

Annual Media Conference, 31 March 2015

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“Heightened risk awareness thanks to the Swiss Solvency Test”

Ladies and gentlemen

I am delighted to take this opportunity to introduce you briefly to the realm of insurance models. It is a field I know very well and in which I was already working before joining FINMA six months ago. In my previous function as project manager at a large insurance company, I oversaw the development and introduction of an internal capital model from the other side. Today, it is fair to say that the Swiss Solvency Test (SST) has fulfilled one of its main tasks – that of heightening risk awareness among insurance companies.

Common features and differences between insurers and banks

I would like to begin by highlighting an important common feature as well as some major differences in risk modelling between banks and insurance companies. What both have in common is the use of models to calculate the regulatory capital companies require to protect their clients.

The differences, however, are more numerous. For insurers, prescribed model calculations to determine regulatory capital have only been introduced in the last few years; banks have had them for decades. Unlike the models used by banks, those used by insurers are purely national: there are as yet no international requirements. Insurers' risk assessment models are also more conservative than banks', typically factoring in events that, statistically, only take place once a century at most. Banks look back over a much shorter period. Insurers' risks are often not correlated. Windstorms in Florida and earthquakes in Turkey occur independently of each other. The market and credit risks that are crucial to banks, by contrast, generally move in the same direction during a crisis.

And one other point: as regards banks, global operators are mostly not far above the statutory minimum capital requirement. International insurers usually aim considerably higher than the regulatory minimum capital defined by models, in order to obtain a rating such as the Standard & Poor's Insurance Financial Strength Rating. This provides an indication of an insurer's financial condition and ability to meet its obligations. The target ratings are typically A or higher, while the solvency requirement is around BBB.

So the realm of insurance models is substantially different from that of banks.

The SST: a success story

Since 2011, the financial stability of insurers in Switzerland has been measured using the Swiss Solvency Test. The SST sets out the minimum level of economic capital an insurer must hold in order to have a high probability of meeting its obligations. The higher the risks an insurer takes on, the higher the capital requirements. The SST takes account of all the relevant market, credit, interest rate and insurance risks. Both assets and liabilities are subject to market-consistent valuation, allowing potential difficulties to be identified at an early stage. By introducing the SST, FINMA has been an international pioneer in insurance supervision. The EU will be following suit in due course with its Solvency II framework.

More than four years on from its introduction, the time is ripe for an initial stock-take of the SST as a supervisory instrument in general, and the way it is calculated – specifically, how the various types of models are used.

The verdict on the SST as a supervisory instrument is positive. Since it was launched and applied, risk awareness among insurers has heightened. It sets the right incentives and has influenced conduct. That is unquestionably its greatest success. The discontinuation of the minimum euro exchange rate is a good example. The SST helped to ensure that insurers selected or hedged their investments in currencies that matched their obligations, so they remained in step and had little effect on solvency. This enhanced risk awareness was one of the chief goals of the SST.

Standard model as the future standard

As regards the details of technical implementation, the track record is not entirely positive. Similar to banking, the SST allows risk to be calculated using either internal or standard models. As the name suggests, internal models are based on companies' own internal risk calculations. All must be approved by FINMA. FINMA also supplies standard models such as the model for calculating the risks of an investment portfolio.

We believe two corrections are needed to prepare the SST for the future. The first is that standard models should be used more than internal models going forward. The revised Supervision Ordinance, recently approved by the Federal Council, therefore names standard models as the default option. The aim is to curb the rapidly growing use of internal models. They still have their place, but are only appropriate where standard models cannot take adequate account of risks – as with insurance groups, for example, or complex reinsurances.

Recently, internal models have become progressively more complex, but the impression of greater precision can often be deceptive. As time goes on, only a small number of experts still understand them. Frequently the insurance company's management, who are supposed to use these model for risk management, do not fall into that category.

That is why standard models will be used more often in future. This approach is also in line with the international trend. We believe simpler and robust models – both standard and internal – are the better

option. In future, FINMA will explicitly ensure that users of standard models do not incur any overall capital disadvantage compared with users of internal models.

Secondly, the approval process needs to be overhauled. It is struggling to cope with the number and complexity of internal models. To date, more than half of the insurance companies required to use the SST have submitted internal models, every one of which must be assessed and approved by FINMA. Often they do not meet FINMA's requirements. They take insufficient account of extreme events when calculating insurance risks, or their logic is inadequately documented. In many cases, FINMA has imposed special conditions or time limits as a condition for approving them. The revised Supervision Ordinance also requires more companies to use the SST. FINMA will therefore streamline and speed up the process for approving internal models in 2015.

Measured improvements to the SST

I now come to my conclusion. Risk-based capital models are an indispensable element of the modern insurance industry. They help management to document and quantify the advantages of an investment strategy matched to insurance obligations. Models also highlight the economic value of diversification within and beyond insurance portfolios and enable capital to be allocated to meet risks. They help the supervisory authority gain a better understanding of an individual insurer's risk profile. However, their value should not be overestimated. In both banking and insurance, the results obtained from models must always be interpreted with a measure of caution.

FINMA is working to improve the SST, but it is important to strike a balance between the potential for technical development and the resources needed to achieve it. We therefore believe it is vital for models to create sensible incentives that insurers actually take on board. In this way they can deliver practical benefits and help to improve risk management, thereby enhancing security not just for companies but also for their policyholders.

Thank you for your attention.