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Analysis of LAGIC and Solvency II's impact on Life Insurers

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Solvency II is a European Union (EU) legislative program that introduces a harmonised insurance regulatory regime across the region. The program is one of the first insurance regulations in the world to follow the Basel Accord approach, with a 3-pillar structure that covers capital requirements, risk management and disclosure requirements. In Australia, the Life and General Insurance Capital (LAGIC) regime, which governs life and general insurers, follows a similar approach. In common with Solvency II, LAGIC adopts a risk-based approach for insurers, aimed at tailoring insurers' capital requirements to their actual risk exposure. This is because the insurance industry is widely considered to be of systemic importance to the financial sector of the economy.

This study focuses on Pillar 1, which deals with the capital requirements of the insurance regulations. The study aims to: (1) Demonstrate the impact of LAGIC and Solvency II capital requirements on insurance product portfolios; (2) Illustrate the differences in the respective capital requirements of LAGIC and Solvency II, with and without a Matching Adjustment (MA); and (3) Stress test the sufficiency of LAGIC and Solvency II capital requirements.

Testing is conducted on three insurance portfolios: risk, annuity, and a combined portfolio. The test results show: The annuity portfolio requires substantially more capital than the risk portfolio. This is because premium income is found to be sufficient to cover future claims and expenses. Significantly, the capital requirement for the combined portfolio is less than the sum of the respective capital requirements for the risk and annuity portfolios. In the absence of a MA, Solvency II requires more capital than LAGIC for the annuity and combined portfolios. This is due to higher capital requirements and higher liability values. The MA significantly lowers the capital requirements, and hence reduces the capital base required, in Solvency II. For both Solvency II and LAGIC, capital requirements for the annuity and combined portfolios are sufficient during a mild crisis, but insufficient under GFC-type conditions. Furthermore, for both Solvency II and LAGIC, the capital requirements for the risk portfolio are insufficient in the event of pandemic stress.

Capital requirements under risk-based capital regimes such as Solvency II and LAGIC are sensitive to the individual risk profile of the insurer. This may incentivise the insurer to change their product design, or adjust their pricing, to incorporate any additional cost associated with the capital requirements.

Although capital requirements are designed to be at least 99.5% sufficient over a one-year period, they do not provide a guarantee of insurers' solvency.