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DEPLOYMENT EFFECTS OF THE SOLVENCY II PRUDENTIAL INDICATORS ON ROMANIAN INSURANCE COMPANIES

Gabriela BILEVSKY, PhD
Institute for Economic Forecasting, Romanian Academy
gbilevsky@gmail.com

Abstract: *This paper shows the extreme way in which three Romanian insurance companies went through important economic-financial moments between 2004-2016 (Romania's accession to the EU starting January 1, 2007; the economic-financial crisis of 2008- 2010; introduction and application of the new system of macro prudential supervision Solvency II from January 1, 2016). The evolution of these companies is studied based on the main financial indicators in the Annual Financial Reports of each company. The three companies chosen are: ABC Asigurări which has the lowest market share, Asito Kapital which has undergone changes in the total structure of the shareholding and Carpatica - a company declared insolvent, in bankruptcy procedure, concluding with the withdrawal of the company's operating license as of 27.07.2018.*

Keywords: *SOLVENCY II, financial insurance evolution, Romanian insurance companies*

JEL Classification: *G19, G20, G22, G28*

1. Introduction

The challenges of the insurance companies determined by the global economic and financial crisis of 2008 have brought to the fore the necessity to deepen the existing studies (Order no. 3105/2005. 12; European Commission, 2002; Jakubík and Teplý, 2008; Sandström, 2005) on the risks to which they are subjected, and their more rigorous and detailed classification by taking into account their complexity and diversity in a integrative approach (Eling and Schmeiser, 2010; Kočović, 2009; Larosière Report, 2009; Ryan et all., 2001; Schich, 2009; The Financial Supervisory Authority, 2019) to enable systemic risk prevention. Insurance companies, by managing the risks of economic activities, are part in the continuous economic processes in industry and agriculture, and in the stimulation of international trade and cooperation. Also, through investments on the capital market, they contribute to the development of the credit and the financing of some economic projects. In addition, insurance companies are financing actions to prevent and combat damage-generating events, thus contributing to maintaining the integrity of the property, stimulating domestic and international tourism through its forms of civil liability and personal insurance.

Solvency II (New Macro prudential Supervision Requirements), the new European Union regulations, have been developed with the purpose of harmonizing the methodologies of the member countries, increasing the degree of protection of the beneficiaries and the financial stability by introducing an efficient risk management. These regulations are included and implemented from January 1, 2016 also in Romania (Mǜller Report, 1997) regarding the authorization and supervision of the insurance and reinsurance activity (Solvency II supervision regime). According to Solvency II, it was necessary to increase the requirements for setting up the technical reserves and those regarding the capital requirement, taking into account the risks assumed by the insurance companies from both the investment perspective and the subscriptions. At the same time, some changes were made regarding the solvency requirements and the method of verifying the "total balance" for the measurement of risks was introduced.

In this solvency regime II, the size of the capital is not the only way to mitigate the failures. Compared to the previous EU solvency requirements, which focused mainly on the liabilities side (insurance risks), Solvency II takes into account the risks related to the assets, meaning all their risks and their interactions. In this respect, insurers are required to hold capital against market risk (regarding lowering the value of insurers' investments), credit risk (for example when third parties cannot repay their debts) and operational risk (for example the risk of systems breakdown or malpraxis). Until 2016, those risks were not covered by the EU prudential regime. For the first time, insurers are required to focus specifically and devote significant resources to identify, measure and actively manage risks.

Therefore, the minimum capital requirement (MCR) is set up, which has been increased in order to cover all possible risks. Its calculation formula, as well as the other qualitative indicators, are provided in the legislation for implementing the solvency regulations II (According to the regulations, the Minimum Capital Requirement (MCR) is calculated based on the formula: MCR = max ($MCR_{combined;}$ AMCR) - Law 237/2015, $MCR_{combined}$ = min (max (MCR_{linear}; 0.25 * SCR); 0, 45 * SCR), where SCR is the Solvency Capital Requirement (Delegated Regulation 2450/2015).

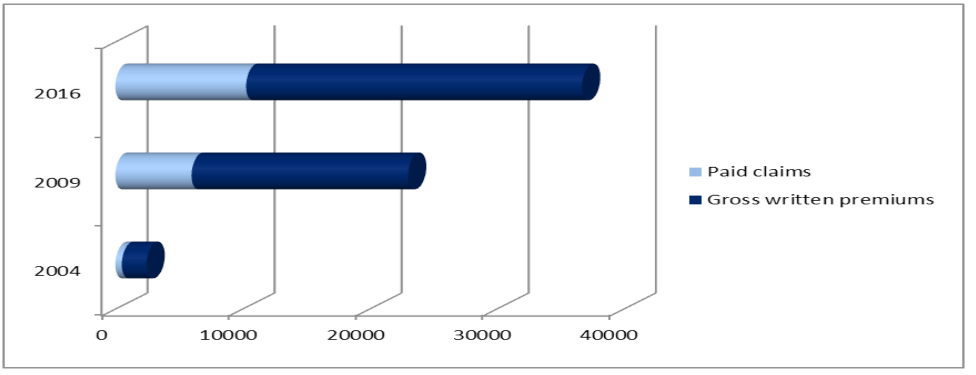
In the same context, the Solvency Capital Requirement (SCR), which represents the sum of the funds that the insurance and reinsurance companies in the European Union must have, is also established. It is based on a value-at-risk (VaR) calibrated formula at a 99.5% confidence level, which takes into account all quantifiable risks, including general underwriting, life underwriting, health underwriting, market, credit, operational and counterparty risks and covers both existing and new business during 12 months, being recalculated at least once a year.

The rates regarding the requirements of the solvency capital requirement (SCR) and those regarding the minimum capital requirements (MCR) on the Romanian insurance market were supraunitary at the end of 2016, as shown in the The Financial Supervisory Authority Report (2016, p. 27), indicating that the insurance market did not face an insolvency risk situation.

2. ABC Insurance –Reinsurance

ABC Insurance-Reinsurance is an insurance company established in 1997, with a fully Romanian share capital. In 2000, the regulator at that time—the Romanian Insurance and Reinsurance Activity Supervisory Office (OSAAR) —requested an increase in the company's capital, which was the reason behind the subsequent diversification of its shareholding. This company's object of activity is the conclusion of non-life insurance policies, and since 2005 (ABC Insurance, 2018), the company has been authorized to offer compulsory civil liability insurance policies for car owners (Ro: RCA), thus becoming a member of the Romanian Automotive Insurers' Bureau (BAAR) in 2006. During the analyzed period, 2004-2016, the value of the indemnities and gross written premiums registered an ascending trend, as shown in Figure 1.

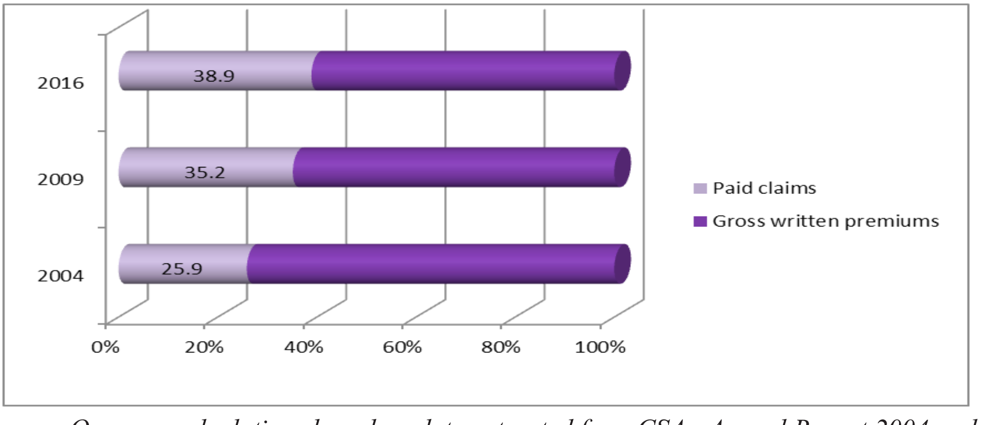
Figure 1. The paid claims and gross written premiums to ABC Insurance-Reinsurance (thousands lei RON)



Source: Data extracted from CSA- Annual Report 2004 and Annual Reports of ABC Insurance –Reinsurance Company (2009, 2016, 2018), (ASF, 2016)

The gross indemnities paid by ABC Insurance-Reinsurance in 2004 were 25.9% of the gross written premiums, the ratio reaching 35.2% in 2009 and 38.9% in 2016 (Figure 2).

Figure 2. The share of paid claims in gross written premiums for ABC Insurance-Reinsurance (%)



Source: Our own calculations based on data extracted from CSA - Annual Report 2004 and Annual Report of ABC Insurance - Reinsurance Company (2009, 2016) 2018), (ASF, 2016)

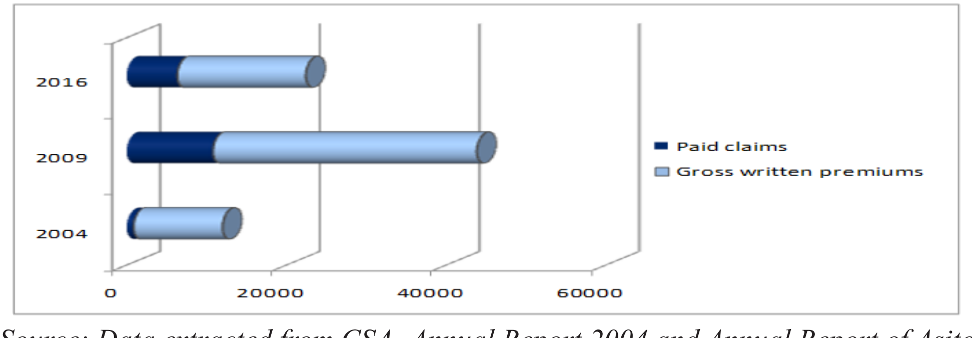
This company's net profit has shifted over the years, also reaching negative values, with losses of hundreds of thousands of Ron in 2006 (Ron 773.7 thousand), in 2011 (Ron 395.5 thousand) and in 2013 (Ron 262.9 thousand).

Starting with 2015, the company management decides to withdraw the company from the RCA market, and changes the development strategy in order to obtain profit. At the end of 2015, the company earns the highest gross profit since establishment, namely Ron 2.3 million, followed in 2016 by a 30% decrease in profit compared to 2015. In order to meet risk management conditions (Solvency II), in 2016, ABC Insurance-Reinsurance (Mùller Report, 1997) has a registered and paid up share capital of Ron 19.7 million, owning sufficient capital pursuant to SCR (Solvency Capital Requirement) and MCR (Minimum Capital Requirement), resulting in a solvency ratio of 1.57 (Order no. 3105/2005). Of the companies selected for analysis, ABC Insurance-Reinsurance is the smallest, which gives a realistic picture of the ample range of the most long-lived players on the Romanian insurance market between 2004 and 2016.

2.1 ASITO KAPITAL S.A.

Insurance-reinsurance company established initially as Lukoil Asito in 1998, with the purpose of supporting the Romanian businesses and securing the Romanian assets of the Lukoil oil group. In 2011, 99% of the company is taken over by the Moldavian company Moldasig, for the amount of $3.1 million paid to British company Norcross Insurance Company Limited, and changing the name to Asito Kapital. The main objective of the insurance products offered by this company is to support various companies in their businesses by streamlining their investments and increasing their sales. The type of insurance policies they provide are general in nature. This company's written premiums registered spectacular changes, as shown in Figure 3.

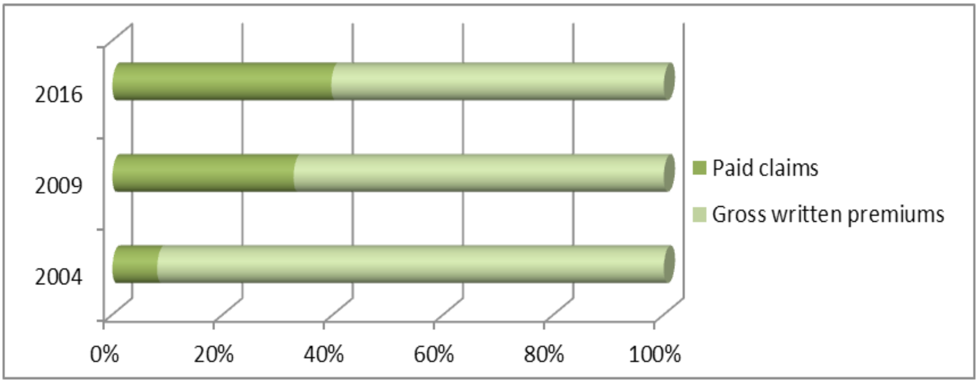
Figure 3. The paid claims and gross written premiums (thousands lei RON)



Source: Data extracted from CSA- Annual Report 2004 and Annual Report of Asito Kapital Company (2009, 2016), (ASF, 2016)

Gross indemnities paid in 2009 were 32.9% of the gross premiums written that year, but in 2016, in the context of a decrease in both gross written premiums and indemnities, the share of indemnities increases to 39.7 % (Figure 4).

Figure 4. The share of paid claims in gross written premiums from Asito Kapital (%)



Source: Our own calculations based on data extracted from CSA - Annual Report 2004 and Annual Report of Asito Kapital Company (2009, 2016), (ASF, 2016)

The company's net profit was RON 0.7 million in 2004; however, not all years were profitable: in 2009, the company registered losses of Ron 1.6 million. The only other negative year in the studied period was 2013, 28% lower than 2009, while the other years brought positive values until 2016. The 2016 deficit was Ron 1.35 million.

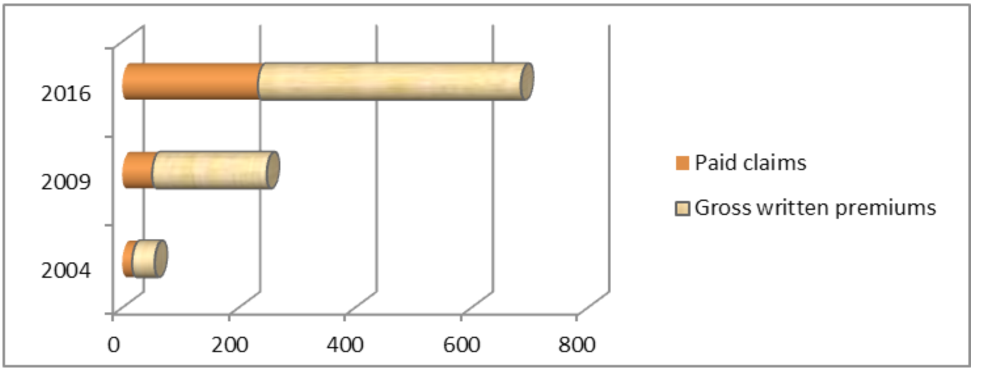
In this context, in 2015 the company was selected by the Financial Supervisory Authority for the assessment of its solvency and for verifying its compliance with the conditions imposed by the Solvency II framework. Initially, based on the balance sheet data up to 2014, Asito Kapital did not meet the Minimum Capital Requirement (MCR). The company management started a process in view of increasing the company's share capital by $1.35 million before the end of 2014.

This company's capital increased by 43% in 2015 compared to 2014, followed by another increase of 12.7% in 2016 compared to 2015, reaching Ron 20.6 million. Starting with 2016, the conditions imposed by Solvency II are met, with a SCR (Solvency Capital Requirement) of Ron 19.8 million and a MCR (Minimum Capital Requirement) of Ron 17 million.

2.2 Carpatica Asig

The company was established in 1996 under the initial name ASA Asigurari Atlassib, which was changed to Carpatica Asig in 2004. The evolution of the gross written premiums and gross indemnities paid (Figure 5) is due to the company's development strategy, especially in 2009, consisting in the promotion of compulsory RCA insurance policies. Between 2008 and 2009, Carpatica had a 15% share of the motor vehicle insurance market, the second player on the market after Euroins.

Figure 5. The paid claims and gross written premiums to Carpatica (millions lei RON)

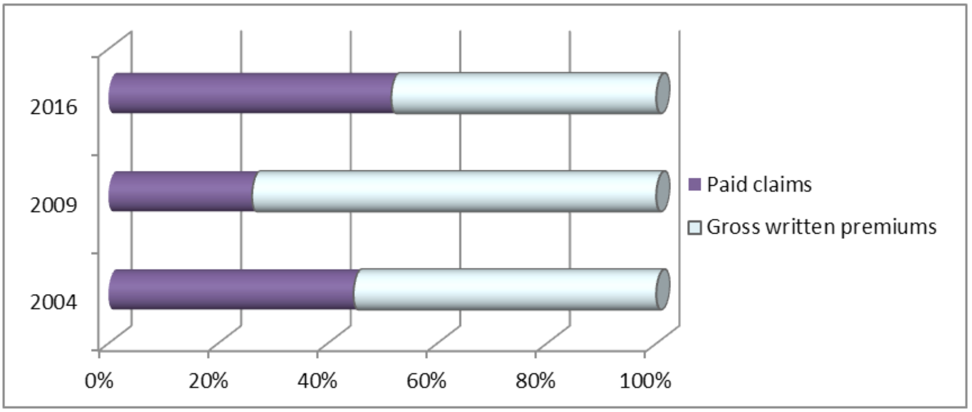


Sources: Data extracted from CSA- Annual Report 2004, Annual Report of Carpatica Company 2009, (ASF, 2016)

Carpatica is considered an aggressive player on the RCA insurance market; its revenue has increased, but also its losses. The gross indemnities paid in 2004 amounted to Ron 17.3 million, accounting for a 44.8% share of the total subscribed premiums, which was fairly high at that time (Figure 5, Figure 6).

Gross indemnities paid in 2009 were 26.2% of the gross premiums written that year, and in 2016 (The Financial Supervisory Authority -ASF, 2016), in the context of an increase in gross written premiums as well as indemnities, the share of indemnities increases to 51.7 % (Figure 6).

Figure 6. The share of paid claims in gross written premiums for Carpatica (%)



Source: Our own calculations based on data extracted from CSA- Annual Report (2004), Annual Report of Carpatica Company (2009), ASF (2016)

In this context, Solvency I requirements were not met by the Carpathians at the end of 2015, when it recorded an equity gap of Ron 690.4 million. In 2016 Carpatica remained in the negative segment of the requirements, with a further equity loss of Ron 613.7 million and a solvency margin of Ron - 615 million, with a sharp deterioration of its financial indicators. These conclusions are based on Mazars' 2015 Financial Audit Report, recognized by the Financial Supervisory Authority (ASF), followed by the Deloitte Assessment Report. According to the new Solvency II requirements, Carpatica does not meet MCR (Minimum Capital Requirement) and SCR (Solvency Capital Requirement), resulting in the need of a Ron 900 million capital injection. The company attempted unsuccessfully to solve its financial issues by trying to attract investors approved by the Financial Supervisory Authority (ASF) between 2015 and 2016.

From the Delloitte Report and the Compliance Report drawn up by the Policyholders Guarantee Fund (FGA), the Council of the Financial Supervisory Authority (ASF) concluded that resolution instruments (Mùller Report, 1997) are not applicable and terminates the recovery procedure, ascertains insolvency and initiates Carpatica's bankruptcy procedure (Decision 1498 / 27.07.2016), the process being concluded with the withdrawal of the company's operating license as of 27.07.2018.

The Financial Supervisory Authority (ASF) collaborated with the Policyholders Guarantee Fund to protect the interests of Carpatica policyholders and to support the stability and functionality of the insurance system. Carpatica's bankruptcy follows the resounding bankruptcy of Astra insurance company, with businesses of over Eur 200 million a year.

3. Conclusions

At the level of 2016, due to the requirements of the solvency regime II, there was an additional capitalization requirement of 1.2 billion lei in the insurance market, about 16% of the volume of gross premiums subscribed in 2015. In the same context, the indicator Solvency Capital Requirement (SCR) of the insurance companies increased by about 8% as a result of the growth of the total assets of the insurance companies (The Financial Supervisory Authority -ASF, 2016), Solvency II implementation in Romania has generated a number of problems for most insurance companies, for small and medium-sized companies, especially monoline insurers, as in the case of the three companies analyzed in this study, which were among the most vulnerable.

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