Diversification Effects in Insurance Groups –
A Regulatory Angle to Efficient Solvency Requirements

By Patrick Darlap and Bernhard Mayr, Vienna

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1. Introduction

This paper is meant to delve into the question of how supervisory authorities may view the current and proposed approaches to recognising diversification in financial groups, in particular where they accrue, how those benefits may be reallocated horizontally between sister entities or down-streamed from the parent institution to affiliates and what shortcomings these approaches suffer from. It builds on an earlier paper by Herzig and Mayr\textsuperscript{2} that relates current industry arguments on diversification effects\textsuperscript{3} and how they should be considered in group capital adequacy requirements to underlying conceptual difficulties.

In a first step the current European regulatory approach to diversification is reviewed and differences between banks and insurers are emphasised in

\textsuperscript{1} Both Austrian Financial Market Authority (FMA). The views expressed in this paper are those of the authors' and do not necessarily coincide with the opinion of their employer.


\textsuperscript{3} Cf. Chief Risk Officer Forum (2005).
this respect. Then the argument of diversification per se is discussed more profoundly. Under the premise that positive group effects outweigh any adverse group-inherent developments it is discussed how the group’s benefits could be reallocated – from the top level of the group to all entities concerned. The feasibility of this approach is then confronted with current supervisory, legal and accounting aspects to detect potential weaknesses or countervailing arguments. In a last step it is highlighted that in a branch-structured group\(^4\) many of the industry’s claims regarding the allowance for diversification effects in financial groups and their consideration in group risk capital calculations are fulfilled.

2. Current Regulatory Approach to Diversification

One of the main principles underlying EU Insurance Regulation as stipulated in the Insurance Directives and national Acts\(^5\) respectively is the separation of life and non-life business. This is reflected in the fact that any new insurance company to be set up may only be granted a license for either life or non life business and existing ‘composite’ insurers have to separate life and non-life accounting. Therefore diversification between life-assurance and non-life-insurance-business is not recognised in solvency requirement calculation, while a P&C-only insurer may reap the benefits of diversification between its different business lines through the solvency requirement calculation as stipulated in Art. 16a of the EU non-life Directive. The reason thereof lies in the political will (probably based on historical experience) to isolate life insurance business from any developments in P&C business: life assurance and its importance for pension provisions – intertemporal capital transformation – generates important positive external effects and therefore needs to be protected from any negative spill-over. One may draw on the parallels to the system established by the Glass-Steagall Act for the US banking system, separating investment banking from commercial banking, which was only recently abandoned by the Gramm-Leach-Bliley Act.

The separation of insurance business lines is, however, based on different arguments and established with different intentions than the separation of the former US separate banking system:

In banking, regulatory impetus is primarily driven by systemic stability considerations and the separation of businesses was – inter alia – seen as one effective way to achieve this goal. However, European negligence to separate investment banking – which ultimately led to the establishment

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\(^4\) It is often claimed that European Financial Groups could reach the intended effects by making use of the existing single market rules.