

SUPERVISION OF GENERAL INSURANCE

This subject covers the supervision of General insurance as currently practised by official Government bodies in the U.K. and possible changes in this practice in the future. Whilst references may be made to the widely differing practices in other parts of the world, there seems little point in discussing these practices apart from their possible impact in this country. It is assumed that those present have a knowledge of Consultative Notes 4, 5 and 7.

PURPOSE OF SUPERVISION

Insurance Companies, like other industrial and service organisations in the U.K., have relationships with creditors, shareholders, staff and clients, the latter in this case being called policyholders. Supervision of the relationships between Companies and the first three of these is governed by general legislation which has no special connotations for insurance companies beyond the position which applies to companies in general. However, the relationships with policyholders falls into a different category since here a special position arises due to the fact that money is collected as premiums in advance against a promise to make a payment if a given event takes place. As a consequence, it is deemed necessary for insurance companies to satisfy more stringent financial legislative requirements to ensure, as far as possible, their ability to meet these future commitments. Most of the insurance legislation in this country and in other countries has been designed with the protection of policyholders in mind against possible insolvency of companies, though as a consequence of this the legislative involvement with insurance has often spread very wide and frequently leads to control of terms and conditions, including pricing.

In the U.K. insurance has been allowed to operate on a free market basis under which they are allowed freedom to offer such terms and conditions as they wish but wide publicity is given to their financial standing. From 1909 onwards, general insurance companies were required to make deposits to cover their solvency position but this was superseded in 1946 by a "solvency margin" basis where the test of solvency of an insurance company was taken at a higher level than the normal commercial solvency with insurance companies being required to keep an excess of assets over liabilities of 10% of their net premium income.

Subsequent to 1946 there have been a number of failures of general insurance companies and this has led to an extension of the legislative requirements with the solvency margin being increased to 20% for the first £5M of premiums and more detailed information being required so that the liabilities in particular can be tested to see if an adequate amount is being put aside to meet them. We are currently in a position where new regulations are shortly to be introduced requiring even more information which the Department of Trade feel is necessary for carrying out this function. Furthermore, the new regulations can be expected to affect the valuation and admissibility of assets and the valuation of liabilities in

calculating the solvency margin of each insurance company. In addition E.E.C. countries will shortly be adopting the U.K. solvency margin approach but with a higher margin in relation to premiums and the U.K. is committed to adopting the same level.

An additional safeguard for policyholders is the power now held by the Department of Trade to ensure that persons controlling insurance companies are both competent and acceptable.

SOLVENCY MARGIN BASIS

The solvency margin basis used in the U.K. appears to have chosen an arbitrary figure of 10% as being appropriate for "guaranteeing" the ability of an insurance company to meet its contracts. From the papers available from the time at which this figure was chosen there does not appear to have been any theoretical basis for the level chosen.

To produce a theoretical basis one would presumably have to apply a theory of ruin choosing an acceptable chance for a company to become insolvent due to the fluctuating nature of the impact of claims and applying this theory to the portfolio of the company reach an acceptable minimum excess of assets over liabilities. Stated simply like this there would appear to be no major problem but unfortunately the complications of the differing types of portfolio which with the large companies range over many different countries make this theoretical approach completely impractical.

Furthermore, such an approach would only be dealing with the random fluctuation in claims incidence. It would not deal with the major problem of ensuring that the fluctuations in the rate of inflation with its impact on claims reserves would also be catered for. At the current time the rapidly increasing rate of inflation would appear to be one of the biggest threats to solvency of even the larger insurance companies.

At present a fixed solvency margin is applied to all companies irrespective of their portfolios. Whilst it is impractical to attempt to calculate a theoretical margin for each individual company, there is a case for considering a variation in the amount of the solvency margin in line with the type of portfolio being written. Fluctuations in experience over the unexpired period of policies tend to apply mainly to property classes where the incidence of claims can vary greatly year to year, particularly claims due to weather damage. Portfolios with a high proportion of this business need a solvency margin which takes into account the fluctuation in this experience. On the other hand, claims are settled quickly here and there is little likelihood of inflation having a major impact. The classes with liability business on the other hand (which include motor) tend to have a more stable experience in the incidence of claims but as a consequence of the long average time to settlement changes in the rate of inflation have a

much greater impact. It would indeed be fortuitous if the balance of the inflation impact here against the fluctuation in claims experience for property classes was such that the same level of solvency margin was appropriate for both types of business.

Some classes, e.g. Consequential Loss and Excess of Loss reinsurance, are likely to have a combination of these two factors and could thus be taken to need even higher solvency margins.

It could also be thought that the wide spread of risk by class and geographically over the world could be expected to lead to lower fluctuations thus pointing to a need for a lower solvency margin for such companies or, alternatively, for a higher solvency margin for companies concentrated in one class of business and operating in a restricted geographical area, e.g. a company only writing U.K. motor business.

A further area for fluctuations is in the value of the investments held to meet the liabilities and recent movements in Stock Exchange prices in the U.K. and overseas has clearly shown that this can be a major factor in maintenance of the solvency of an insurance company.

Actuaries with their knowledge of probability and of investments should clearly be able to provide useful guidance in the area of determining the appropriate level of solvency margin to be applied either on a basis unrelated to the composition of the portfolio or with variations depending on the portfolio. However, at the end of the day there are so many complicated factors to take into account that it is clear that we are unlikely to get any objective criterion for the desirable level of solvency margin to be maintained by insurance companies and, therefore, subjective views must be brought into play.

The present U.K. solvency margin is shortly to be replaced by a revised formula to be adopted throughout the E.E.C. which is approximately as follows :-

The larger of

(A) Premium basis

18% of first £5 million)	applied to gross premium
Plus 16% of balance)	income

(B) 26% of first £3½ million)	applied to average of last
23% of balance)	three years gross incurred
	claims

multiplied by the ratio

Incurred claims net of reinsurance ceded

Incurred claims gross of reinsurance ceded

A discussion of how a suitable solvency margin should be calculated seems appropriate, including the desirability of it covering all fluctuations or whether the valuation of assets and liabilities should include margins.

RETURNS TO GOVERNMENT

Under the solvency requirements the basic method of control has been to require detailed information on the Company's operations and its assets and liabilities to be given annually to the Government in statutory returns. In recent years there has been an expansion in the returns required with the intention of improving this control, though the industry has suggested from time to time that the information is both too expensive to collect and too difficult to interpret for it to really serve its purpose. We are, however, faced with an even bigger expansion in the returns starting next year. A major difficulty arises from the fact that the returns do not just cover business in the U.K. but cover the global operations of each U.K. based insurance company or, with the agreement of the Department of Trade, of a group of companies operating as a single entity. This means that in the overseas areas of operation many companies are finding they have to produce two sets of figures on different bases, one for the local control and one for the U.K. This clearly is very expensive and some companies try to avoid this by handling their operations through local subsidiaries though tax problems, either local or U.K., can arise from domestication of local business.

The returns provided for the Government must contain sufficient information to allow the level of assets and liabilities to be checked and to enable these to be compared with the premium income to establish the Company's solvency margin level. Such returns on the General insurance side would normally work on a retrospective basis and do not appear to give any scope for consideration of future movements of any of the different factors. To date returns have been made on an annual basis but for the future supplementary returns will be made on a quarterly basis giving much less detailed information but allowing a check to be made on movement since the end of the previous financial year.

VALUATION OF ASSETS

Details are required of the various assets incorporated in the Company's balance sheet. These are broken down into a considerable number of different categories. The value placed on the assets has traditionally been cost less investment reserve allowing Companies to conceal some of their strength if the current market value is above the balance sheet value. It might be considered surprising that Companies have not been required to use their market value throughout but over a long period insurance companies like banks have been allowed to have concealed additional margins. They are, however, required to certify that market value exceeds balance sheet value. No provision appears to be made for allowing any other values, e.g. amortised values for dated fixed interest securities.

In the new regulations limitations are being built in on the proportion of assets which can be held in various types of securities or in some cases

in individual securities and some types of assets will be totally inadmissible. Furthermore, for equity stocks values will have to be discounted to allow for an average Stock Market price over a 3 year period if the current index is above that average. They will also be limited as to what proportion of assets can be Agents' outstanding balances. Incidentally, the latter two requirements do not apply to the long term fund. These limitations are expected to lead to increased solvency requirements in the short term and in the long term they will undoubtedly be likely to lead to a slightly changed pattern of assets.

Are these new fluctuations realistic? Do they build in too large a margin? Will they direct insurance company investment in a manner which will reduce profitability and ultimately mean higher premium levels?

VALUATION OF LIABILITIES

These items generally comprise the technical reserves of the company normally sub-divided into unearned premium, unexpired risk and outstanding claims both known and unknown. As a whole session is being given over to discussing realistic estimation of these reserves, it would seem appropriate to confine further discussion to the formulae included in Consultative Note 7. Is the requirement of working on a break-up basis appropriate? Are the margins in the unearned premium and unexpired risks reserves reasonable? How sensible is the "chain formula" for outstanding claims even as a guide line? How can changes in trend, either of incidence or cost of claims, including changes in the rate of inflation, be allowed for?

REINSURANCE RETURNS

For solvency purposes it is necessary to test the net asset position (assets minus liabilities) against the premium income of a company and the returns must, therefore, show the premium income. In the U.K. we have always worked on net premium income whereas the Continental leaning is towards using gross premium income. The latter, of course, requires a higher solvency margin. This is partly due to the fact that reinsurers on the Continent are not subject to Government supervision whereas in the U.K. they are treated in exactly the same way as direct insurers. However, although the U.K. net premium income is checked, returns are always required to show the level of reinsurance undertaken by the Company with indications being given of how much of this is placed with Companies subject to Department of Trade control and how much of it with Companies outside their control - it is obvious that a very large proportion placed in the latter area could lead to a need for further enquiries from the Department. How useful are the returns on reinsurance in allowing the Department of Trade to check the position of the individual company?

QUARTERLY RETURNS

As well as the requirement for a retrospective view on the position of the Company there is clearly a case to consider looking on its likely future position, particularly if a Company's solvency margin is anywhere near the statutory minimum. The profitability of the Company would clearly affect its net asset position whilst movement in the volume of premiums written affects the minimum solvency margin required. The new quarterly returns will go some way towards this but are they too comprehensive? Will too much detail delay the returns and thus reduce their usefulness?

ALTERNATIVE APPROACHES

The retrospective solvency margin method although made more up-to-date by quarterly returns, means insolvency becomes apparent in arrears. Would it be more appropriate to limit premium writings in a given period by reference to solvency margin at beginning of period?

U.K. regulations only allow inspections of insurance companies if there is some doubt as to solvency. In other countries, such as the U.S.A., the practice is to inspect companies once every three years as a supplement to comprehensive returns. Is there a case for considering this in the U.K. notwithstanding the high cost involved?

COMPREHENSIVENESS OF CONTROL

The Government legislation works on the basis that the same returns and controls should apply to all Companies irrespective of their size or their strength. This means that Companies with undoubted financial strength are caused to bear excessive burdens in satisfying Government requirements and this seems particularly unnecessary in view of the fact that most of the problems have arisen with the smaller Companies operating basically in the U.K., whereas the burden falls on our international giants thus reducing the value of their contribution to the economy, particularly from their invisible earnings. This wide-ranging basis of control is justified by the Department of Trade on the grounds of fairness between Companies - they would seem to consider that to impose these requirements on the weaker Companies without their being met by the stronger Companies would give the latter a competitive edge in the U.K. market but ignore the fact that the very minimal requirements placed on Lloyds gives them a competitive edge in the same market. It is interesting to note that an investigation carried out by McKinsey & Co. on behalf of the National Association of Insurance Commissioners pointed out that they were spending 80% of their time investigating the larger Companies who, in fact, due to their size required more consideration per Company than the smaller Companies and only 20% of their time in those areas of the market giving rise to any problems for their solvency. Should an approach which takes this into account be adopted in the U.K. ?

PREMIUM CONTROL

Historically the British approach has been freedom of action for insurance companies along with publicity for their financial standing. There has been no control of premiums as a part of the control of the solvency of the company and it is only with the introduction of price control generally in the economy that there has been the introduction of any premium control for insurance companies. Due to the special position of the Department of Trade in supervising insurance companies arrangements were made for the Department to exercise price control so that they could take into account both the national needs of the economy in restricting price increases and the possible conflicting requirements of an individual company in maintaining its solvency.

Under Phase II restrictions were fairly tight and it is believed that many companies were asked to reduce their requirements for increasing premium rates, particularly in the politically sensitive Private Motor area. Under Phase III it was possible to agree that only Private Motor increases for the large companies would be subject to pre-notification and detailed control though other increases are usually advised to the Department of Trade, if only for information. Preparation of forms for requesting price control became more complicated, mainly due to the desire of the Department to have a formula established - once again there would seem to have been an advantage in having a pseudo-scientific approach since this could be shown to be acceptable in political terms. It was interesting to note that investment income was excluded from the calculations and comments on the use of investment income in deciding premium rates within companies would be of interest.

For the future it seems clear that price control for insurance will be with us as long as there is price control in the rest of the economy. Beyond that the Industry has not accepted price control as either desirable or justified for insurance on its own. The maintenance of price control would obviously also need to lead to investigations in establishing the viability of differing price levels for different classes of business and for different companies whilst it would be an easy extension from there to require regulation of the terms and conditions of contracts. This will look to be so foreign to the approach which has been applied in the past that it would completely transform the U.K. insurance market and indeed might be thought to lead to the possibility of our international earnings being affected.

How have companies been affected by price control? How can the formula be improved?