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The insurance sector will be able to meet new financial sustainability requirements

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Changes to insurance sector regulation

On January 10, 2020, the Bank of Russia approved the new regulation "On individual requirements for the financial sustainability and solvency of insurers", which brings about a significant change to the regulation of the insurance sector. The regulation will come into force in a year and a half and replace several existing key regulatory acts that set requirements for the assets and equity of insurance companies.

The new regulation requires that insurers comply with a single ratio that replaces several indicators used by the existing regulation. This is the ratio of the sum of internal funds and subordinated loans to an indicator calculated based on insurance activity parameters and the composition of assets on the insurer's balance sheet.

The Bank of Russia's regulation sets out the criteria that determine which assets can be used to calculate insurance companies' internal funds. If an asset fails to meet the criteria, then it will have zero value for the purposes of calculating internal funds. This, however, does not mean that such assets cannot be held on balance sheets. If a company possesses surplus internal funds, then it is entitled to own any assets. In this regard, the new regulation gives insurers more freedom compared to the current regime, which practically forbids them from holding certain asset classes, regardless of their level of capitalization. At the same time, the new regulation is much more conservative in terms of assessing asset value. Many assets (for example, part of receivables and deferred acquisition costs) that were previously used to calculate internal funds will now be excluded, as they will have zero value for such purposes. As it is unlikely that companies will be able to stop offering deferred payments on insurance premiums and payment of commission to intermediaries, they will need to create additional equity in excess of the ratio in order to cover these assets.

The new regulation makes fundamental changes to the calculation of the denominator of the normative ratio, which in essence is the estimated value of the required size of an insurer's internal funds. Above all, it alters the calculation of the required solvency margin — the indicator that depends on the volume and results of insurance activities and reinsurance protection. In particular, the margin will be calculated separately for business lines and then summed up. However, a different change will have a much larger impact — in addition to meeting the required margin, an insurer's internal funds will also have to cover the risk premium, which is calculated based on asset composition and the company's liabilities.

This premium covers the main market and credit risks accepted by an insurer, including insurance portfolio concentration risk. The risk calculation formulas are largely in line with the approaches used in European insurance regulation (Solvency II), but a number of the parameters applied in Russia are more conservative. For example, diversification between counterparties is taken into account when assessing concentration risk in Europe. The current version of the Russian regulation involves a simple adding up of concentration risks, which obviously results in a higher assessment. The new regulation introduces the concept of credit quality groups for assessing credit risks. The board of directors of the Bank of Russia will establish the procedure for determining the group depending on credit rating. Unlike Solvency II, the size of the credit risk of Russian insurers will be determined based on the results of statistical modeling of defaults. According to ACRA, this approach to assessing credit risk of insurers' assets is still used for stress testing, but not to assess capital adequacy.

The Bank of Russia first announced the drafting of new principles for regulating financial sustainability in March last year and then discussed possible approaches with market participants, who made adjustments to the final version of the regulation. There will be a gradual transition to the new regulation, which will soften the impact of its introduction. The new regulation will come into force on July 1, 2021, but its parameters will gradually change over the following four years (this period should be sufficient for the Russian insurance market to adapt). Given the complexity of the new approaches, it looks like the Bank of Russia will issue additional clarifications on their application and hold respective training sessions.

The introduction of the new regulation will result in greater transparency of insurance companies' assets and growth in equity, which will have a positive effect on their solvency. The Russian insurance market is characterized by its high return on equity. According to the Bank of Russia, as of September 30, 2019, overall return on equity of insurance companies was 31%. Internal funds exceeded the current capital adequacy ratio by almost three times on average. Therefore we assume that most companies will be ready to fulfil the new requirements without delay. At the same time, the tougher requirements will create additional incentives for consolidation of the insurance market, as it will be easier for larger insurers to deal with the additional financial and regulatory burden.

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