INSURANCE AGENCY OF REPUBLIC OF SRPSKA

АЗОРС
Агенција за осигурање
Републике Српске

STRATEGIC FRAMEWORK FOR PREPARATION FOR TRANSITION TO REGULATORY FRAMEWORK BASED ON SOLVENCY II

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Contents

1. INTRODUCTION

This document represents the strategic framework within which the Insurance Agency of Republic of Srpska (further: Agency) will act while preparing the insurance or reinsurance companies (further: insurance companies) for transition to business aligned with the regulatory framework based on European Union Directive 2009/138/EC (Directive on taking-up and pursuit of the business of Insurance and Reinsurance – further: Solvency II).

The strategic framework for preparation for transition to Solvency II starts with competences of the Agency prescribed by law, without prejudice to timelines of change and adjustment of insurance regulatory framework in the Republic of Srpska with Solvency II requirements.

Starting with the fact that regulatory framework based on Solvency II, is conceptually significantly different compared to the regulatory framework within which insurance companies in the Republic of Srpska currently operate (Solvency II) and that for the compliance with Solvency II requirements in the European Union countries a longer preparatory period and additional resources (financial, personnel and technical) were necessary, this document defines the priority activities of the preparation for the transition period and business adjustment/implementation with new regulatory requirements.

This strategic framework anticipates a cautious and gradual approach of preparation for transition to a new regulatory framework, in order to create possibilities so that:

- Insurance companies gradually develop their abilities and possibilities for Solvency II implementation and

- The Agency develops its own supervisor capacities for implementation of its own jurisdictions according to Solvency II, in cooperation and coordination with all relevant local and foreign institutions.

The activities defined by this strategic framework represent the first, that is the preparatory stage, and only after adopting the new regulatory framework, it will be necessary to determine and conduct the implementation and transition activities to Solvency II.

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

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

Directive 2009/138/EC represents the first level of rules for insurance business in the European Union, which the member countries adopt in national regulatory rules.

The regulatory framework Solvency II, besides the Directive 2009/138/EC, includes the European Commission acts and measures for its implementation too, which have direct application in the European Union member countries and provide full harmonization of the rules which regulate the insurance business. Beside it, the European Commission, on the proposal of the European Insurance and Occupational Pensions Authority (EIOPA) adopts technical standards for application. The acts and measures for implementation and technical standards represent the second level of rules that regulate the insurance business in the European Union. The third level of the Solvency II regulatory framework represents guidelines issued by EIOPA, that provide consistent application of the rules and cooperation between the European Union member countries. Although the guidelines are not binding, it is necessary to elaborate the reasons for which one does not act in accordance with those guidelines..

In the previous period, insurance business in the European Union was regulated by a great number of directives from the Solvency I framework, with whom a gradual harmonization of the rules for insurance business in the previous decades was made. During the application of the Solvency I regulatory framework, among numerous advantages, certain deficiencies were identified. Those are: the accent was on accounting and not on market values, it was not stimulating enough for insurance companies to adequately manage risks and investments, the capital adequacy indirectly included only the insurance risk, while the other risks were neglected, all barriers for the timely intervention of the supervisor were not removed, the adequate capital allocation was not completely provided and not enough attention was paid to the group supervision.

Solvency II replaced thirteen directives of the Solvency I framework and the key changes are related to new solvency and risk management rules, that frequently connote with the term of Solvency II. This regulatory framework is based on the obligation to recognize and valuate all risks that the insurance company is exposed to and to manage those risks, as well as the possibility of pre-emptive action of the supervision/regulatory authority. The main goals of Solvency II are protection of an insured person, making solvency margins that will represent a total exposure to all the risks, early recognition of the market changes, based on principles and not on strict rules. Solvency II is a continuation of the “new regulation” that started with introduction of Basel II as new rules of measuring the capital requirements of the banks.

The base of Solvency II is made of three interrelated units that are three pillars:

I – pillar: Quantitative requirements

This pillar reffers to set of quantitative requirements that the insurance company has to meet in order to protect the interest of the insured persons, that is the insurance users, as well as to provide a stable and secure business. The quantity requirements are related to harmonization of the valuation standards instead of former strict quantity limitations and requirements. These regulatory requirements are related to valuation of property and obligation, technical reserves and own assets, and establish two levels of capital requirements: the necessary capital for solvency/solvency limit (*SCR-solvency capital requirement*) and minimum necessary capital (*MCR-minimum capital requirement*).

The solvency capital requirement (SCR) is a capital level that needs to enable the insurance company to cover all obligations on the basis of the insurance contract and to keep solvent business with regard to risks covered, while minimum necessary capital represents a lower limit of necessary insurance company capital. Between these two levels, the supervision authority will, if needed, enact legal measures.

II – pillar: Qualitative requirements

The second pillar reffers to so-called quality requirements, that is the development of comprehensive management system that includes internal audit, risk management, actuarial function, compliance function and internal control. The insurance companies are obliged to conduct their own evaluation of risk exposure (ORSA-Own Risk Solvency Assessment) and to identify the risks that the rules for calculating capital adequacy fail to recognize, but are important for business.

III – pillar: Transparency

The third pillar is based on disclosure and transparency in order to reinforce market mechanisms and risk based supervision. The aim is to give to insured persons, investors and other interested parties an overall view about the insurance companies' risks. Namely, this regulation set emphasizes importance of market discipline, business transparency and supervisors reporting.

The mentioned characteristics of the Solvency II regulatory framework imply that it represents a completely new concept in calculating capital adequacy of insurance companies and new comprehensive approach to risk management within insurance companies, which also requires a change of supervisory approaches.

Therefore, it is necessary to, starting with the actual situation in the insurance sector, undertake the activities that create presumptions for gradual transition into a new and more complex regulatory framework, together with considering the needs for previous activation of conservative measures for increasing the capital of insurance companies.

The Agency gives operational support to the process of accession of Bosnia and Herzegovina to the European Union with realization of preparation activities of insurance companies in the Republic of Srpska to achieve transition to the regulatory regime based on Solvency II.

3. SITUATION OF INSURANCE SECTOR IN REPUBLIC OF SRPSKA

In order to ensure careful and gradual transition to Solvency II, preparation priorities for transition to Solvency II need to be based on the actual situation of insurance companies in the Republic of Srpska, that is, the insurance market in the Republic of Srpska. In this regard, the data on insurance market development in the Republic of Srpska and complete financial capacity and human resources of insurance companies with headquarters in the Republic of Srpska are presented here.

Development level of insurance market

On insurance market of the Republic of Srpska, on the day of creation of this document, operated twenty five insurance companies, from which fourteen insurance companies with headquarters in the Republic of Srpska and eleven insurance companies with headquarters in the Federation of Bosnia and Herzegovina which conduct insurance activity in the Republic of Srpska via branch offices.

Twenty two of a total number of insurance companies conducted business in the type of obligatory automobile liability insurance and eight of them conducted business in the type of life insurance. The business of insurance in all types of non life insurance conducted twenty four insurance companies.

On insurance market of the Republic of Srpska exists a fairly strong competition, what can be seen from all competition indicators, that is indicators of concentration on the market. In that regard, it is emphasized that the trend of reduction of Herfindahl Hirschman index is present on the whole insurance market, as well as on the insurance market for automobile liability insurance as the largest section of the insurance market in the Republic of Srpska. Herfindahl Hirschman index in 2017 was 620 points if we take into account all types of insurance, and 775 points on automobile liability insurance for motor vehicles. On a low level of concentration on the insurance market implies an arrangement of insurance companies according to peer groups too. Namely, none of the insurance companies did not achieve participation in the market more than 10%, while seventeen companies had participation less than 5% and eight of them were in the peer group from 5% to 10% participation in the total calculated insurance premium.

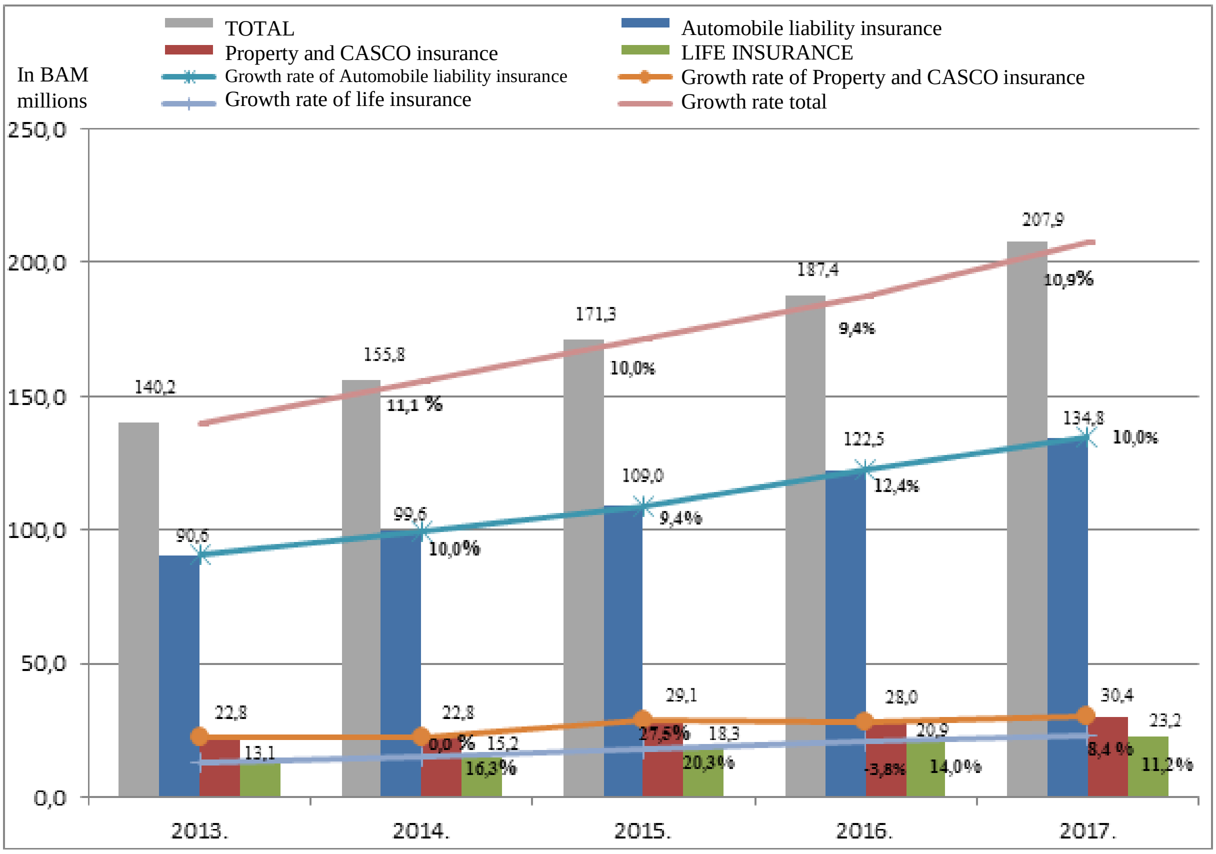
Insurance premium in GDP (Gross Domestic Product) with approximately 2% is roughly on the same level as in the other surrounding countries with the similar development level of the insurance market. The premium per capita still did not reach the amount of €100 and it is constantly lower, compred to the developed insurance markets, as well as the developing ones.

Financial capacity and business of insurance companies with headquarters in Republic of Srpska

Insurance companies with headquarters in the Republic of Srpska have written a premium of BAM 207, 9 million in 2017, which is 10, 9% more in relation to 2016. In the period from 2013 to 2017, nearly the same annual growth rate of insurance market was registered in amount of about 10%.

In the total written premium, the insurance premium for motor vehicles liability is dominant, which in 2017 was BAM 134, 8 million and within which the obligatory automobile liability insurance premium participates with 99,6%. Life insurance premium in 2017 was BAM 23, 2 million. Notwithstanding the high annual growth rate, life insurance premium still did not reach participation of 20% in total premium. In the following chart, change of the total written premium and written premium for the type of insurance with significant participation in total written premium in the period of 2013-2017 is shown.

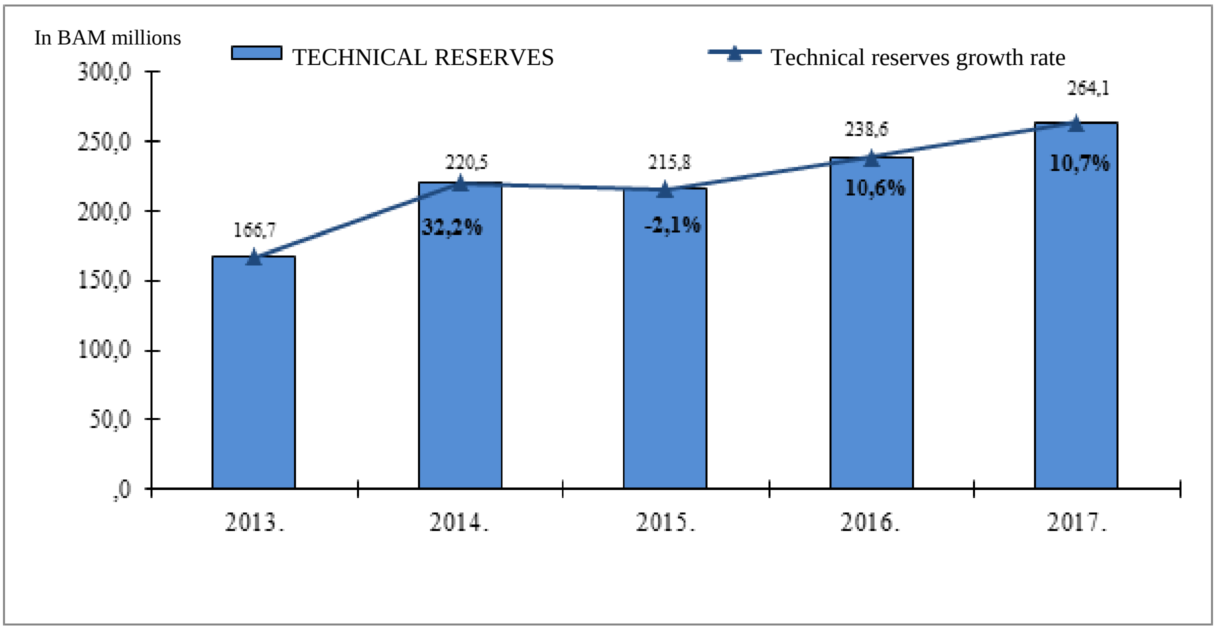
Chart 1. Total written premium and premium with the biggest participation in the period of 2013-2017 in BAM millions



Total available capital of the insurance companies, calculated upon Solvency I requirements, with balance on 31.12.2017. was BAM 92, 3 million. The surplus of available capital in relation to treshhold value of available capital adequacy of BAM 25, 9 million (or 39%) was shown, from which BAM 22, 9 million in non life insurance (or 40%), that is BAM 3 million surplus in life insurance (or 31%).

Classic/standard actuary methods are used for calculation of technical reserves and their amount with growth rates in the period of 2013-2017 is shown in the following chart.

Chart 2: Total calculated technical reserves of all insurance companies in Republic of Srpska in BAM millions



In the structure of investments of assets covering technical reserves of non life insurance, the most significant participation have term deposits (35%), real estates (24%) and securities (22%), while in the structure of investments of assets covering technical reserves of life insurance, the most significant participation have securities of local issuers (88%). Investments in securities, primarily in Republic of Srpska bonds, record constant growth, with a decrease of investments in a term deposits.

Foreign capital share in the total capital of the insurance companies with headquarters in the Republic of Srpska was 41%. Insurance companies with majority foreign capital hold 56% of the total asset and 43% of gross invoiced premium.

Human resources

Experiences of the surrounding countries and other member countries of the European Union during Solvency II implementation, due to conceptual difference in relation to Solvency I, show that investments are necessary in human resources development. This segment will be subject of a special analysis of preparation for fulfilling quality requirements of Solvency II, therefore for the purpose of introduction only actual data on the number of employees in insurance companies and the way of functioning of actuary role are given.

On 31.12.2017. in insurance companies with headquarters in the Republic of Srpska there were 1.446 employees, of which 50% are employees with completed secondary education, 38% with university degree and 12% of other employees.

Actuary role in insurance companies functions as internal and external. An external role may perform persons with authorization from the Agency for performing actuary jobs and who are registered in the register of authorized actuaries. On 31.12.2017. in the Register of authorized actuaries at the Agency 36 persons were registered. The rules for external, that is authorized actuaries of insurance companies, are prescribed by law. Authorized, that is external actuaries are not constantly present in insurance companies; they are obliged to give their opinion about annual financial reports, actuary acts of business policy and their application, as well as an opinion on the calculation and investment of assets covering technical reserves, fulfillment of the requirements for capital adequacy etc.

Additionally, insurance companies are obliged to employ at least one person to constantly perform actuary jobs in the insurance company. Considering Solvency II requirements, it can be expected that the development and strengthening of the role of the internal actuary function will be necessary, together with the development of other functions of the management system.

4. *PREPARATORY ACTIVITIES FOR TRANSITION TO BUSINESS ACCORDING TO SOLVENCY II REQUIREMENTS*

Having in mind that, after adopting the regulations that will require performing insurance business according to Solvency II, the insurance companies from the Republic of Srpska will be obliged to adjust its business with new regulatory requirements, which are conceptually different in relation the actual ones, it is necessary to conduct the activities of stage adjustment and implementation of Solvency II.

In order to minimize potentially negative effects of transition to a new way of business, that is to create preconditions for optimization of the process of adjustment of the Republic of Srpska insurance companies business with new regulatory requests, the following priorities of Agency activities are determined:

1. Analysis of the possibility of exclusion of Solvency II implementation on small insurance companies,
2. Gap analysis of insurance companies' capacities for implementation of of Solvency II quality requirements and
3. Evaluation of quantity effects/influences of Solvency II implementation on insurance companies and insurance sector as a whole.

4.1. Analysis of possibility of exclusion of Solvency II implementation on small insurance companies

Solvency II contains conditions, so-called small insurance companies need to fulfill, in order to be excluded from its implementation. Those insurance companies can operate within one country and their license is not being treated as "European passport". Evaluation of influence of Solvency II regulations on small insurance companies, namely the possibility of their exclusion from an implementation, should represent the first step while identifying preparatory activities for entering the stage of harmonization with the new regulatory framework.

It is necessary to make an analysis of influence of Solvency II regulations which determine exclusion of application on small insurance companies, on the insurance sector of the Republic of Srpska, that is, to identify whether there are insurance companies on the market that will be excluded from business according to Solvency II regulations. Projections to meet the conditions for exclusion from the Solvency II implementation should be a component part of this analysis.

Evaluation of the effects and possibilities that insurance companies from the Republic of Srpska, with lower market share, adjust their business to prescribed exclusion conditions of Solvency II, is one of the assumptions for optimization of preparation for a transition period.

4.2. Gap analysis of insurance companies' capacities for implementation of Solvency II quality requirements

Having in mind that Solvency II sets quality, as well as quantity requirements for insurance companies and that fulfillment of quality requirements is assumption for successful quantitative requirements fulfillment, it is first necessary to make preparation of insurance companies for the process of compliance with quality requirements.

Identifying readiness and capacities of the insurance companies from the Republic of Srpska for fulfillment of basic quality requirements of the so-called second pillar of Solvency II is a starting assumption for beginning of adjustment with complete requirements of Solvency II. For that purpose it is necessary to determine a level of understanding of Solvency II concepts and changes that it brings, as well as to analyze development level of actuary function and the actual way of conducting activities from the scope of other functions from the management system of Solvency II. The Analysis should have, as a result, identification of starting state in the insurance companies, indicating their understanding of Solvency II and development of functions needed to fulfill new requirements.

Determination of priorities for preparation for entering into a process of adjustment and implementation of Solvency II and optimization of this process is this activity's main goal.

This analysis should include insurance companies from the Republic of Srpska that constitute a representative market pattern with tendency to cover all insurance companies from the Republic of Srpska, in order to raise levels of reliability of the assessment and to enforce more efficient preparation of the whole sector for implementation and transition to Solvency II.

4.3. Evaluation of quantity effects/influences of Solvency II implementation on insurance companies and insurance sector as a whole

Evaluation of quantitative effects/influences of Solvency II on insurance companies from the Republic of Srpska and insurance sector as a whole should enable an overview of financial position and capital adequacy of insurance companies after implementation of quantitative requirements, so-called the first pillar of Solvency II.

This evaluation should be conducted by stages. In the first stage, it is necessary to make an evaluation of influence of quantitative requirements of the first pillar of Solvency II on capital adequacy and technical reserves of insurance companies and sector as a whole, while in the following stages the evaluation should expand on the balance approach, the value of property and obligations, as well as on the evaluation of the influences of all quantity regulations of Solvency II.

Purpose of conducting the mentioned evaluations is to enforce insurance companies and the Agency to gradual preparation for the process of adjustment and implementation of Solvency

II, as well as the starting estimation of the capacities of the insurance companies from the Republic of Srpska for implementation of Solvency II.

Depending on disposable time that will arise from planned dynamics of adopting legal framework in the Republic of Srpska based on Solvency II and time left for adapting to the new legal requirements, possibility for segmented or complete additional evaluation of quantitative requirements of the first pillar of Solvency II stays open, which will be based on data relevant on the day of new evaluation.

Evaluation of influences of quantitative requirements of the first pillar of Solvency II should be based on insurance companies with headquarters in the Republic of Srpska, which constitute a representative market pattern with tendency for evaluation to include all insurance companies in order to raise levels of reliability of the evaluation and enforce more efficient preparation of the complete sector for implementation and transition to Solvency II.

5. ASSUMPTIONS OF IMPLEMENTATION OF PREPARATORY ACTIVITIES FOR TRANSITION ON BUSINESS ACCORDING TO SOLVENCY II REQUIREMENTS

In order to conduct the activities defined by this strategic framework as efficient as possible and implementation of Solvency II in general, it would be necessary:

- Harmonized action with the Ministry of Finance of Republic of Srpska about mutual coordination of a term plan for conducting activities of transition and adjustment with Solvency II;
- To achieve operative cooperation with insurance companies from the Republic of Srpska, while a special section of collaboration should be forming and acting of Work group of representatives of the Agency, the Association of Insurance Companies of Republic of Srpska and the Actuarial Association of Republic of Srpska, for assessment of quantitative effects/influences of implementation of Solvency II on the insurance companies and insurance sector as a whole;
- To plan additional investments of the Agency for the preparation and implementation of Solvency II in the Republic of Srpska (funds for education and seminar organization, as well as development of the existing or transition to a new information system etc.);
- Accomplish harmonized action with the Agency for the insurance supervision of the Federation of Bosnia and Herzegovina in realization;
- To strengthen coordination with other supervisory and regulatory authorities in the Republic of Srpska, Bosnia and Herzegovina and abroad and
- Continuous following of regulatory changes in the European Union insurance sector and revision and amendments of this strategic framework accordingly.

Obtaining and realization of international projects of technical and/or financial help would provide additional development impulse, making this process more efficient and effective, and in that sense support of the Insurance Agency in Bosnia and Herzegovina and other relevant institutions when applying for such projects would be necessary.

Conducting activities from this strategic framework will be specified within the Agency’s work program for following years, while certain realization sections will be included in realization of the recommendations of FSAP mission, consistent with Solvency II.

Realization of activities defined by this strategic framework begins on the day of its adoption and lasts until adoption of the new legal framework, that is until the beginning of the defined period for adjustment to new legal framework based on Solvency II.

Having in mind significance and complexity of Solvency II, the need for engaging significant professional and financial resources, and possibility of receiving new recommendations related to the process of accession of Bosnia and Herzegovina to the European Union, it is realistic to foresee the need for change and amendment of this strategic framework too.

The strategic framework for preparation of insurance companies in the Republic of Srpska for transition to regulatory framework based on Solvency II will be published on the website of the Agency, in order to be available to all interested parties.