DEVELOPING INSURANCE MARKETS

WHY RISK-BASED CAPITAL REFORM WORKS BETTER THAN NOMINAL CAPITAL INCREASES?

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— Kumud Ghimire and Craig Thorburn[1] —

Summary

Risk-based approaches including projects to introduce risk-based capital (RBC) have been identified as an imperative to enhance insurance market development. To develop, markets need to change. Innovation is often constrained by both skills and funds, both of which can be in short supply particularly if competitive pressures are delivering unprofitable and unsustainable business performance. This note discusses why risk-based supervision (RBS) and RBC make sense and the relevance of these approaches in support of other imperatives identified for development.[2]

Risk based approaches have been popular to respond to changing markets and an increasing range of risks. Increasingly interdependent economies, political change, shifting financial landscapes locally and internationally, new technologies, innovations, new insurance exposures from issues ranging from cyber to climate change have all been getting attention by insurance regulators. Risk-based approaches offer flexibility and responsiveness to emerging, complex risks. Many regulators also have a market development mandate. Understanding how risk-based approaches support development is, therefore, an important link to add to the case for change.

This note sets out some features and elements of supervising risks rather than rules, then discusses why they appear to work better than, for example, simply increasing absolute minimum capital requirements. Some of the elements that advance market development imperatives through RBS and RBC are:

- Risk-based approach develops capacity and technical skills of firms and supervisory agencies;
- Risk based approaches align incentives to business actions, encouraging and rewarding actions that move toward market development outcomes;
- RBC allows insurance to play a greater role in investment markets and development;
- Data based approaches, collection and research is encouraged and rewarded;
- Market structures constraining innovation can be addressed creating an environment for change; and
- Risk-based approaches can offer proportionate relief to low-risk innovations that reach underserved and unserved segments – facilitating inclusive insurance.

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[2] Insurance for Inclusive and Sustainable Growth: Imperatives for action from a four-country synthesis

Introduction

Insurance market development is often constrained by an absence of innovation, limited technical skills at insurers as well as at supervisory and policy making levels, and short-term management priorities. Less developed markets are often fragmented and heavily reliant on compulsory motor insurance where irrational competitive behavior usually leads to low profitability providing little space for investment in new ways of doing business, improvements in processes and products, or in acquiring and developing technical skills.

One of the key priorities identified to create robust, efficient, and inclusive insurance markets is a greater focus on risk-based capital and risk-based supervisory approaches. Recognizing the role that insurance can play in catalyzing sustainable and inclusive growth, the UK Government's DFID partnered with the World Bank, FSD Africa and Cenfri to understand how these mechanisms manifest in four countries across Sub-Saharan Africa through deep-dive country diagnostics synthesizing some key cross-cutting themes as imperatives to insurance market development.[3] This note captures deeper observations from the country diagnostics supplemented by a broader experience from other jurisdictions on one of those key areas.

This is one of a series of notes examining specific issues raised in the overall project work on insurance market development but separated for ease of access to readers with a particular interest in one or another situation.

Supervising Risks Rather Than Rules: Key Features

In a risk-based world, the focus moves to risk from rules. Assessments are made on a continuous rather than a binary scale. Choices are made in shades of grey rather than simply in black and white

Risk-based supervision is a dynamic approach assessing the probability and severity of material risks facing an insurer and departs from a static and rules-based approach. In an ideal risk-based supervisory world, the supervisor is equipped with tools and knowledge to examine the business of insurers through offsite monitoring and onsite inspection processes: evaluation of risk profile and adequacy of risk management systems, quality and effectiveness of corporate governance, market conduct, and even overall strategic positioning.

Risk-based approaches encourage managers to focus on risk, managing and improving it with the incentive that financial metrics respond to changed risk settings. Supervisors in a risk-based world also focus on risk to their supervisory objectives, rating and ranking supervised entities and risk elements on a continuous scale rather than the binary choice. Grey areas replace black and white decisions. Graduated ratings require risk sensitive metrics (ratings or early warning systems) and graduated actions appropriate to the level of concern (ladders of intervention).

[3] The full report is available at https://www.fsdafrica.org/wp-content/uploads/2019/10/Insurance-for-growth-01.10.19.pdf.

Rules-based approaches use laws and rules to define acceptable behavior and then supervise the observance of those rules. Managers in a rules-based world often default to consider the rules as the definition of appropriate practice. Even if they want to focus more on the risks and more economic merits in making decisions in their business there is insufficient flexibility in the rules to allow them to get benefit from implementing these approaches or it may be prohibited altogether. Rules can get out of date and stop meeting the condition that they define safe practice in all situations. In a rules-based world, supervisors make binary determinations on observance or otherwise. The rules governing this determination are static by design and are limited in complexity and scope to capture the unique risks faced by a given insurer with regards to their operations, investment or other business decisions.

Risk based regulations better align supervisory and regulatory responses to business risks, providing incentives for good managers to invest and develop their business in a well-managed way.

Risk-based regulatory frameworks and supervisory systems "protect consumers without unnecessary barriers, incentivize innovation, improving inclusion and technical capacity, value and overall standards in the market".[4] Given the growing importance of supervising risks rather than rules, an enabling regulatory architecture is critical. Given that transitioning to a risk-based world is a gradual process requiring a collaborative approach between all stakeholders, regulators at the beginning of the process may "start by outlining an RBS approach in consultation with industry."[5]

Some Reasons Why A Risk-Based Approach Might Work Better

This section examines a number of explanations of why risk-based capital (RBC) reforms might work better than absolute minimum capital requirement increases. It is clear that several insurance market development imperatives are advanced by RBC simultaneously.

There appears to have been limited success in raising industry standards – and improving some key enablers of insurance market development – through absolute minimum capital requirement increases. Nigeria is an example from the country studies completed where a series of increases in the absolute minimum capital requirement does not appear to have delivered a lasting improvement in some key performance metrics and, in particular, has not delivered improved financial outcomes that could provide space to invest in innovation. In Ghana, fragmentation has increased despite minimum capital increases.[6] Minimum absolute capital requirements were increased in Kenya with no material effect on competitive settings.

4 Insurance for Inclusive and Sustainable Growth: Imperatives for action from a four-country synthesis

5 Insurance for Inclusive and Sustainable Growth: Imperatives for action from a four-country synthesis; For a list of potential actions and roles for policymakers, regulators, and development partners, see page 14 of the report.

6 Increases in Ghana in 2015 from 5 million to 15 million Shillings had no impact on insurer numbers. A further increase from 15 million to 50 million has been enacted in 2019 with the impact to be seen.

The journey is important, not just the destination.

To secure the benefits of risk-based approaches to foster development, implementation processes are at least as important as risk-based formulas.

Done well, insurers realign their focus over time to manage risks and not merely react to rule compliance.

But this transition needs to be a consultative discussion. Reforms that are well designed but not communicated will only end up being just a more complicated rule.

Instead, recognizing that managers of insurers have a day job dealing with challenging business settings that are a symptom of the problem, then elaboration and communication efforts in consultative phases are critical.

A well implemented reform can powerfully address many of the root causes for lack of innovation. With innovation, change is possible toward a new and different insurance market. Without it, stuck in the "status quo", it is no surprise that "doing the same thing only gets the same result".

In Rwanda and Kenya, comprehensive and market sensitive risk-based capital reforms have been pursued. Market competition metrics in Rwanda are not consistent with problematic fragmentation and a parallel run is also showing signs of improved technical capacity and realignment of business risks based on business decisions. Kenyan insurers have responded by growing their market perspective to a regional level, enabling local fragmentation costs to be carried in the broader regional perspective of their businesses.

Risk-based capital approaches require insurers to hold capital in proportion with the risk composition of their underwriting business and the investment portfolio: the greater the risk, the greater the amount of capital to be held. A central element of a risk-based capital approach to ensure financial soundness of insurers and protect policyholders is an introduction of thoughtfully calculated asset-based and liability-based risk charges, a nuanced approach to capital adequacy which contrasts with a static minimum capital requirement.

Liability-based charges depend on the risk level associated with underwriting various policies and could differ even for the same amount of premiums (for example, charges differ between underwriting insurance policies for mandatory motor insurance versus airplane insurance even under a hypothetical scenario where the premium exposures are the same). Asset-based charges depend on the risk level associated with investing in a particular asset class. What this means for capital adequacy is the following: for the determination of solvency, a company requires a certain percentage – the risk charge – on every dollar invested in a particular asset class, in line with the risk profile of that asset class.

Risk-Based Approaches Develop Technical Skills

As risk-based approaches are developed and implemented, they enable companies to manage themselves better and develop in-house capacity as it relates to investment decisions or innovative thinking. Inadequate technical skills are often seen as an inhibiting factor in development of insurance markets across jurisdictions. Of the benefits that RBC reforms bring to the overall market, development of technical skills is one of the most important.

The transition towards risk-based supervision improves professionalism and in-house capacity in firms and regulatory & supervisory agencies. There are a number of steps in transitioning towards a risk-based world, and it is often a continual learning process involving consultations with industry stakeholders, drafting enabling legislations, learning from international best practices and successes from comparable peer jurisdictions, and developing context-specific frameworks, manuals and other tools. The entire process allows both the supervisor and the private sector to broaden and deepen their technical knowledge. The transition process marks a steep learning curve for a wide range of stakeholders in the market and creates opportunities for significant technical advancement and a fundamental shift in mindset across the entire process lasting several years. It is precisely the multi-dimensional nature of the transition and the multi-year, multi-step implementation that ensures a degree of sustainability built into the process for capacity development.

The transition towards risk-based supervision improves professionalism and in-house capacity in firms and regulatory & supervisory agencies. Following the capacity development that takes place during the multi-step, multi-year implementation and transition to risk-based supervision, capacity development takes a lasting form since it gets gradually embedded into the "company's DNA".

To elaborate the point of development of technical skills in a lasting form, we can think about one specific example: the notion of risk charges applied in RBC approach and how it shapes the company thinking. By assigning different charges to the different assets and liabilities in the portfolio, an insurance manager (or an insurer's investment manager) is constantly pushed to think about the different moving parts affecting overall risk to the business, and consequently the capital adequacy. A fundamental shift in the mindset of management and employees happens: the notion of capital adequacy then becomes a new business reality, and assessment of it becomes deeply embedded in business processes and risk management approaches as opposed to the perception of a static threshold that needs to be met just for supervisory compliance.

Effectively implemented through a discursive consultative process, the process of transitioning towards risk-based supervision allows the sector leadership to think of risks rather than rules – developing a new line of thinking that catalyzes innovation.

Risk-Based Capital Enhances The Transparency Of Decision Making In Firms And Changes The Alignment Of Incentives For Management

Risk-based capital builds a risk-based culture and changes the alignment of incentives for company management. Management can be rewarded for decisions that better manage risks, including underwriting risks, strategic risks, reputational risks, investment and liquidity risks, and other operational and business risks facing insurance business. This enhances the quality of decision making in firms, having longer term implications for the business, its policyholders and shareholders.

Allocating capital aligned to business strategies (and to a certain extent, aligned to the risk appetite) rather than as required by broad and ill-fitting, insensitive, blunt and static rules enhances the quality of decision making. It also goes a long way towards shaping a risk-based corporate culture with the right alignment of incentives for insurance executives and managers.

Capital adequacy becomes a new business reality, with regular assessment being embedded in business processes and risk management approaches as opposed to a static threshold that needs to be met solely for supervisory compliance.

Risk Based Capital Can Reduce Constraints On Investment Activities And Encourage Those That Contribute To Broader Economic Development

As institutional investors, insurance companies can make a meaningful contribution towards a deepened, stable, resilient and diversified financial sector and better financial intermediation for economic development. In particular, life insurers are crucial to mobilization of long-term finance given that the industry is looking to match long-term liabilities with long-term assets.

In a rules-based world, there is always a considerable lack of flexibility for insurers given that rules are general and implemented based on a single view of an insurer's risk appetite, risk management capacity and in-house financial acumen. Risk-based capital reduces constraints on investment activities and could empower insurers to play a greater role in financial markets – both long term and short term investments – and could particularly encourage investments in sectors that are more important to the broader economic development including with an appropriate level of investment in long term assets whilst managing assets appropriately to their credit and liquidity needs.

Additionally, with a risk sensitive approach to asset liability matching, life insurers would be encouraged to develop their approaches to asset-liability management and Enterprise Risk Management more generally. This has positive consequences for their more active participation in fixed interest markets as they manage duration in line with capital available. Most rules-based systems are limited to simply require insurers to hold bonds relatively less scientifically.

Risk-Based Approaches Encourage And Reward Investment In Data Collection And Analysis

Inadequate data and research is a common and recurring constraints identified for innovation and market development. Rules-based approaches do not incentivize investment in data gathering and analysis in much the same way as they do not encourage investment in technical skills, especially capacity building initiatives with a degree of sustainability built into them. Instead, inflexible rules suggest to managers that more data is costly and may not allow any useful implementation from what is learned from it anyway.

In contrast, risk-based approaches encourage further data-based study as they can present the option for improved knowledge to permit more granular and accurate capital costs aligned to risk, improving efficiency of all parts though the insurance value chain.

Risk-Based Approaches Catalyze Innovation When They Can Help Address Market Constraints

Innovation is often constrained by similar factors across emerging markets and developing economies. Excessively fragmented markets have been noted as one of the key factors hindering innovation. Irrational competition squeezes resources and prohibits investment in new approaches that are sorely needed for change. Given that the relative success of risk-based approach in reducing fragmentation, it tends to support innovation.

Some of the other causes for lack of innovation, suggesting that the benefits can flow in all markets include:

- Inadequate technical skills and capacity across the industry (often including the private sector and the regulator);
- Lack of reliable data and quality market research (particularly on the demand-side of the market);
- Short-term thinking of insurance managers and inadequate focus on long-term strategy;
- Weak balance sheets against the backdrop of unhealthy competition.

The several observations presented in this note demonstrate that risk-based approaches help address each of these challenges.

Risk-Based Approaches Can Offer Proportionate Relief To Low-Risk Innovations That Reach New Segments

Furthermore, risk-based approaches can offer proportionate relief to low risk innovations that reach underserved and unserved market segments. “Microinsurance” and lower value insurance products catered to Micro, Small and Medium Enterprises (MSMEs) are examples of areas requiring focus.

Some products are lower risk given that low amounts are at risk at a per policy level and that a large number of insured entities are involved (individuals or enterprises). Risk based approaches can invite lower capital charges for lower risk profile portfolios, but a flat (non-risk based) capital rarely reflects such differentials. Risk-based systems also tend to be more sensitive to reinsurance requirements or, in the case of some microinsurance applications, the lower need for reinsurance.

Some products and segments are lower risk given that low amounts are at risk that is spread over a large number of insured entities, but a flat (non-risk based) capital rarely reflects such differentials.

Risk Based Supervision Ensures Scarce Supervisory Resources Are Directed At Key Priorities

Against the backdrop of insurance supervisors working on competing priorities and operating with limited supervisory resources, risk-based supervision allows "to allocate resources to insurers with the greatest risk"[7] and helps prioritize better. These key supervisory decisions are informed by a range of supervisory tools employed during the offsite monitoring and onsite inspection processes.

Conclusion and Next steps

This paper contrasted the limitations of rules-based approaches, particularly minimum capital requirements, and the more sensitive mechanisms of risk-based capital and supervision. It highlighted the observations that these approaches have on insurance market development. With a careful and well implemented reform, risk-based supervisory and capital has been seen to deliver benefits to advance development in many key dimensions. In particular, when innovation is constrained by scarce financial and human resources, risk-based approaches provide the incentive to free up poorly allocated resources used for unprofitable and unsustainable activities to allow positive change for good.

We will add to the work with further notes on capital reforms and the resulting impacts on developmental outcomes as well as examining other imperatives identified in the wider study in more detail as part of this series.

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[7] *Insurance for Inclusive and Sustainable Growth: Imperatives for action from a four-country synthesis*

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