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Capital Adequacy and Risk Management in Insurance
A reflection on Mutuals

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- There has been an ongoing debate for some years in the financial sector – initially in the Banking Sector with the Basle II Project and later in the Insurance Sector with Solvency II – on the need to set minimum capital requirements in accordance with the risks assumed by the insurance companies, irrespective of their legal nature. Therefore, these requirements will affect the mutual insurance companies, regardless of their size or structure. While, as a concept, it is easy to understand the purpose of the regulator compared with current legislation, in practice a great many difficulties arise. As for the implementation of Solvency, the most optimistic predictions are talking about 2007 (the internal risk measurement models were recently postponed to that date).

- Indeed, current European legislation does not consider setting minimum capital requirements in line with assumed risks, something that is considerably prejudicial for those companies with a conservative risk profile, as it obliges them to hold the same capital reserves as those with a more aggressive profile. This affects mutual insurance companies, particularly those formed by traditional groups that insure against conventional or "noble" risks.

- It is worth recalling some of the particularities of the mutuals that could affect the consideration of this Solvency project:

  a) Mutualists are both owners and policyholders. It is rather contradictory to demand solvency as a guarantee for themselves.

b) Mutualists, especially those that form part of the governing bodies, may provide an additional guarantee through their own financial capability, this constituting a certain degree of indirect solvency.

c) The possible supplementary contributions constitute – at least theoretically – an additional form of solvency.

d) The fact that dividend remuneration is not requested makes cost of capital a lower than in the case of limited companies.

e) They can undertake long-term projects that offer lower returns in the short term.

f) Capitalisation in the mutuals is not very flexible and may only be achieved through earned surplus or by way of "subordinated debt" formulas or suchlike, whether or not these are permitted by current legislation.

g) The smaller mutuals are formed by collectives with an elevated sense of participation and ownership, although their human and economic resources might be somewhat limited.

h) Excessive capitalisation in the mutuals favours attempts at demutualisation by third parties or internal groups less akin to mutualist principles.

i) There exists a certain feeling of a lack of protection before the authorities and major limited companies.

- In a process of growing globalisation, it would seem wise to harmonise the criteria adopted for gauging the solvency levels of companies, but the evolution of solvency should not depend solely on financial/accounting data, but also on those related to the company's organisation, the risks assumed and how these are managed, as well as certain particularities, as is the case of the mutual insurers.

- Obviously, it seems necessary to adapt the method of calculating solvency to the changes introduced when the International Accounting Standards come into force. In this respect, there is a clear need for appropriate determination of the technical provisions, which, in the mutual insurance companies, may entail excesses that prove highly beneficial when it comes to determining solvency.

- Focusing on the first pillar of Solvency II ("Equity Requirement") and its impact on mutual insurers, it must be accepted that we are facing a change that will require significant economic and human effort to ensure its comprehensive implementation. The size of the organisation will be a determining factor: the larger companies will have advanced risk measurement systems at their disposal; meanwhile, the smaller ones will encounter difficulties and will probably have to make do with the standard system or model, with the result that their capital requirements will be greater, something that is especially detrimental for the small mutuals.

- Despite the above, the public presentation of information – not just financial, but also on the possible risks of the companies and their management – will have positive effects for the markets and investors, in general, and for the insureds, in particular, although to a lesser degree in the case of the mutualists, who are both insured parties and have a closer perception of the entity itself.

- The reform is not without its difficulties and the proposed solution should be flexible, taking into account the heterogeneity of the European insurance sector (especially the mutuals), the legislative differences that exist between member states and the diversity in size, nature and complexity of the insurance companies. It will prove difficult to apply

one sole model and we should perhaps consider the creation of a special model for mutual insurance companies.

- The mutual insurers have an added difficulty: they cannot turn to the capital market in times of need. The debate has been opened as to whether or not the mutuals should be able to issue participative contributions or something similar, in order to strengthen their policyholder surplus.

- The mentality and the roles played by all the actors (rating agencies, supervisors, auditors, actuaries, etc.) should also be adapted to the aforementioned particularities of the mutuals, which merit special attention if we wish to guarantee their survival in the European market, given their remarkable tradition, presence and historical role.

- Everyone knows that the Solvency II project involves complexity, particularly in aspects such as the development of internal models, methods of quantifying each risk, the level of equity, etc. There will be a need for the appropriate human and technical resources, with truly elevated implementation costs, particularly for smaller entities such as many of the local or regional mutuals. Solvency II should envisage a lesser degree of sophistication with costs that these entities can withstand.

- The rating systems furnished by independent firms can provide informal assistance to the control bodies, when it comes to directing their supervision efforts towards the different entities, according to the rating obtained. To date, the smaller entities and the mutuals have seldom accepted this kind of analyses, as they feel that their cost is excessive and the methodology does not contemplate their peculiarities. Were these factors to be taken into account, we could make advances in the rating process, which would be useful for both these entities and the supervisory bodies.

- On determining a future solvency system, agreement must be reached on a grouping of risks that should include, at the very least, the underwriting, market, credit and operational risks. An adequate evaluation of these risks should contemplate the specific

nature of the mutuals, normally with better underwriting criteria, less affected by market risks (of a financial nature) and operational risks (lesser operational complexity). On the other hand, credit risks, especially those related to reinsurance, may be higher, given that there exists greater dependence on this protection.

- Solvency II poses significant doubts and unknown factors for insurers and, to a greater degree, for mutual insurers. The proposal appears to be overly ambitious and complex. It aims to resolve everything and it is hard to believe that mechanisms or models can fully quantify the risk and the running of an enterprise as complex as that of an insurer. For this reason, it should not be considered a panacea.

- It could prove worthwhile to analyse the models currently implemented in the United Kingdom, also for the mutual insurers. From that starting point, advances could be made on the basis of greater experience.

- In any case, future models should envisage the particularities of the mutual insurance companies. Otherwise, it could be felt that this project is against the mutuals or aims to lead to their demutualisation; or, what is even worse, is designed to lead to their disappearance, on the basis of the idea of globalisation, where all that matters is the big player and the capitalist forms of ownership.

- We could not deny the evidence that we are on the road to an internationalisation of economic activity, with increasing transparency of both management and information and greater participation of the control bodies. Capital adequacy and risk management are important concepts to be improved, but the implementation of any method or model should be undertaken in phases, learning from experience and striving to take into account the specific nature of widely contrasted markets or legal patterns, as is the case of the mutuals.

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