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THE TREATMENT OF SOLVENCY II IN THE OPERATION OF INSURANCE COMPANIES

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Abstract
The adaptation of the first Non-Life Insurance Directive (Directive 73/239 / EEC) in 1973 and the Life Insurance Directive (Directive 79/267 / EEC) six years later were the first steps towards the harmonization of insurance supervision in Europe. The implementation of these directives results in the harmonization of solvency requirements in the EU member states. The Supervisory Mode of Solvency 1 was promoted by the Second and Third Directives (Directives 88/357 / EEC, 90/619 / EEC, 92/49 / EEC and 92/96 / EEC), which implement the freedom to provide insurance services in industry. The basis of solvency in the EU was established in 1970. The notion of solvency, including the insurance sector itself, financial markets, regulatory approach, risk management techniques and accounting standards, has changed radically. The solvency regulation for insurance companies operating in the territory of the EU is based on the calculation and maintenance of a minimum solvency margin, which should enable control and monitoring of the required capital and the assumed risks (Jankovik, 2007). The current numbers confirm that insurance is a serious, stable and loyal partner of the citizens, the economy and in general of the whole society of our country. Insurance is gaining momentum in all spheres of human activity, increasing the number of participants in the insurance sector or the number of insurance companies as main pillar. The aim is to take a decisive step to pave the way to an industry that conquers the industrial market by offering stable insurance products, designed according to customer requirements.

Key Words: *Solvency, capital, insurance.*

Basic charecteristics

The Solvency 1 framework has been in use since 1970, using a very simple model for calculating capital requirements. The main reasons for the changes in the Solvency 1 concept were that the capital claims were not related to the risk taken by the insurance companies, ie the capital claims were not compatibile with the risk profile of the insurers.

Looking at the events in the banking system, especially with the advent of the Basel 2 standards, the idea and the insurance sector to have its own system called Solvency 2 emerged on the same principle.
The Solvency 2 concept was designed to reflect the economic risks faced by insurance and reinsurance companies. It is intended to improve the financial stability of insurers and reinsurers, all in order to improve the protection of policyholders, including in difficult times. Regulatory insurer insolvency has changed substantially with the advent of the Solvency 2 model.

The purpose of the Solvency 2 model is to harmonize insurance regulations in EU countries, to improve protection of policyholders, and to increase the stability of the financial system as a whole. To achieve these goals, the Solvency 2 model applies a 3-pillar structure, capital requirements (pillar 1), qualitative claims (pillar 2) and public disclosure (pillar 3), (see EC, 2007b).

At the core of this model is the goal to protect the owners of insurance contracts. The protection of policyholders is considered mandatory due to the existence of asymmetric information between policyholders and insurance companies, which opens the possibility of moral hazard.

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Another argument in this series is that the insolvency of insurance companies can impose disproportionately high costs on policyholders or society. This can happen in the event that an insured event occurs at the same time if the company becomes insolvent. In this case, the insured will not receive any compensation which could seriously jeopardize their economic survival. From the insurer's perspective, the risk of insolvency is directly related to the quality of the insurance product and is therefore part of the decision whether to contract with a particular insurance company or not.

Regulation of insurance under solvency 2 model

Insurer solvency is one of the most important factors for adequate assessment of insurance contracts

Regulation of the solvency of insurance companies

Perspectives and approaches	- Wide range of solvency frameworks currently implemented - Insurer protection as a common goal of these models - Insurer protection as a common goal of these models - Solvency models should minimize distortions in insurance markets
Придонес	- Overview of solvency systems in different countries - Expanding the conceptual criteria from (Cummins et al.1994) for estimating solvency models. -Evaluation of the selected solvency systems according to these criteria

Areas of research and contributions

Since 1990, most large economies have changed their regulatory models for the insurance industry from non-risk-based rules to those based on risk assessment.

Accelerated capital-based standards are becoming the norm in the use of regulatory frameworks. The United States and Canada were among the first to use a capital-based standard from 1992 and 1994. In 1996, Japan followed the trend by implementing the Margina Solvency standard. In 2001, Australia promoted its General Insurance Reform Act. The United Kingdom promoted the concept of "extended capital requirement" and "individual capital calculation" in 2004, while Switzerland promoted its Swiss Solvency Test in 2006.

EU countries have generally been slow to implement these standards. The legal Solvency 1 framework was implemented in 2002, but due to the fact that the desired standards were not met, the system was redirected to Solvency 2, which started to be implemented in 2004 and finally completed in 2009. Implementation of the Solvency 2 node is expected to start implementing after 2010, after the approval of the proposals for the new EU Directives and the provision of detailed instructions for its implementation (Pricewaterhouse Coopers, 2007).

The new concept also aims to promote more effective supervision which would change the behavior and philosophy of insurers. Solvency 2 system has a capital-based approach to risk-taking with the intention of aligning capital with risk.

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The Solvency 2 concept is based on 3 thematic areas or pillars of regulation that are designed to complement each other. Pillar 1 consists of quantitative requirements (ie how much capital one insurer should hold). Pillar 2 sets requirements in the area of management and risk management. Pillar 3 addresses oversight reports and transparency of requirements.

The three basic pillars of Solvency 2

Pillar 1- focuses on the quantitative aspects of solvency, ie how capital claims will be calculated. The quantitative requirements of Pillar 1 are set out in five sections.

The valuation of assets and liabilities, the valuation approach for all assets and liabilities listed in the framework is based on the concept of fair value set by (IASB-International Accounting Standards Board).

Technical reserves - represent the liabilities arising on the basis of insurance contracts contracted with the insured. Technical provisions represent the amount recognized in the balance sheet.

Solvency capital requirement - defines how the insurer will determine the amount of capital to be retained.

Minimum Capital Requirement (CAP) means the minimum amount of capital that an insurance company must have to carry on its business. The method of calculation (ISA) was a controversial topic of debate among shareholders in the process of developing the Solvency 2 framework. The framework won in April 2009 shows that ISAs should not fall below 25% or more than 45% of the SCR (Sandstorm 2006, p285).

Capital adequacy requirements - Capital adequacy should be sensitive to the size, complexity and risk assumed by insurance contracts as well as the accounting claims required by insurers.

A serious threat to insurance solvency can be,
A) Operational risks, or the risk of systemic collapse or negligence,
B) Credit risk, or the risk that third parties will not pay their debts,
C) Market risk, or the risk of falling value of investments made.
Pillar 2 focuses on quality measures (including the supervision process). Not all risks can be assessed through quantitative measures alone. The supervision process is required in addition to the quantitative elements of Pillar 1. In the event that the risk can be quantitatively evaluated, the adequacy of such evaluation should be reviewed by a qualified third party (supervisor). This is especially important when the insurer uses internal models to make such risk assessments.

Under Pillar 2, the supervisor will;
- Review and evaluation of the strategies, processes and reporting procedures established by the insurer to be in compliance with the framework directive.
- Assess the insurer's management capacity to identify, assess and manage the risks and potential risks they would face in the business.

The Supervisory Review (SRS) also assesses the adequacy of insurers' methods and practice to identify possible future events or future changes in economic conditions that may adversely affect the company financial position.

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Pillar 2 is also intended to encourage insurers to improve their risk management systems and their effectiveness in identifying, monitoring and managing risk.

Supervisors should have the power to force insurers to reduce the weaknesses and shortcomings of their management system. The supervisor should be able to ask the insurer to change its reporting strategies, processes and reporting procedures to ensure that they are strong enough. Under Solvency 2 pillar 2, corporate governance consists of 4 basic functions:

- **Risk management** - consists of underwriting (risk taking) and booking, asset and liability management (ALM), investment, liquidity, risk mitigation, etc.
- **Actuary** - this function consists of methodologies and procedures for assessing the adequacy and uncertainty of technical provisions, among other problems.
- **Internal audit** - this function must be independent within the company
- **Internal control** - used to ensure the effectiveness and efficiency of company processes regarding the availability and confidentiality of information and compliance with relevant regulatory institutions.

Pillar 3 - the directive frame requires from the insurer to disclose annual basic information regarding the firm's solvency and financial condition, supervisory reports and financial statements. Prior to publication, the annual reports must be approved by the competent insurer administrators or management body.

If we take as a benchmark the share of liquidated damages in the gross written premium, we come to data that the same ratio in Macedonia is about 40% while the same is about 71% in the EU countries, in 2010. Percentage of investments in our country is generally concentrated in investing in deposits and loans with a share of 47% while the same investments in EU countries participate with only about 6%. However, insurance risk management in Macedonia is not sufficiently developed, as the focus is generally on the individual risks of the companies, and less on the market and macroeconomic risks. Due to this and the fact that the new European regulations or the new directives Solvency 2, which is already mandatory for every EU country, it is necessary for every insurance company in our country to be careful about the possible shocks that may occur.

Advantages and disadvantages of Solvency 2 model

The basis of solvency in the EU was established in 1970. The notion of solvency of the time, including the insurance sector itself, financial markets, regulatory approach, risk management techniques and accounting standards, has changed radically. The solvency regulation for insurance companies operating in the territory of the EU is based on the calculation and maintenance of a minimum solvency margin, which should enable control and monitoring of the required capital and the assumed risks.

The main disadvantage of the model is that when formulating it, the systematic risk is not taken into account, which also has a great impact on the entire insurance industry. The introduction of this factor (systematic risk) in the insurance regulation contributes to the solution of social costs from the collapse of financial institutions. All this in order to prevent future crises.
Also a disadvantage of this model is that it can not promote and contribute to a more effective and unitary system of the insurance industry, which would be achieved by strengthening the function of insurers as institutional investors and developing a regulatory framework that improves the adequate level. to protect the owners of insurance contracts and to support the stability of the wider financial system.

This process or legal package of reforms has its costs not only for the company (cost of implementing reforms, periodic costs for legal compliance including direct costs for financing

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supervisory agencies, indirect administrative costs and costs of regulating capital) but for the whole insurance sector. (The evolution of insurance regulation in the EU since 2005.)

The solvency two model follows the initial establishment of the Solvency 1 model, which became effective in use in 2004. Through this model the approach to calculating capital was to use fixed rates and measure risk exposure. Solvency 1 was a transitional regulatory scheme that would be abandoned when the Solvency 2 model came to the fore, which was expected to apply from 2012.

Basel III Impact on Solvency 2 for the operations of insurance companies

Similar to insurance companies, the Basel 3 model is an international business standard that requires financial institutions (ie banks) to maintain sufficient liquid assets as reserves to cover the risky events that may arise in the course of their business. The Basel 3 provisions are a series of recommendations for banking laws and regulation issued by the Basel Committee on Banking Supervision. The name of these provisions is derived from Basel, Switzerland, where the committee that makes these provisions meets.

There is quite a bit of overlap between the Basal 2 Model and the Solvency 2 Model. The new capital and liquidity rules for banks (Basel2) and the new capital requirements for insurance companies (Solvency 2) are planned to be introduced from January 2013. Since the insured represent one of the larger institutional investors - in bank bonds, among other things - reciprocal effects will occur between these two sets of regulatory models in their implementation.

The solvency 2 model has changed the way insurance companies allocate their capital. Initially, the amount of capital that insurance companies are required to hold is determined by premiums. In the future, the risk that insurers are required to retain as part of their investment activities will be calculated at fair value and will determine the amount of capital that these institutions need to retain.

The solvency 2 model provides preferential treatment of bonds with good credit rating and short maturity. Government bonds issued by euro area member states do not require capital protection regardless of their credit rating. This creates incentives for insurers to allocate their capital.

Basel 3 askes the banks to establish more stable, long-term ways of investing. Newer liquidity requirements oblige banks to invest their funds in more stable, longer-term terms. As a result, they will issue more long-term bonds. At first glance, this seems to be quite the opposite of what the Solvency 2 system required because this model provides a preferential treatment for short-term investments. Although this scenario will cause some funds to be relocated, no dramatic changes are expected. If we take a closer look at the main types of insurance in banks bonds in different initiatives that will influence investment decisions, it will be clear that there will be changes in the allocation of funds. However, the investment base is not expected to disintegrate as the covered bonds are expected to increase significantly.

Insurers have always been considered stable, long-term and investors, thus making a major contribution to the financing of national economies. They also perform an indirect financing function, ie they play a very important role in financing banks, as they are one of the largest buyers of bank bonds, holding about 12% of all liabilities of the banking sector. So insurers invest in banks, which in turn finance the business through various loans. This is especially important for small and medium-sized companies, most of which are unable to obtain capital market funds.

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A more critical factor will be the impact of the Solvency 2 model combined with the Bezel 3 liquidity changes, which require banks to establish a more stable financing structure. Because insurance companies play an important role in financing banks, the new rules established by the application of new regulatory models will have a negative impact in the future on insurance companies as lenders to banks.

New regulatory rules for banks stipulate that banks must be able to guarantee their long-term financing sources with a more independent and stable base. In this context, stable includes intermediate, share capital, long-term (senior) bonds (longer than one year) and covered bonds.

Another component of the model is in terms of liquidity receivables where banks are required to practice covered or guarantee financing especially in conditions of limited liquidity in the market. The aim is to promote risk-free financing.