for the operation of insurance and reinsurance companies. These requirements concern competences of persons responsible for entity management and its particular strategic elements, risk management, own risk and solvency assessment, internal audit, external audit, actuarial function and outsourcing — Figure No 2.

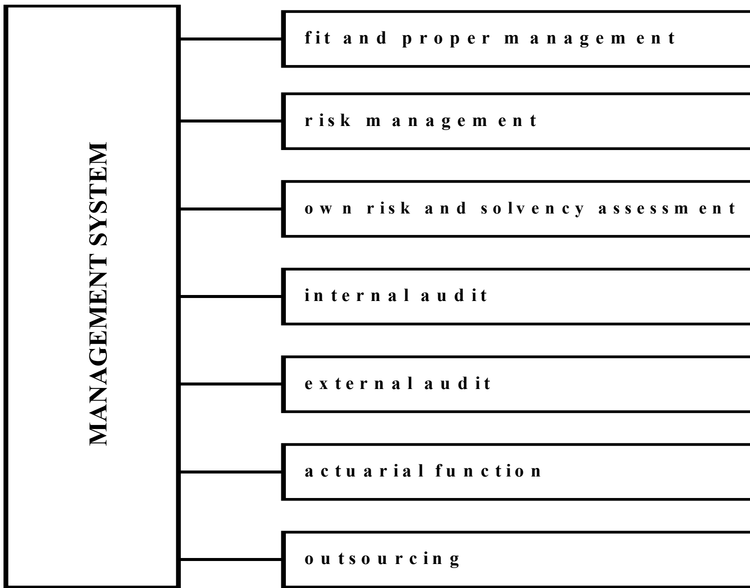

Figure 2. Requirements for a proper insurance and reinsurance company management in the light of Solvency II [3]

In order for a management system in an insurance and reinsurance company to function properly, an entity's specificity, operating scale and complexity of operations conducted should be taken into account. We need to note that in the light of the Directive management functions can either be performed by a company's personnel, or outsourced to external experts.

The need to implement organizational and procedural solutions in the scope of managing an additional category of risk, i.e. operational risk, is a big challenge. In this context, determination of insurer's solvency by obliging the entity to meet two capital requirements that are harmonized within the territory of EU is of key importance for an insurance company:

- Solvency Capital Requirement, corresponding to such a level of own resources which allows covering unforeseeable losses and provides relevant protection to insurers and insured parties,
- Minimum Capital Requirement, covered by insurer's own resources, below which an insurer and an insured party would be exposed to an impermissible risk level.

The Solvency II Directive has determined an non-negotiable lower threshold of the Minimum Capital Requirement [4]:

- EUR 2.2 million for non-life insurance companies, including subsidiary insurance companies, except for covering all or some risks from groups from 10 to 15, where this threshold amounts to at least EUR 3.2 million,
- EUR 3.2 million for life insurance companies, including subsidiary insurance companies,
- EUR 3,2 million for reinsurance companies, except for subsidiary reinsurance companies, where the Minimum Capital Requirement amounts for at least EUR 1,0 million.

The Directive specifies in detail capital requirements concerning subsidiary entities, which should be the same as for mother entities, except for reinsurance, where requirements are more liberal.

New regulatory solutions are aimed at a more precise linking of capital owned by an insurance company with the scale of risk related to conducted activities.

An important element that influences financial security of insurers is the introduction of new risk management mechanisms by applying the requirements of the *Solvency II Directive — Own Risk and Solvency Assessment (ORSA*) [5]. The Directive obliges insurance companies to perform own risk and solvency assessment under the risk management system. *ORSA* is a process in which an insurance company assesses all company-specific risks and determines related capital needs. Therefore, the system should:

- be a part of decision-making processes at the insurance company,
- take account of a specific risk profile, risk tolerance limits and action strategies,
- provide constant meeting of Minimum and Solvency Capital Requirement by an insurance company,
- assist decisions related to risk transferring or retaining,
- help in capital management,
- express the magnitude of risk in numbers.

Therefore, *ORSA* is a mechanism assessing all significant risks related to insurance company's business activities and is a part of the risk management system as an assessment process. It is also a part of decision-making processes that include strategies, business plans and demand for risk.

Summary. Financial security of an insurance company is the key element to guarantee its solvency and meet the obligations towards the insured parties. Apart from the micro-scale, i.e. direct relations with a client covered by insurance protection, by accumulating significant

financial resources acquired in the framework of operational activity an insurer influences the entire financial market - both domestic and international. In this context we need to emphasize that efficient risk management and sufficient financial resources needed to conduct business activities, which is regulated by the Solvency II Directive, is a necessary condition for efficient management and meeting the obligations by an insurance company.

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Статтю подано до редакції 09.10.2012 р.