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2010-05-28

The position of the Swedish Insurance Federation regarding

Contingency Reserve (*säkerhetsreserven*) as risk capital of highest quality

Swedish non-life insurance companies may make allocations to a contingency reserve (*säkerhetsreserven*). The maximum allocation allowed is decided by the Swedish Financial Supervisory Authority (SFSA) based on experience and theoretical assessment. Allocations are largest for insurance branches, where risks are difficult to predict and where results can be subject to sharp fluctuations. The contingency reserve provides non-life insurance companies with opportunities to build up reserves in good times for use in bad times.

Being able to allocate reserves to cover risks difficult to predict provides more protection for policy holders. The contingency reserve functions as an extra buffer when a company incurs losses. It should, thus, be regarded as buffer capital when assessing the financial position of a company.

The proposals for implementing measures discussed in the Solvency Expert Group are detrimental to the contingency reserve. Not having rules for restricted reserves have severe implications for the capitalisation of the Swedish non-life industry. The contingency reserve is a general reserve applicable to company losses stemming from insurance risk. The use of the reserve is restricted with regards to financial losses. The proposed regulation of ring fenced funds is ill fitted to the horizontal characteristics of the contingency reserve.

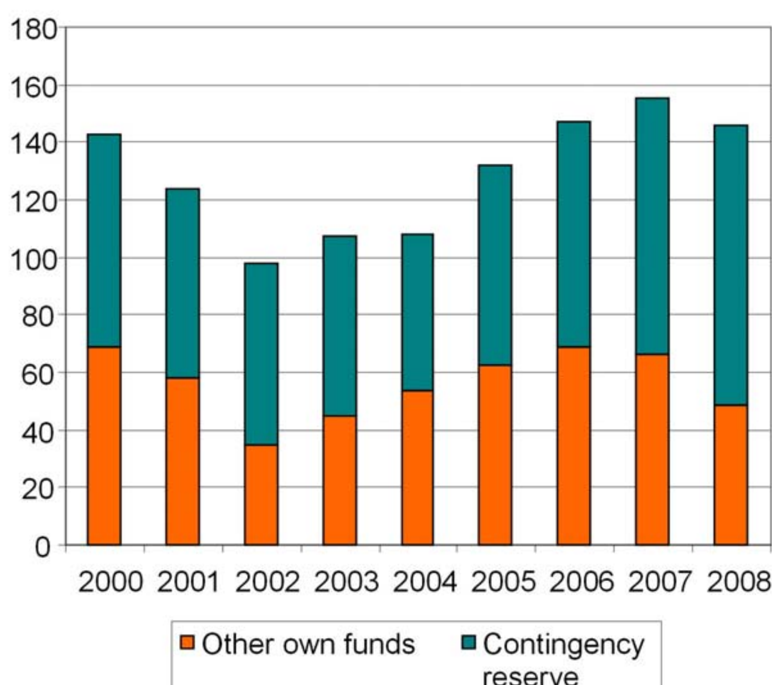
The Swedish Insurance Federation urge the Commission, EIOPC and the European Parliament, to include rules guiding restricted reserves in the Solvency II Level 2 regulation. The contingency reserve is not a ring-fenced fund.

The Contingency Reserve (*säkerhetsreserven*)

One point of departure in the new accord for the capital requirement for insurance companies – Solvency II – is that the capital requirement should be risk-based. The amount of own funds an insurance company must have in order to run insurance operations depends on the actual risks to which the company is exposed.

Non-life insurance companies in Sweden are permitted to make allocations to a contingency reserve. The treatment of contingency reserves is a subject of debate within the framework of Solvency II work. Tier 1 own funds include reserves with the main purpose of covering company losses.

Figure 1: The contingency reserves and other available capital in non-life insurance companies, 2000-2008, billion SEK.



Source: Swedish Insurance Federation

The contingency reserve is one of the most important sources of risk capital for the Swedish non-life insurance industry. Figure 1 shows that the contingency reserve's proportion of available risk capital in Swedish non-life insurance varied between 50 and 66 percent over the past 8 years. In 2008, the total equity capital in Swedish non-life insurance amounted to 146 billion SEK and the contingency reserve amounted to 97 billion SEK. 129 non-life insurance companies rendered accounts of contingency reserves.

Moreover, the contingency reserve is an important source of risk capital for those operators with more limited opportunities of obtaining capital from external sources. In Sweden, there are many mutual insurance companies, especially in regional non-life insurance markets. In these mutual

companies, the contingency reserve totalled 62 billion SEK in 2008, or 69 percent of the available risk capital.

In some Member States, specific products result in ring-fenced funds which give one class of policyholders greater rights to assets within their own fund. The excess of assets over liabilities within such funds can not be used to cover losses in other parts of the company's business. To be consistent with the economic approach, the assessment of own funds should be adjusted to reflect that some assets are restricted and can not be used to cover all losses in an insurance company (recital 49 in Solvency II directive).

Other reserves are used for covering losses across the company, but are restricted as to the type of losses they can cover. They are not restricted by where in the company the loss occurs, but rather by the kind of loss. The regulation of restricted reserves as proposed in IM7 Rev 1, COF3 (d) and specified in the technical specification of the QIS 5, clearly meets the needs for the horizontal nature of the contingency reserve.

The proposed rules guiding ring-fenced funds are ill-suited to the contingency reserve. The whole of the available capital in the contingency reserve is available for the coverage of losses stemming from unforeseen events in the insurance business, and also to a certain degree from financial losses.

If the level of available capital in Swedish non-life insurance operations is to remain the same without contingency reserves being counted in, a capital injection of over 80 billion SEK[1] will be required. One effect of an increased demand for capital is that premiums will be raised across the board for non-life insurance. Insurance stock companies can obtain capital injections by means of contributions from the shareholders. In mutual companies, the insurance policyholders will have to supply the risk capital. These companies can raise premiums to strengthen their equity capital. An alternative would be to issue subordinated debentures, these being a form of hybrid capital. However, this source of capital is also being questioned.

Seen against this background, it is of the utmost importance that rules governing restricted reserves are put in place in the Solvency II level 2 regulation.

Allocation to Contingency Reserves

Allocation to the contingency reserve is voluntary, while opportunities for dissolution are limited. Profits that an insurance company has set aside for the contingency reserve will thus be locked up in the insurance company. As regards taxation issues, allocations are deductible and dissolution shall be entered as income.

The premium for taking over a risk is fixed by the insurance company in advance. To calculate the premium the company makes a risk assessment

[1] Tier 3 capital may be included in the capital base to a proportion of maximum 15 percent for SCR coverage. Tier 3 capital cannot be used to cover MCR.

and a calculation of the estimated costs based on e.g. information about the customer regarding past experience of loss incidence, loss extent and assessment of future development. Experience from similar cases is also included in the assessment.

The consequences of taking over a risk can be difficult to predict. The reason might be that the risk is caused by general economic development (such as credit insurance or unemployment insurance) or that the risk of a loss occurring is small but that if it does occur the economic loss is extremely large (as for nuclear accident insurance). In which case, the facts are random or generally difficult to predict. When the insurance company fixes the premium such factors cannot normally be fully taken into account.

The contingency reserve is intended to function as a reserve to cover the losses incurred by an insurance company due to facts that are random or otherwise difficult to predict. The reserve provides the company with a possibility to distribute losses caused by such factors over a number of years. The SFSA's regulations[2] covers, among other factors, the maximum allocation to the contingency reserve and rules for the dissolution and dispensation of reserves. The maximum allocation differ across segments of the insurance industry. The largest maximum allocations are applied to lines of business where risks are difficult to predict and where results can fluctuate sharply. The maximum limit for each line of business is added up into a total sum for the company.

A company's maximum contingency reserve may not exceed the highest of the maximum limit of the lines of business' maximum, an amount of 2.5 million SEK or three times the highest actual retention for an individual risk. The SFSA may allow larger allocations to the reserve.

The contingency reserve is not included in the technical provision but is shown in the balance sheet as an untaxed reserve. Even though the calculation of the maximum limit is dependent on the company's lines of business the reserve is considered as one undivided, horizontal, reserve.

Since the insurance companies have the possibility to reserve capital to cover risks difficult to predict, the contingency reserve provides additional protection for the insurance policyholders. Even though these allocations are voluntary, they are "locked up" once a company has chosen to use the allocation opportunity and used only in the circumstances described in SFSA's regulation.

Dissolution of Contingency Reserves

Dissolution of the contingency reserve is mandatory if the amount contained in it at the beginning of the year is greater than the maximum amount at year-end. The exceeding amount is then dissolved. This leads, for example, to dissolution if the scale of the operation is reduced. It also ensures that at year-end the contingency reserve does not exceed the maximum limit. Even though the maximum limits vary depending on lines

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[2] SFAS's Regulations and General Guidelines (FFFS 2002:2) regarding the normal plan for non-life insurance company calculation of the contingency reserve.

of business, the dissolution is not dependent on which branch has experienced loss.

In addition, a voluntary dissolution can be undertaken to cover losses in the insurance operation. A voluntary dissolution may not be higher than the amount required, together with any mandatory dissolution, to cover the loss.

Apart from losses in the insurance operation the contingency reserve can also be used to cover financial losses. Since a part of the financial result is attributable to the insurance operation it is included in the technical result. The loss that is eligible for cover by the contingency reserve contains also that part of the results from the investment operations.

The SFSA rules are intended for companies that operate in normal conditions and have a normal portfolio. In special circumstances SFSA may dispense, both of allocation rules and dissolution rules.

Moreover, SFSA may in extraordinary circumstances allow larger dissolutions than are required to cover accrued losses. This could take place when losses are so great that equity capital is less than one third of the registered share capital corresponding to the situation where a balance sheet for liquidation purposes must be drawn up. Another example of an extraordinary case is when large indemnifications result in considerable losses to financial operations owing to, for example, assets having to be sold at an unfavourable time and at a value well below book value.

The contingency reserve is thus available to cover all significant risks in the non-life insurance company's operations.

Conclusion

Because the contingency reserve is available to cover all significant risks in non-life insurance companies' operations there is a need for regulation guiding restricted reserves in line with what was proposed in IM 7Rev 1 COF3 (d). The proposed regulation as a ring-fenced fund is ill suited to the function of the reserve.

The notion and treatment of ring-fenced funds can only be workable if the "fund" can be seen as a separated business within the company. This is not possible when it comes to the contingency reserve. It is impossible to set up a separate economic balance sheet which comprise the contingency reserve and the parts of the business the losses of which the reserve can cover. There are also no separated assets corresponding to the contingency reserve.

If contingency reserves were to be treated as ring-fenced funds it would have major consequences for Swedish non-life insurance and their customers. New capital would need to be injected in the entire sector. This increase in the need for capital will be met first and foremost by higher insurance premiums. By discharging the reserves, the non-life insurance company can free capital, but this also weakens consumer protection.