A Comparison of Solvency II and Chinese Solvency Regulation

The introduction of Solvency II – an updated version of Solvency I – by the European Union is bound to cause more than a ripple across insurance industry in Europe once it comes into effect on 1 January 2014. Following from this new Regulation, supervisory bodies will now shift their focus from compliance monitoring and capital, to evaluation of the risk profiles of insurers as well as the quality of their risk management and governance systems.

This article looks at some of the similarities and differences between the current Chinese solvency regulations and Solvency II.

**Solvency II**

Briefly, the European Commission adopted a three-pillar approach to the structure of Solvency II:

Pillar 1 stipulates that capital adequacy is calculated by reference to the solvency capital requirement (SCR) – the capital’s target level – and the minimum capital requirement (MCR), which lays down a minimum threshold insurers must be met to be allowed to trade;

Pillar 2 outlines the components essential to a risk management system, i.e. risk management strategy, policies, processes and internal reporting procedures;

Pillar 3 reinforces market discipline through disclosure. Insurers will be required to publish their Solvency and Financial Condition Reports (SFCR) and confidential Reports to Supervisors (RTS). These will be publicly available.

**Comparison with Chinese Insurance Regulation**

1. **Solvency Capital Calculation**

   This is one of the key differences between the Chinese and EU regulatory systems. In China, solvency capital is currently calculated using a fixed formula – ratio factors are used for reserves and sum at risk for life insurers while premium income and claims reserves are used for non-life insurers. This is a simplified version of the EU-Directives 73/239/EEC for non-life insurance and the 79/267/EEC for life insurance.

   The calculation method under Solvency II is far more complicated. To comply with SCR, an insurer must hold capital to cover a 1/200 event (99.5% confidence level) for the next 12 months. Insurers may calculate it using the standard formula provided in the Regulation, or they may demonstrate to the supervisory body that their internally developed model meet the requirements under Solvency II. Most are adapting the latter approach.
(2) Risk Governance Process

Under Solvency II, insurers are liable to attract a capital charge if their governance process is deemed inadequate. They are required to establish the following four functions – risk management, actuarial, compliance and internal audit – and also demonstrate that they have an adequate and transparent organisational structure, an effective information transmission system and documented roles and responsibilities.

In China, the CIRC issued a risk management circular in 2007, which provides guidance to insurers on issues with respect to the principles of a sound risk management framework, the risk categories to be assessed and the composition of effective risk controls, and in 2008, it released an updated solvency regulation that requires the establishment of a risk-based solvency monitoring framework. Furthermore, the Basic Standard for Enterprise Internal Control requires all Mainland China listed companies to establish and later evaluate the effectiveness of their internal control.

(3) Regulatory Action

Under the European regime, a possible regulatory action results when insurers breach the SCR; the MCR meanwhile sets the limit which insurers must abide by, failing which, regulatory intervention will ensue. Possible sanctions include closure of the company’s new line of business or even revocation of business licence.

On the other hand, the Chinese regime assesses the need for regulatory action on a simpler three-tier structure: insurers that fall within the “Adequate II”, i.e. with a solvency ratio greater than 150%, attract the lightest regulatory attention; insurers with a solvency ratio between 100% to 150% are categorised as “Adequate I”, and the CIRC can request them to come up with an insolvency-prevention plan; delinquent insurers with a solvency ratio below 100% attract the harshest sanction as they are deemed to be “Inadequate”.

(4) Disclosures

As in Europe, Chinese insurers are also required to submit various reports - annual, quarterly and interim – to the CIRC on a regular basis. There is also the requirement that if an insurer suffers a downturn that severely affects its solvency, it is required file a report to the CIRC within 5 working days of the occurrence. Insurers are also expected to disclose their solvency condition to the public.

Can China adopt Solvency II?

The CIRC is moving in pace with reforming the insurance industry in China. It has come up with a slew of regulations and guidelines in recent years, which show signs of gravitating towards risk management – a core principle of Solvency II – as the cornerstone of Chinese insurance business. The new draft “Guidelines on Implementation of Risk Management for Life and Health Insurance Companies” released in 2010 is one such example.

Despite this apparent shift towards a direction closer to Solvency II, a wholesale adoption of the new regulation is not likely to occur in the near future, as pointed out by some commentators, for the following reasons:

(1) There is a large gap between China and its European counterpart in terms of the procedure and technique

Risk management is on its infancy in Chinese insurance industry, and therefore it is still beset by a host of problems, such as a weak foundation, a lack of experienced professionals in this area, outdated techniques and underdeveloped risk management system, the CIRC is likely to wait and learn from the lessons of other foreign countries and push for insurance companies to enhance their risk management and governance systems before considering adopting the European model.
(2) The Chinese insurance market is still exhibiting the behaviour typical of a nascent market.

In Europe and America, monitoring market behaviour is not the focus of their supervisory bodies. However, in China, this remains top on the CIRC’s agenda because delinquent behaviour, such as lax management, widespread infringements, bad customer service, and especially fraud remain a serious problem. Moreover, insurers are still not subscribing to the idea of fair play. And, there is no quick solution to all these problems. This shows that the CIRC is facing a different set of problems from the supervisory bodies in Europe and America. Thus, from a pragmatic point of view, the CIRC should not lose its grip on monitoring market behaviour; on the contrary, it has to put more effort in this area for a long time to come.

(3) The capital adequacy calculation method is far more dynamic and complicated under Solvency II

Although it is conceded that the current calculation method utilised in China is ineffective since and in dire need of reform, it is not practical to import the method of calculation under Solvency II since it is more complicated and demands a higher level of expertise on solvency management. The method used in China should be clearer and simpler so that it can be audited. Moreover, the fundamental realities in China and practical conditions, e.g. distribution of social capital, training of risk management professionals and the risks insurers are facing, should be considered when reforming the current methodology.