Insurance Regulation in Spain and its application to non-life lines

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The Regulation and Supervision of Private Insurance Ordinance was passed on November 20, 1998 and came into force on January 1, 1999. This ordinance is further to the Regulation and Supervision of Private Insurance Act of November 8, 1995, as required by that act.

In general terms, this ordinance, as with the act which it is subordinate to, differentiates between the precepts applicable to the activities of insurance companies based in Spain, subject to control by the Spanish regulatory authorities, and those which refer to the Spanish activities of companies based in the European economic space - which are subject to the control of the regulatory authorities of their home country - and to companies which belong to other countries.

The way in which this ordinance deals with underwriting reserves is especially significant. This was necessary given that over the last three years, since the enactment of the Regulation of Private Insurance Act until the time the above referenced ordinance came into force, insurance companies had constituted their technical reserves in accordance with that laid down in the previous Insurance Ordinance of August 1, 1985.

The transition from one ordinance to another has meant significant changes in some technical reserves, as is the case in the unexpired risks reserve, and the appearance of other new reserves such as those for burial insurance or sickness insurance, which were not explicitly cited in the previous regulation.

Given their purpose, these reserves should be provided with sufficient funds in order to guarantee the insurance company's payment obligations and necessary economic stability at all times.

The Spanish legal code recognises the following reserves:

- Unearned premiums.
- Unexpired risks.
- Life insurance.
- Profit commissions and for rebates.
- Benefits.
- Stabilisation.
- Burial insurance.
- Sickness insurance.
- Shortfalls in special capitalisation operations.

All of these are applicable to direct insurance, whilst only the first five are applied to assumed reinsurance, and the same five reserves - with the exception of the second - are applicable to ceded reinsurance.

The methodology used for the calculation of these loss reserves and for their correction and adaptation to the company's technical bases and to the real behaviour of the parameters which define them should be certified by an insurance actuary, although the insurance company is still ultimately responsibility.

As was mentioned earlier, the reserve for unexpired risks takes on new significance in the sense that it should be constituted as a complement to the unearned premiums reserve, to make up for any shortfall in covering the risks and expenses for which the insurance company is liable corresponding to the unexpired period of cover until the end of the fiscal year. This reserve is therefore constituted to make up for premium insufficiency and,

consequently, negative underwriting results.

When it is necessary to contribute to the unexpired risks reserve for two consecutive fiscal years, the insurance company is required to present an actuarial report to the Directorate General for Insurance concerning necessary changes to the technical bases in order to reach premium sufficiency.

The reserve for unexpired risks for assumed reinsurance operations should be provided with funds when a prudent assessment of underwriting experience and policies indicates premium insufficiency for assumed reinsurance, even though complete or sufficient information is not available.

In life assurance, even though this is not the subject of this article, some new features are introduced with regard to the rate of interest applicable to the life assurance reserve, age of the mortality and survival tables used, regulation of policy surrenders and the obligation to provide adequate information concerning profit commissions, surrender and reduction values etc. when taking out a policy. These new features reflect conservative regulations based on extremely prudent technical reserve calculation criteria and precise and transparent information systems to the public and are in the interests of policyholder protection, technical reserve sufficiency and the economic stability of insurance companies.

Given the actuarial nature of the risks covered in burial insurance, the ordinance technically equates this insurance to life insurance, and establishes the obligation to use techniques similar to life insurance for new business; both with respect to setting the premium and with respect to the provision of funds for the burial insurance technical reserves.

With regard to the technical reserves for benefits, one of the most notable characteristics is the differentiation of this reserve into professional third-party liability risks, product sales and decennial construction risks, amongst others; since these are risks in which losses tend to manifest themselves after the end of the period of cover and are therefore referred to as benefits reserves for deferred manifestation risks.

The calculation of the loss reserve for benefits is expressly stated to include the reserve for benefits pending settlement or payment, the reserve for claims still not reported and the reserve for internal claim settlement expenses. This last mentioned reserve does not expressly have regulatory precedents, its aim is to recognise and to make express provision for internal management expenses incurred by the company in settling or finalising claims which are pending settlement, payment or notification.

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Insurance companies may use statistical methods for the calculation of the benefits reserve. Before the company uses these methods however they should be submitted for approval to the Directorate General for Insurance which may accept or reject their use, and may propose specific methods.

Despite the fact that these statistical methods have certain advantages when estimating these reserves, as they take account of trends and eliminate the subjectivity implicit in a case by case assessment, which may be advisable in certain cases, the ordinance sets a lower limit concerning the minimum sum which may be deducted in terms of corporation tax when the benefits reserve is calculated by statistical methods. Once again, there is an unreconcilable difference between the technical and the fiscal viewpoints concerning reserves.

Lastly, in the field of technical reserves, the stabilisation reserve is being widely introduced, and does not have similar antecedents in previous insurance regulations. This reserve must now be compulsorily made in certain business lines, as compared with the freedom of criteria which existed previously.

The above reserve must obligatorily be made in cases of civil liability arising from nuclear risks, risks included in the combined agricultural insurance plans, credit insurance, surety, third-party liability insurance in land motor vehicles, product liability, construction damage insurance, industrial multi-risk, environmental hazard insurance and catastrophic risk cover.

The reserve must be made in each fiscal year and for the amount of the safety surcharge included in written premiums, with the minimum limit set by the technical bases, to reach a certain accumulated amount. It will be applied in a certain year in order to compensate for an excess in loss ratio on the premiums of retained risks (direct insurance plus assumed reinsurance net of ceded and retroceded reinsurance) which has occurred in the year in the pertinent business line or risk.

As the technical bases, rates and the make up of the policies are basic elements in insurance, it would be useful to make some mention of the technical and contractual documentation involved in insurance during this

brief and partial overview of the contents of the Ordinance on The Regulation and Supervision of Private Insurance.

In this ordinance, although the technical and contractual documentation does not have to receive previous authorisation by the Directorate General for Insurance, it must be made available to this body when required.

The insurance companies are therefore not exempt from the obligation, technical in every case, and occasionally legal, of having available technical bases and rates for all their products and any changes which are made to these products.

Amongst other things, the technical bases must include all elements related to the statistical information concerning the risks which are to be underwritten, surcharges for management expenses; in harmony with the sufficiency principles and the organisational structure of the company, setting of commercial premium rates; in accordance with the principles of indivisibility and stability, sufficiency and fairness, together with the determination of the methods to be used for the calculation of technical reserves.

These technical bases are therefore the basic document on which any insurance product is based, and are an expression of actuarial studies aimed at the determination of insurance premiums, creation of the rates, risk selection and underwriting policies, the assessment of the reserves, together with the planning of the future development of the product and estimates of results, aimed at increasing the dynamic solvency of the company.

Under the influence of the single licence and of multinational insurance activity, the characteristic rigor and precision of the technical bases may be altered, despite more or less rigorous domestic legislation. In the future, this will very probably make necessary cross-border harmonisation rules and greater identification of local factors in the assessment of risks by insurers, in order to achieve a stable and sufficient long-term pricing policy. ■