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pension funds would initially be restricted to those who are not covered by a collectively agreed pension fund, but it will be possible for a closed pension fund member to transfer one's rights to an open fund after five years of membership.

Likely developments of the new market will be that new pension funds will be established along a number of different lines. First, there will be a number of national industry schemes, applying to certain employment sectors which will be largely influenced by the national trade unions. Second, several large employers will establish closed pension funds to cover their employees, contracting out of the relevant industry-wide arrangement. Third, the main financial services providers, such as banks, life companies, mutual fund companies, and SMI, apart from offering investment, administration, custody, and consultancy services to the closed-pension funds, will establish their own open funds.

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Insurance Regulation in Spain—Changes and Challenges

by Daniel A. DeKeizer

The European insurance market has been rapidly changing in the last five years. Adoption and implementation of the life and nonlife directives, the converging economies required by the monetary union, privatizations, mergers, and acquisitions have all helped reshape the insurance landscape.

Spain has not been exempt from these changes. In response to the 1995 Ordinance on the Supervision of Private Insurers, the Direccion General de Seguros (DGS) has proposed a sweeping new set of regulations. These regulations replace the 1985 and 1986 regulations and their amendments and are intended to bring Spanish regulation and practice into line with the European Community (EC) directives.

This article reviews some key aspects of the new Spanish regulation and discusses possible responses by the insurance market.

Technical Note

Much of Spanish regulation builds on the concept of the "Technical Note," which is a formal statement of the pricing basis for a given contract form. This concept is carried forward from the 1985 regulations. The Technical Note must include a guaranteed mortality table and interest rate, benefit descriptions, the calculation of the net premium, and the expense loads used to convert the net premium to a gross premium. It also describes the basis for participation, if any. This note must be certified by a qualified actuary.

Reserves

Articles 32–38 of the proposed legislation deal with the calculation method, the interest rate, mortality tables, and expenses. Previously, the reserves were determined on a valuation premium basis, which provided for maintenance expenses but not the amortization of acquisition expenses. The interest rate and mortality table were the same as those used to determine the premium in the Technical Note. Under the new regulations, products of up to one year duration require an unearned premium reserve, while longer term products require a seriatim, prospective, gross-premium-type reserve.

Interest

The interest rate can be no more than 60% of the weighted average of long term (five or more years) government bond yields during the last quarter of the last three years. The weighting is 50% of the most recent year's rate, 30% of the next prior year's rate, and 20% of the yield from three years ago. The government will publish the rate on an annual basis. If the actual investment returns of the insurer are less than this benchmark rate, then the actual returns are to be used. For certain contracts, the interest rate used in determining the premium—if lower than either of the above rates—is used in reserves as well. Previously, actual returns were allowed to be below the reserve interest rate for up to two years before reserve strengthening was required (Article 71 of the 1985 regulation).

For policies denominated in non-Spanish currencies, a similar formula, applied to the appropriate governments' bond yields, is required for foreign currency contracts.

Currently, this formula would result in a statutory interest rate of approximately 3.4%, which by itself will require substantially higher reserves than many companies are now holding. However, for "unit-linked" contracts, in which the insured is bearing the interest-rate risk, the company can simply hold the market value of the assets. These contracts are reported as part of the general account. No separate accounting treatment is currently required for such products.

This provision should encourage companies to move more aggressively into variable products or products with market value adjustments.

Mortality

There is no explicitly specified mortality table, such as the U.S. Commissioner's Standard Ordinary table. Instead, the table must satisfy certain criteria:

- It must be based on national or foreign experience and determined using generally accepted actuarial methods.
- It must be within certain confidence intervals specified by the government.

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- It must be based on observation periods within the last 20 years.
- It must include mortality improvements if significant survivorship benefits are available.

In addition, if emerging experience credibly demonstrates that the original table is inadequate, reserves must be increased to reflect the actual behavior.

Expenses

The administration and acquisition expenses included in the product's Technical Note are also reflected in the reserve. Under the previous regulation, expenses were generally charged as incurred, although the amortization of certain acquisition costs (in excess of first-year loads) was allowed.

In contrast to GAAP reserves or DAC in the United States, no lapses or withdrawals are included in the calculation. Companies will need to be very careful that they do not overestimate how much of the acquisition costs can be front-loaded.

If the company's actual expenses exceed those assumed in the Technical Note for more than two years running, and those expenses cannot be rationally explained as being "extraordinary" or one-time expenses, then the actual expenses must be reflected in the reserve calculation. This loss recognition concept will encourage careful monitoring and strict controls on expenses as compared to the loads in the Technical Note. It may also encourage companies to refile the Technical Notes on existing products, reallocating expenses, interest gains, and mortality tables even if the price and benefits to the consumer are unchanged.

Adequacy of Reserves

Unlike the United States or Canada, where the actuary opines on the adequacy of the reserves in aggregate, the Spanish regulation requires the actuary to test the interest, mortality, and expense components of the reserve separately. This is a more conservative standard in that gains from one component or product form will not be allowed to offset losses on another. This may create an interesting opportunity for surplus relief reinsurance treaties supported by the gains of one component of the reserves to offset the surplus strain created in another area.

Assets

The growing cross-border activity of the EC is expected to bring greater liquidity to the asset side of the balance sheet. Increased liquidity and a broader range of assets should improve insurers' asset/liability matching and the margins available from cash-flow management. These advantages may be offset by additional competitive pressure as companies with superior investment performance pass on a portion of these gains to their customers.

Articles 50–53 control the asset allocation and valuation rules for those assets supporting the technical reserves. These clauses contain much more detail than the corresponding clauses of the previous regulation. Insurers are allowed greater access to assets from across the entire EC. New asset types, such as derivatives and futures, are explicitly covered as admitted assets.

Solvency Margins

Solvency margins are discussed in Articles 61 and 62. For life companies, the standard of 4% of reserves plus 0.3% of the net amount at risk is continued from the previous regulation. "Unit-linked" products have a lower requirement of 1% of reserve plus 0.3% of the net amount at risk. This is consistent with those of a number of the EC nations. However, because of the stronger reserve requirements, keeping the same formula has the effect of strengthening the required capital.

The simple nature of this formula means that it may not do a good job of discriminating between strong and weakly capitalized companies. At this time, regulators do not appear to be seriously pursuing a more detailed risk-based capital formula such as the U.S. or Canadian methods.

Conclusions and Future Possibilities

This regulation takes a big step toward an open market with the EC, improves the technical bases for reserves and assets, and generally strengthens the solvency of the Spanish insurance community. The application of the regulation is likely to produce new products, especially of the variable or unit-linked type, and some reinsurance opportunities. The expense component of the reserve formula will put pressure on inefficient companies and distribution methods to reform.

I speculate that future regulation will include commission and cost disclosure as is already being practiced in Great Britain and Portugal, and the growing cross-border and direct marketing insurance transactions will act to further reduce expense margins.

The Spanish market has become a fast-changing, challenging place in which to do business. Insurance companies must respond to the new Spanish regulations and, at the same time, manage the Euro, Y2K, new competitors, and falling interest margins. Recognizing and taking advantage of the opportunities in this regulation is one way for superior companies to distinguish themselves in this market.

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