Insurance Industry Perspectives Regarding the Implementation of Solvency II in Mexico

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New Solvency II Rules

LISF and CUSF Structure

General Overview of the Inquiry Process – Negotiating the LISF and the CUSF

Qualitative and Quantitative Impact Studies

Challenges of the Three Pillar Directive

Final Thoughts
1. New Mexican Solvency II Regulation
¿What is Solvency II?

Includes the capital adequacy revision project for the European insurance industry.

It will establish a new set of capital requirements and risk management standards in Europe.

Establishes requirements for reducing insolvency probability of insurers and reinsurers.

It’s a strengthened solvency regime that will diminish consumers losses, as well as problems in the insurance market operation.
**LISF`s Secondary Level Regulation**

**Solvency II Pillars**

**LISF General Structure**

- Risks:
  - Technical
  - Market
  - Credit
  - Liquidity
  - Concentration
  - Mismatch
  - Operative

**Solvency II**

- **Pillar I**
  - Technical Reserves
  - Capital Requirement
  - Investments
  - Reinsurance
  - Other Prudential Risks

- **Pillar II**
  - Corporative Governance
  - Risk Administration
  - Control and Internal Audit
  - Supervisory Powers

- **Pillar III**
  - Disclosure and transparency
  - Market Revision and Discipline

**Solvency**

**Control**

**Disclosure**
Pillar I – Risks Included

SCR

Underwriting Risk
- Life
  - Mortality
  - Longevity
  - Morbidity
  - Disability
  - Lapses
  - Catastrophic
  - Expenses

Underwriting Risk
- Heath and Accidents
  - From premiums/
    - From reserves
    - Mortality / Longevity
    - Disability
    - Disease / Morbidity
    - Catastrophic
    - Expenses

Casualty and Property
- Underwriting Risk
  - From premiums/
    - From reserves
    - Catastrophic

Market Risk
- Market
  - Interest rate
  - Equity
  - Spread
  - Exchange
  - Concentration

Counterpart
- Reinsurers
- Derivatives
- Other debtors

Operational Risk
- Operational processes
- Legal
- Technology
Pilar II – Supervision Process

Supervision process based on 6 basic principles

- Risk management and monitoring system
- Risk strategy and risk appetite
- Own Risk and Solvency Assessment (ORSA)
- Internal Control Function
- Actuarial Function redefinition
- Outsourcing
Pillar II – Corporate Governance

Accountability of

- Board of Directors
- Officers
- Internal Control

Responsibilities for

- Investments
- Reinsurance
- Retention Levels
- Reserves
- Models
- Stress Testing
- Audit
- Compliance

Corporate governance based on autoregulation that guarantees compliance.
Pillar III – Market discipline

Insurance and reinsurance companies must disclose relevant information to all market participants

Information characteristics
- Periodicity: at least once a year
- Policies and processes
- Confidentiality
- Internal and external audit

Information transparency based on:
- Information Policy (approved by the Insurance company officers).
- Quantitative and qualitative reports for the market.
- Disclosure based on pertinence and relevance. To privilege quality over quantity.

Rating
- Insurance company rate provided by a rating agency.
Solvency II Status / Europe and Latin America

Europe

Solvency II was postponed until January 1st, 2016 due to economic crisis. Long term guarantees issue

Latin America

Chile
Approved by the Senate, in discussion in the the deputy’s chamber, CBR Law. Implementation (3 to 5 years). Model’s analysis, 2 QIA studies performed

Peru
Advances in risk’s assessment regulation. Gap analysis of insurance sector. Beginning project of SII law

México
LISF was approved in 2013 and entered into force last April 4th. A transitory period was given for methodologies, SCR, BEL and Economic Balance to January 1st 2016

Brazil
Pillar I almost implemented Counterpart Risk’s regulation in process. BEL Reserves in force SUSEP’s Projects for Pillar II and Pillar III

Colombia
Solvency Capital Calculation for some credit and financial risks. Retrospective Reserves adequacy in force
## Natural Evolution of Regulatory Frameworks

<table>
<thead>
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<th></th>
<th>Solvency I</th>
<th>Transition</th>
<th>Solvency II</th>
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<tbody>
<tr>
<td><strong>Accounting</strong></td>
<td>Statutory</td>
<td>Convergence IASB / NIIF's / Economic Balance</td>
<td>Stochastic Models/ Internal Models</td>
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<tr>
<td><strong>Risk Models</strong></td>
<td>No</td>
<td>Risk Based Factors</td>
<td></td>
</tr>
<tr>
<td><strong>Risks Dependency</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Risks Measurement</strong></td>
<td>No</td>
<td>VaR (90-97.5%)</td>
<td>Tail VaR / VaR (99.5%)</td>
</tr>
<tr>
<td><strong>Financial Risk</strong></td>
<td>No</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Operative Risks</strong></td>
<td>No</td>
<td>Yes (Life)</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Stress Tests</strong></td>
<td>No</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Technical Reserves</strong></td>
<td>Retrospective Methods</td>
<td>Adequacy Actuarial Models</td>
<td>Prospective Methods</td>
</tr>
<tr>
<td></td>
<td>Unearned Premium % S/ Premium // 365avos</td>
<td>Adequacy Actuarial Models</td>
<td>Best Estimator (BEL) + Risk Margin</td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td>Quantitative Limits</td>
<td>Investment Policy</td>
<td>Credit Qualifications</td>
</tr>
<tr>
<td><strong>Reinsurance</strong></td>
<td>No</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>ORSA (Self Risk Assessment)</strong></td>
<td>No</td>
<td>Partial</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Corporative Governance</strong></td>
<td>No</td>
<td>Partial</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Information Disclosure</strong></td>
<td>No</td>
<td>Partial</td>
<td>Yes</td>
</tr>
</tbody>
</table>
2. LISF (law) and CUSF (secondary level regulation)

*Ley de Instituciones de Seguros y Fianzas (LISF)* - Insurance and Surety Institutions Law  
*Comisión Nacional de Seguros y Fianzas (CNSF)* - National Insurance and Surety Bond Commission
Mexican Insurance and Surity Law

The LISF’s initiative was dictated by the Finance and Public Credit Commission in the Senate.

December 11th 2012
The Senate voted and approved the Law and sent it to the Deputies Chamber

December 13th 2012

February 28th 2013
Approved in Deputies Chamber

April 4th 2015
Entry in to force

April 4th 2013
Publication in the Official Journal of the Federation

A Transitory period for January 1st 2016 was provided for SII methodologies application for SCR, BEL calculation and Economic Balance

First LISF Project, from August 2018. At that time negotiations started
**LISF Elements**

*LISF* contains provisions in order to achieve the following:

1. More precise **Capital Requirements**.
2. Solid **Corporative Governance**.
3. Better **Risk Management**.
4. A more in depth review by the **Insurance Supervisor**.
5. Greater **transparency** and information **disclosure**.
3. General Summary of the Inquiry – Negotiation Process
On December 19th 2014, the Integral Insurance and Surety Regulation (Circular Única de Seguros y Fianzas, CUSF) established the legal framework for the 3 Pillars, which entered into force in April 2015.

The CUSF consultation process, which concluded October 2014, implied three main processes:

1. The consultation (negotiation) process for the proposed Secondary Regulation (CUSF) Project issued by the National Insurance and Surety Commission (CNSF) and that stem from the LISF

2. Carry out Quantitative Impact Studies

3. Carry out Qualitative Impact Studies
CUSF Consultation Process
1540 comments & 67 letters
Topics covered in the Three Pillars
• SCR Formula for the three EIQ’s
• Corporate Governance
• Disclosure of Commissions
• Outsourcing
• Investments Rules
• Special Funds of Insurance

14 additional topics were negotiated with the CNSF prior to sending the CUSF to COFEMER:
Deductibles and copayments in micro-insurance, catastrophic reserves investment, Certification Center of Agents operational issues, process and dates to register products and technical provisions methods.

Identifying Priority Issues to Negotiate with the Ministry of Finance:
• Quantitative requirements (RCS model methodologies and stabilization )
• Accounting Items / Economic Balance
• Commissions Disclosure
• Product Registration (Major Medical Expenses benefit period)
• Transitory periods
• Insurance Sector Development Agenda

5 additional topics agreed with the CNSF:
• Product registration process, among these additional time, until December 2015, to instrument all necessary changes.
• 2 investment topics, the most important of which deals with unsecured loans which are part of the basis for investments up to 10%
4. Quantitative Impact Assessment and Qualitative Impact Assessment
Quantitative Impact Assessments (EIQ’s)

For the standard formula testing the CNSF has performed 5 Quantitative Impact Studies (QIS/ we are currently in the middle of the fifth one).

The CNSF provided methodological notes, manuals for information’s integration, as well as an executable program.

In the beginning the methodological notes sent by CNSF have an academic profile structure.

AMIS performed an exhaustive analysis of this materials and contributed with proposals and comments that have been taken into account by the CNSF during the process of all 5 studies.
Qualitative Impact Assessments (EIC’s)

Implementation Level by Study

<table>
<thead>
<tr>
<th>Category</th>
<th>Study</th>
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<tbody>
<tr>
<td>1. Corporative Governance</td>
<td>GC</td>
</tr>
<tr>
<td>2. Integral Risks Administration</td>
<td>AR</td>
</tr>
<tr>
<td>3. Internal Control</td>
<td>CI</td>
</tr>
<tr>
<td>4. Internal Audit</td>
<td>RI</td>
</tr>
<tr>
<td>5. Actuarial Function</td>
<td>ST</td>
</tr>
<tr>
<td>6. Board Members and Officers</td>
<td>FC</td>
</tr>
<tr>
<td>7. Committees Operation</td>
<td>FA</td>
</tr>
<tr>
<td>8. Third parties sourcing</td>
<td>100</td>
</tr>
<tr>
<td>9. Information Disclosure</td>
<td>60</td>
</tr>
</tbody>
</table>

- GC: Corporative Governance
- AR: Integral Risks Administration
- CI: Internal Control
- RI: Internal Audit
- ST: Actuarial Function
- FC: Board Members and Officers
- FA: Committees Operation
- EIC-1: Third parties sourcing
- EIC-2: Information Disclosure
5. Challenges of the Three Pillar Directive
Pillar I Challenges. SCR Model

Understand all the model’s components and the way in which the risks interact.

Generate good quality information for the standard formula calibration and for running the model in a monthly basis.

Assess if the model’s calibration represents the company’s risk.

Use the model in the enterprise risk management and decision making process.

Assess the need of developing internal models, total or partial.

Board members' training.
Pillar I Challenges. Technical Reserves

- Development of an internal model for reserves calculation under the LISF: BEL and RM.
- To develop a methodology for the recognition of the Non Proportional Reassurance in the reserves’ risk transference.
- File the Reserves Technical Note (BEL).
- Generate good quality information for reserves calculation.
- Generate the Regulatory Report 3 (RR-3).
- Automatize the process to include two reserves valuation under different financial assumptions with the objective of avoiding the Balance Results volatility.
Pillar I Challenges. Accounting and Investment Issues

- New accounting rules that do not necessarily are aligned with international standards.
- Operation with an Economic Balance that other countries employs for solvency purposes but not for statutory purposes.
- New investments rules that appear insufficient for achieving an optimal capital management.
- A very short time scope for compliance with the operative administration process of adoption.
- Financial Information Reporting System (SIIF) entirely redesigned.
I. ORSA requires that the Company assess their own necessary funds for ensuring that the global solvency needs are covered in all moment.

II. Includes all the process and procedures employed in the identification, assessment, control, administration and reporting of the short and long term risks.

III. Should take into account all significant risks, perform prospective analysis and be integrated in the business strategy.
Pilar II Challenges

Train the Board members.

Implement the Risk, Actuarial, Internal Control and Internal Audit functions, as well as define the outsourced services.

Elaborate the Risk Manual.

Develop the ORSA test.

Develop the policies needed for LISF´s compliance (including those related with the board´s delegation to committees and/or officers).

Submit for Board´s approval all the policies and manuals included in the LISF.
Challenges related to Pillar III

During the CUSF’s consultation process it was agreed an important reduction of the information elements to disclose. **To privilege quality of information over quantity. Pertinence.**

Regardless of the above, some of the information required that prevailed is strategic, and therefore should not be disclosed.

Insurance Companies should redesign their web pages to integrate the content of the information disclosure requirements.

To obtain the company’s financial rate by a recognized rating agency.
6. Final Comments and Reflexions
Potential Strategic Implications

- **Organizational Structure:**
  - Vacancies/ Eliminated positions.
  - New and broader responsibilities for officers and board members.
  - “Solvency II” Actuaries.

- **Markets and Intermediaries**
  - New market segments.
  - Price realignment.
  - Requirements for intermediaries.

- **New Skills:**
  - In order to meet their new responsibilities, **Board Members** must develop new skills and participate in many processes through committee-work.
  - Communication regarding **Risk appetite** and Risks taken by the insurer will compel areas to integrate **new knowledge and develop new skills**.
  - Generate **high quality** information.

- **Cultural change will take time** and requires great efforts as it must be integrated as an **Insurance Integral Risk Management System**.
Thank you for your attention
ANEXES
Solvency II is based on **3 fundamental principles**, known as **pillars**, that apply to a series of risks: market, credit, operational, underwriting and liquidity.
Reserves covers:

- Estimated obligations.
- In some cases they include margins to allow for deviations.
- It is not always valid for these margins to overlap with those from capital.

Required capital covers:

- Extreme events.
- Atypical events and those due to expected parameters.
- Required capital for other risks.

Solvency is considered to entail Required Capital and Reserves in an integral way.
**LISF Agreements: 2010 Position Paper and November 20, 2012**

- **Entry into Force:** 730 days after Enactment of LISF (April 5, 2015)
- **To not consider either reputational or strategic Risks within the standard model for Solvency Capital Requirements**
- **Insurers’ surplus capital is not subject to a specific investment regime**
- **Recognition of the size, scale and complexity of Risks across the 3 LISF Pillars (Principle of Proportionality)**
- **Computable Shares of Real Estate Companies for Reserve Coverage and Solvency Capital**

- **Only mandatory requests are for credit ratings**
- **Allows preventive medical insurance as severance pay. Allows Health Insurance Companies to cover personal accidents.**
- **Recognition of Non-Proportional Reinsurance in SCR**
- **Return period for catastrophic Risks**
- **Product Registration**
- **Standard SCR Model**

*Four points in the Position Paper were negotiated in the CUSF*
Final topics chosen by the decision-making branches of AMIS to resolve with the CNSF and SHCP

- Quantitative Requirements
- Title 22, Accounting
- Special Insurance Funds
- Fees Disclosure
- Product Registration/GM
- Information Disclosure/ Pillar III
- Corporative Governance
- Investment Regime
- Third-Party Services (Outsourcing)
- Transient/ SCR Parallel and Economic Balance
- Intermediary Certifying Center
- Mass Marketing Rules
Conclusions and Final Comments

Solvency II will have a great impact on the enterprises’ risk administration.

The Pillar I elements, which are essential for companies to understand their risks’ behavior, will be administrated in the Pillar II.

Corporative Governance plays an essential role in this new way of administrating an enterprise.

It will be necessary to perform changes in the organizational structure, assign responsibilities and functions.

The standard formula model is a mechanism for starting to understand the companies’ risk behavior, but their real administration can only take place with an internal model that captures the enterprises risk profile.

The Board of Administration and the General Director own the processes of ADR, and the risk capital administration, so it’s fundamental that they understand the Risk Capital Requirement model.
Reflections and lessons learned in the process

In the process of instrumentation of any Solvency II initiative, regulators must search a close collaboration with the industry.

The training at a sectorial level is indispensable, with an involvement of the insurance association, for helping with the capacitation, enhance in the statistical data, risk administration and corporate governance knowledge. Solvency II must be a risk administration model.

In the same way, any consultation process must consider proper times, because institutions must continue business administration according to the current regulations. Institutions count with limited resources for addressing all the requirement that demand a process with very ambitious terms.

It’s preferable to have a Capital Requirement model that allows the risk administration and favors the strategic discussion within the insurance institutions.

The process must be completely documented and the programs for executing the models must comply with programming standards.