INSURANCE AGENCY OF THE REPUBLIC OF SRPSKA

АЗОРС

Insurance Agency of
the Republic of Srpska

STRATEGIC FRAMEWORK FOR THE TRANSITION TO A SOLVENCY II REGULATORY FRAMEWORK

Banja Luka, year 2023

CONTENTS

1. INTRODUCTION

This document represents the amendment of the Strategic framework of preparation for the transition to the Solvency II regulatory framework, which the Insurance Agency of the Republic of Srpska (hereinafter referred to as the Agency) issued in November 2018 and within which it operated in the previous period and by which it is foreseen the need to actualize and amend the same. It should be noted that the adoption of this document is based on the Agency's statutory powers without prejudice to the timelines of change and harmonization of the regulatory framework for insurance in the Republic of Srpska with the demands of Solvency[1] and that consultation with the Ministry of Finance of the Republic of Srpska was carried out during its preparation, in terms of strategic commitments regarding the modernization of the legal framework in the field of insurance.

Based on the findings obtained by conducting the activities from the previous. i.e. initial strategic framework, the analysis of the stability and solvency indicators of the insurance sector as well as the directions of action of the regulators in the area, whether or not they are from the Member States of the European Union, the need to update and revise the Agency's direction of action was identified to gradually prepare for the transition to Solvency II.

In addition to the above, the need for more intensive preparation and updating of the course of action also arises from the need to prepare the available resources of the Agency, but also of insurance companies, for reporting following the requirements of the International Financial Reporting Standard 17 (IFRS 17), as experience shows that the integration of certain Solvency II requirements has facilitated and minimized the risks involved in the transition to the same.

As the regulatory framework based on Solvency II is conceptually different from the regulatory framework in which insurance companies currently operate in the Republic of Srpska (Solvency I), the Agency, while respecting principles of prudence, determines the directions of action and priority activities with a reasonable level of complexity, with the intention of stage revision of the same.

In addition to the above, by this strategic framework, the Agency, within its competencies, also offers operational support to the accession process of Bosnia and Herzegovina and the European Union.

At the 176th assembly, held on 30 June 2022, the Government of the Republic of Srpska adopted the conclusion *(point 5):*

“Bearing in mind the significance and complexity of the introduction of the new legal and regulatory framework Solvency II in the legal system of the Republic of Srpska both in terms of regulation and in terms of application and supervision, The Government of the Republic of Srpska calls the Insurance Agency of the Republic of Srpska that, in cooperation with the Ministry of Finance establish the strategy of introducing Solvency II and to intensify the activities on developing awareness among the participants at the insurance market on the needs and benefits of the timely preparation for an upcoming new business model.“

Following the above conclusion of the Government of the Republic of Srpska, the Agency has

[1] Solvency II is a legislative and regulatory framework of insurance companies' business in the European Union, based on the Directive 2009/138/EC.

prepared this document which is based on:

- Roadmap for the improvement of reporting, regulation and supervision of the insurance sector in Bosnia and Herzegovina, defining the extent, time framework and responsibility for harmonization from the segment of Solvency II, which is prepared within the framework of consulting support project of the World Bank for the insurance sector in Bosnia and Herzegovina,
- Conducted consultations with the Ministry of Finance of the Republic of Srpska regarding the strategic decisions related to the modernization of the legal framework in the field of insurance and
- Results of activities carried out until so far in this regard.

In the course of preparation of this document, consultations with the representatives of the World Bank were carried out, within which it was announced that the start of development of the comprehensive roadmap for the introduction of Solvency II has begun and that the Agency will develop a strategy for alignment with Solvency II in the next period, based on the acceptable results of the technical assistance provided by the World Bank consultants.

2. REASONS AND PURPOSE OF THE PREPARATION FOR SOLVENCY II IMPLEMENTATION IN THE REPUBLIC OF SRPSKA

Solvency II is a new legislative and regulatory framework of business of the insurance companies in the European Union, based on Directive 2009/138/EC, adopted on 25 November 2009 and which started to apply on 1 January 2016.

Directive 2009/138/EC represents the first level of rules for conducting insurance activity in the European Union and which the Member States take over in the national regulations.

In addition to Directive 2009/138/EC, Regulatory framework Solvency II also includes acts and measures of the European Commission for its implementation which have direct application in the Member States of the European Union and provide full harmonization of rules which regulate insurance activity. In addition, European Commission, upon the proposal of EIOPA-European Insurance and Occupational Pensions Authority adopts the technical standards of application. Acts and measures for implementation and technical standards represent the second level of rules which is regulated insurance activity in the European Union. The third level of regulations of the regulatory framework Solvency II represents the guidelines adopted by EIOPA, which is ensured the consistent application of the rules and cooperation between the Member States of the European Union. Although the guidelines are not binding, it is necessary to explain the reasons for not following them.

In the previous period, the insurance activity in the European Union was regulated by a higher number of directives from the framework of Solvency I and in which, in the previous decades, was conducted gradual harmonization of the rules for conducting insurance activity. During the application of the regulatory framework Solvency I, in addition to numerous advantages, certain deficiencies are identified and those are: the emphasis is on the accounting and not the market values, it is not sufficiently stimulative for insurance companies to adequately manage risks and investments, capital adequacy indirectly only includes insurance risk, while the other risks are neglected, all obstacles are not removed for the timely interventions of the supervisor, it is not completely provided with the adequate allocation of the capital and it is not devoted enough attention to the groups' supervision.

Solvency II has replaced 13 directives of the framework Solvency I and the key changes relate to the new rules of solvency and risk management, which are frequently included under the term Solvency II. This regulatory framework is based on the obligation of recognition and evaluation of all risks to which the insurance company was exposed and management of those risks as well as the possibility of preventive action of the supervisory/regulatory authority. The primary goals of Solvency II are the insured person's protection, positioning of the solvency limit which will represent the total exposure to all risks and early recognition of the market changes, based on principles and not on the strict rules. Solvency II is the continuance of the “new regulation” which started with the introduction of Basel II, as the new rules of measurement of capital requirements of banks.

The basis of Solvency II consists of three interconnected sections, that is, three pillars:

I – pillar: Quantitative requirements

This pillar relates to the set of quantitative requirements which the insurance company must meet for protecting the interests of the insured persons and to provide a stable and safe business. Quantitative requirements refer to the harmonization of valuation standards, instead of the previous firm quantitative restrictions and requirements. These regulatory requirements relate to the valuation of property and liabilities, technical reserves and own funds and they establish two levels of capital requirements: SCR-*solvency capital requirement* and MCR-*minimum capital requirement*.

Solvency capital requirement is the level of capital which should enable the insurance company the coverage of all liabilities based on the insurance company and solvent business operation considering the undertaken risks, while the minimum necessary capital represents the lower limit of the necessary capital of the insurance company. Between these two levels, the supervisory body will, if it is necessary, prescribe corrective measures.

II – pillar: Quantitative requirements

The second pillar relates to the so-called qualitative requirements, i.e. the development of a comprehensive system of management that includes internal audit, risk management, actuarial function, compliance and internal control monitoring function. Insurance companies must implement their Own Risk Solvency Assessment and identify risks that do not recognize the rules of capital adequacy calculation and are important for business operations.

III – pillar: Transparency

The third pillar is based on disclosure and transparency, to increase market mechanisms and supervision which is based on risk. The purpose is to provide a complete image of the insurance company's risks to the insured persons, investors and other interested parties. However, this set of provisions emphasises the importance of market discipline, transparency of business and performing supervisory functions.

Mentioned characteristics of the Solvency II regulatory framework indicate that the same represents a completely new concept in the calculation of capital adequacy of the insurance company and a new comprehensive approach to risk management in insurance companies and which also requires a change of supervisory approaches.

Therefore, it is also necessary, starting from the current state of the insurance sector, to undertake the activities which create assumptions for a gradual transition into a new more complex regulatory framework, by considering the need for previous activation of conservative measures of insurance companies' capital increase.

With the realization of preparation activities of the insurance companies in the Republic of Srpska for the transition to the regulatory regime based on Solvency II, within its competencies, the Agency also provides operational support to the accession process of Bosnia and Herzegovina.

3. STATE OF THE INSURANCE SECTOR IN THE REPUBLIC OF SRPSKA

For the provision of a careful and gradual transition to Solvency II, the priorities of preparation for the transition to Solvency II should be based on the current state of the insurance sector in the Republic of Srpska, namely, the insurance market in the Republic of Srpska. In this sense are presented the data on the development of the insurance sector of the Republic of Srpska and the total financial capacity and human resources of the insurance companies with a seat in the Republic of Srpska.

Level of development of the insurance markets

On the day of the creation of this document, at the insurance market of the Republic of Srpska, 24 insurance companies operated, of which 14 insurance companies with a seat in the Republic of Srpska and 10 insurance companies with a seat in the FBiH and they perform the insurance activity in the Republic of Srpska via their branch office.

Of the total number of insurance companies, operations in the type of compulsory auto insurance conducted 22 and the operations in the type of life insurance, 7 companies. In the insurance market of the Republic of Srpska, there is a quite strong competition, as all indicators of competition, i.e. concentration of the market indicate. In this sense, it is emphasized that there is a continuous trend of reduction of Herfindahl Hirschman's index, on the complete insurance market (622 points in 2021) and also on the auto liability insurance market (645 points in 2021) as well on the largest segment of the insurance market in the Republic of Srpska. Increased competition is also indicated by the distribution of insurance companies by peer groups, in which no insurance company achieved a market share of more than 15%, while 17 companies had a market share of less than 5%.

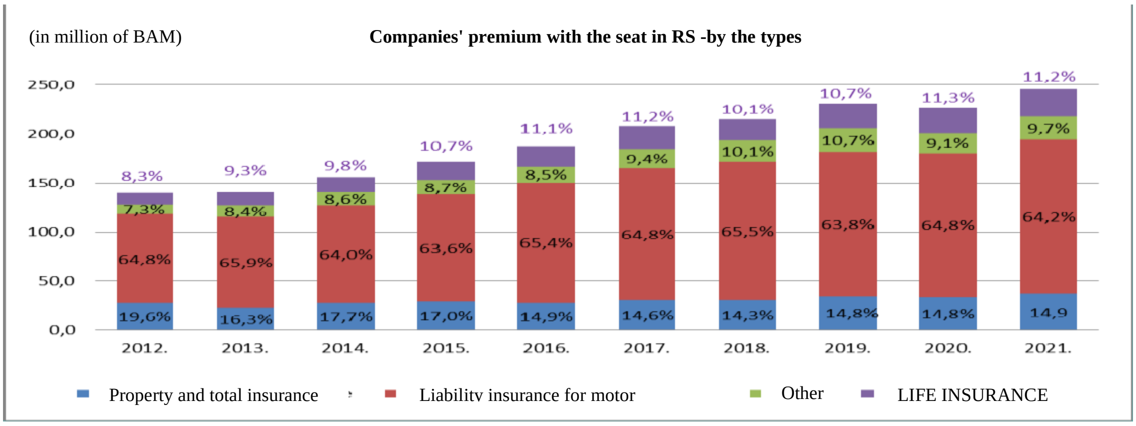
The premium participation in GDP with around 2% is approximately at the same level as in the other countries from the region with a similar level of insurance market development. Premium by the resident is about 117 EUR and it is lower in comparison with the developed and also in comparison with emerging insurance markets.

Financial capacity and operations of the insurance companies with a seat in the Republic of Srpska

Insurance companies with a seat in the Republic of Srpska achieved a premium of BAM 245.6 million in 2021 which is higher by 8.3% in comparison with 2020.

In the period from 2013 to 2021, it is marked approximately the same annual growth rate of insurance companies' premiums with a seat in the Republic of Srpska and which was 7% on average. In the total calculated premium, it dominates the compulsory motor vehicle liability insurance premium which participates with approx. 70% of the total calculated non-life insurance premium for insurance companies with a seat in the Republic of Srpska. Although it marks continued growth, the participation of the life insurance premium is just about 11%. In the following chart is displayed the movement and the structure of the total calculated premium for the period from 2012 to 2021.

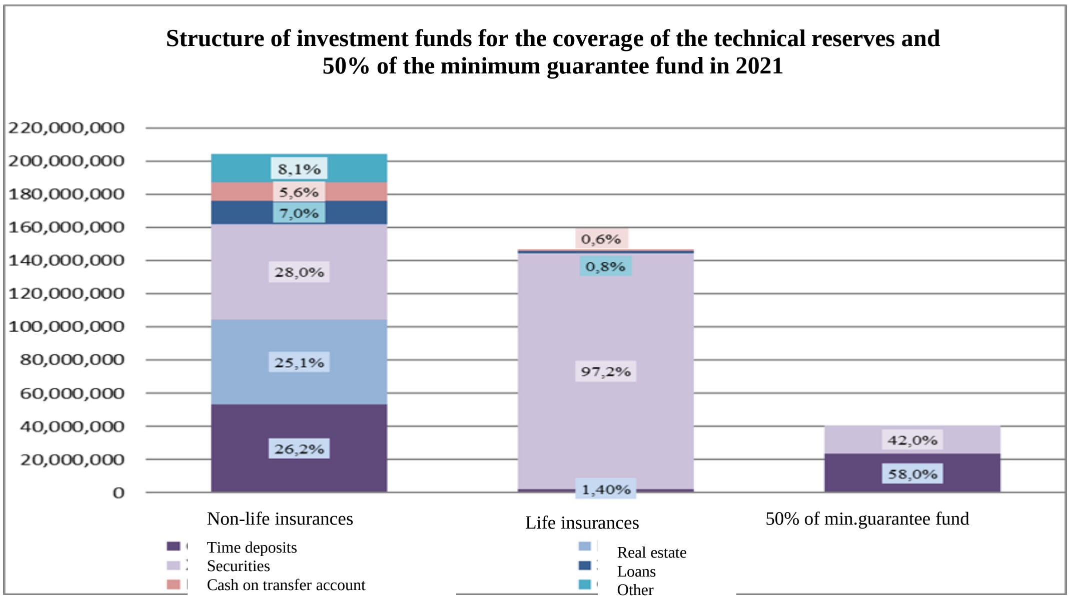
Chart 1. Structure of the calculated premium of insurance companies – by the types (in million of BAM)



As the regulatory requirements from the Solvency I framework do not originate from the approach of risk measurement and valuation of the entire asset for determining financial capacity for settlement of obligations from an insurance contract, the following text is given as an overview of the structure of investment funds for the coverage of technical reserves and 50% of the minimum guarantee fund and the participation of categories defined as "more difficult to maintain" assets in the total assets and finally meeting current capital requirements.

The following chart gives the structure of investment funds for the coverage of the technical reserves of non-life insurance, life insurance and 50% of the minimum guarantee fund at the level of the insurance sector of the Republic of Srpska.

Chart 2. Structure of investment funds for the coverage of the technical reserves and 50% of the minimum guarantee fund in 2021 (in BAM)



Apart from the fact that, viewed from the point of view of the sector's average, there is a dispersion of investment funds to cover technical reserves of non-life insurances, at the level of individual companies there is a more pronounced concentration of certain forms of assets (e.g. real estate, loans) with the present risk of the adequacy of their assessment. In the investment of funds for the coverage of technical reserves of life insurances are dominated by investments in bonds issued by the Republic of Srpska, where it should be pointed out that in the previous period due to business policies of guaranteeing returns based on life insurance contract, there was a transformation of the assets for the coverage of the technical reserves from deposits into bonds of the Republic of Srpska.

Participation of the so-called "more difficult to maintain" assets (intangible investments, real estate, long-term and short-term investment to related, associated, parent and dependent legal entities and receivables) consisted of 28% of the operating assets, where the range of this participation with the individual insurance companies is between 4% and 60%.

Insurance companies with a seat in the Republic of Srpska are obligated to maintain the capital adequacy level which corresponds to the scope and types of insurance which the companies perform within its activity.

At the level of the insurance sector, capital adequacy requirements are constantly met, bearing in mind that they only address, to a limited extent, exposure to insurance risks and take into account actual and potential losses, i.e. calculation is not based on an assessment of exposure to all current business risks. According to the current capital adequacy requirements, the total available insurance companies' capital was BAM 108.3 million, with the balance on 31 December 2021. It is displayed the surplus of the available capital, in comparison with the limit value of available capital adequacy of BAM 25.4 million (or 23.5%) of which BAM 20.9 of surplus in non-life insurance (or 82.3%), that is, BAM 4.5 million in life insurance (or 17.7%).

Human Resources

The experience of the surrounding countries and other EU Member States in the implementation of Solvency II, due to conceptual difference from Solvency I show that investments in the development of human resources are necessary. This segment will be the subject matter of the specific preparedness analysis for meeting Solvency II qualitative requirements and for introduction are only given the current data on the number of employees in the insurance companies and the method of functioning of the actuarial function. On 31 December 2021, the insurance companies with a seat in the Republic of Srpska employed 1,572 employees of which 51.9% make employees with secondary school education, 39.5% with a university degree and 8.6% of other employees. In insurance companies, the actuarial function functions both internally and externally. The external function may be performed by the persons who have been authorized by the Actuarial Services Agency and are registered in the Register of Authorized Actuaries. On 31 December 2021, the Register of Authorized Actuaries with the Agency registered 38 persons. The law prescribes independence rules for external, i.e., authorized actuaries of insurance companies. Authorized, that is, external actuaries, are not continuously present in the insurance company, but they must give an opinion on actuarial positions in the financial and other statements of the insurance companies.

In addition, insurance companies are obligated to have as an employee at least one person who will continuously conduct actuarial affairs in the insurance company. Considering the Solvency II requirements, it is to be expected that it will be necessary for the development and strengthening of the position of the internal actuarial function, together with the development of the other functions from the management system.

4. RESULTS OF THE CONDUCTED ACTIVITIES IN THE PREVIOUS PERIOD

In the previous period, within their capacities, the Agency conducted activities that were identified as a priority, in the originally issued strategic framework, as follows.

- ***Analysis of the possibility of excluding small insurance companies from the application of Solvency II***

The analysis was carried out to assess the effects and possibilities for insurance companies from the Republic of Srpska, with a smaller market share, to adapt their operations to the prescribed conditions of exclusion from Solvency II, which is one of the assumptions for optimizing preparations for the transition period.

Results of the performed analysis show that, according to the current conditions, all insurance companies from the Republic of Srpska are obligated to operate following the Solvency II requirements.

The main reason for these results mainly stems from the fact that:

-insurance companies with a lower amount of the calculated premium perform/are registered for operations in the types of liability insurances and therefore they will be obligated to operate following the Solvency II requirements.

It should be emphasized that the rules of exclusion from the application of proportionality rules should not be equated to smaller companies, where proportionality does not mean a reduction of quantitative and essential qualitative legal requirements, but only a relaxation in terms of reporting and/or merging some of the key functions.

- ***Gap analysis of the capacity of the insurance companies to implement the qualitative requirements of Solvency II***

The identification of the readiness and capacities of insurance companies from the Republic of Srpska for the fulfillment of the basic qualitative requirements from the so-called second pillar of Solvency II is a starting point for the start of alignment with the overall requirements of Solvency II. For establishing the initial level of understanding of the concept of Solvency II and the level of development from the management system Solvency II, the Agency conducted a survey in the manner that the insurance companies with a seat in the Republic of Srpska were given a survey questionnaire „Determination of the level of development of management system functions against Solvency II requirements“. The aim of the research was that the insurance companies conduct the self-assessment of the position and level of development in comparison with the mentioned questions from the questionnaire but also to consider future regulatory requirements and directions of establishment and/or improvement of the key internal functions. The results of this research are the initial basis for the appropriate identification of needs in the insurance sector but also for future regulatory activities.

The results of the survey indicate that a certain level of knowledge of the qualitative requirements of Solvency II exists, while knowledge related to the ORSA process has not been identified. The exemption is the companies that operate within the groups whose basic activity is insurance and it can be recognized a certain level of understanding of the requirements of the ORSA process from their responses.

Regardless of the other results of the performed self-assessment, it should be noted that twelve insurance companies (out of fourteen registered) replied that they expected Solvency II to have positive effects on the market, with ten insurance companies stating that they expected positive effects on their business, which can be seen as a signal for the necessity of regulatory changes.

The results of the research are also published on the Agency's internet page.

➢ ***"Stress-test" of the insurance companies and the insurance sector of the Republic of Srpska***

Following its function as the insurance sector supervisor, at the end of 2021, the Agency conducted the first "stress test" of the insurance companies and the sector in its entirety which included three mutually independent and extreme scenarios and those are the drop of values of the certain assets' categories, loss due to default of the other contracting party – reinsurers and the loss due to increase of mortality due to pandemic and insufficient reserves for damages. The stress test was developed following the recommended supervisory practice and appropriate adaptation of the stress test methodology of the European Insurance and Occupational Pensions Authority (EIOPA). The conducted stress test aimed to assess the vulnerability of insurance companies and the sector as a whole to adverse market scenarios that would directly affect financial stability, i.e. to analyze events and their impact on the capital adequacy of insurance companies and their operations as well as the readiness of insurance companies in the case of the adverse events and their response to those events. An additional aim was the raising awareness in the insurance companies on the real market risks whose development can harm their solvency position. Results of the stress test indicate that individual adverse scenarios if made on a realistic basis, would not jeopardize the financial stability of the insurance sector, even though companies would react differently in the event of some of the extreme scenarios being realized.

The implemented stress test concludes that the regulatory framework and supervisory practices are not sensitive to external and internal risks.

➢ ***Other activities***

Within the framework of priorities' identification for IPA 3, the Agency informed on the need for technical assistance for alignment with Solvency II (development of risk management systems as well as the process of supervision of the same, including own risk and solvency assessment (ORSA) and tools developed for the implementation of stress-tests, quantitative impact study (QIS) and similar). During the time of the creation of this document, still it was not received feedback.

Furthermore, the Agency was a beneficiary of a short project of the World Bank supported by the European Union in the framework of which obtained the proposal of the framework road map whose results were used in this strategic framework, during the defining of the directions of action of the Agency and the questionnaire: "Qualitative impact study of Solvency II".

Also, the activities of education of the employees are initiated in the Agency on the topic of implementation of the qualitative requirements of Solvency II and raising awareness among insurance companies in this regard. Several working meetings were held with the representatives of the FBiH Insurance Supervision Agency and the Insurance Agency in BiH.

To develop awareness among insurance companies and following the Conclusion of the Government of the Republic of Srpska from the 176th session held on 30 June 2022, the Agency organized education on the need and benefits of timely preparation for the future regulatory requirements based on Solvency II on the topic: “Own assessment of risk and solvency of insurance companies. The education was attended by the persons in the highest positions in the organizational structures of insurance companies (members of management boards, directors, executive directors).

5. DIRECTIONS OF AGENCY ACTIONS IN THE FOLLOWING PERIOD

Bearing in mind that, after the adoption of the law based on Solvency II, insurance companies from the Republic of Srpska will have an obligation that in the short term align their operations with the new regulatory requirements, which are conceptually different from the current ones, the Agency considers that it is necessary to carry out prior activities to raise awareness of the need for a new approach to the business of insurance companies and to supervise them. The aforementioned need exists regardless of whether the alignment of the legal framework with Solvency II will be carried out in stages or not.

Based on the Agency's knowledge of the results of the previously conducted activities, the current level of development of the insurance sector and the framework recommendations obtained within the project of consultancy support for the insurance market in BiH, financially supported by the World Bank and the European Union, the Agency's directions of action are aimed at achieving two goals, namely:

- In the short term – preparation for the implementation of qualitative requirements of Solvency II, with considering the possibilities for improvement of capital requirements - based on one's assessment of risk and solvency and a more cautious approach in asset valuation and
- In the long term – preparation for the application of the new capital standards based on the so-called Pillar I of Solvency II, primarily by conducting quantitative studies of the impact of individual and/or all requirements.

The aforementioned directions of action of the Agency do not prejudge the dynamics of the adoption of the new law and its scope, but they can be dynamically harmonized with the regulatory determination and concept.

For the realization of the set goals of implementation of the activities defined by this strategic framework, but also generally of the final implementation of Solvency II, it is necessary:

- Conducting of "*gap*" analysis based on the questionnaire "Qualitative study of the impact of Solvency II" developed within the project of consultancy support for the insurance market in BiH, financially supported by the World Bank and the European Union;
- Conducting the stress test of the financial capacity of the insurance companies and insurance sector on the possible internal and external impacts but also for raising awareness in the insurance companies on the risks which may negatively influence their solvent position;
- The preparation for the implementation of the Solvency II qualitative requirements with a special focus on the ORSA process (Workshops and consultancy assistance related to the practical aspects of the implementation of the ORSA process). It is possible that for these activities it will be necessary to plan the investments of the Agency, considering that by the end of 2023, it will be adopted a new law and that the deadlines for obtaining concrete technical assistance in that segment will be quite long.

- Coordinated action with the Ministry of Finance of the Republic of Srpska regarding the mutual reconciliation of the timetable for the implementation of transition activities and alignment with Solvency II;
- Realize operational cooperation with the insurance companies from the Republic of Srpska, where the special segment of cooperation could be the forming and action of the working group of the Agency's representatives, Associations of the Insurance Companies of the Republic of Srpska and the Associations of the Actuaries of the Republic of Srpska for the preparation of the introduction of Solvency II, including also the assessment of quantitative effects/impacts of implementation of Solvency II on insurance companies and insurance sector in the whole;
- Achieve coordinated action with the Insurance Supervision Agency of the Federation of Bosnia and Herzegovina in implementation;
- Strengthen coordination with other supervisory and regulatory bodies in the Republic of Srpska, BiH and abroad and
- Continued monitoring of the regulatory changes in the insurance sector in the European Union and accordingly the revision and amendments of this strategic framework.

Obtaining and realization of international projects of technical and/or financial assistance would give an additional development impulse and make this process more efficient and more effective and in this sense, support of other relevant institutions during the application for this kind of project would be necessary.

The conduction of the activities from this strategic framework will be specified in the Agency's work program for the coming year.

The realization of the activities defined by this strategic framework starts on the day of its adoption and lasts until the identification of the necessities for revision of the mentioned strategic directions and for that purpose adoption of a new strategy for the transition to Solvency II, independently of the regulatory dynamics.

Bearing in mind the importance and complexity of Solvency II, the need of engaging important expert and financial resources and the ability to obtain new recommendations related to the accession process of Bosnia and Herzegovina to the European Union, it is possible to anticipate the need for adoption of the comprehensive Strategy with the Action Plan and the quantification of the effects and for that technical assistance is necessary which the Agency has already initiated.

The strategic framework of the preparation of insurance companies in the Republic of Srpska for the transition to the regulatory framework based on Solvency II will be published on the Agency's Internet site, to be available to all stakeholders.