

# Stay with Solvency too

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Predicting is a dangerous game. Making Predictions in writing is an even more dangerous game, but this is BRAVE Partners – so here are the firm's bold statements about the insurance industry in 2012.

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Business is getting into full swing for 2012. In keeping with the firm's name, BRAVE Partners LLP likes to make some bold predictions for the coming year.

BRAVE Partners focuses on two sectors (re)insurance and alternative energy as well as pension across industries. Most of the partners have extensive backgrounds working with the financial services sector and insurance in particular from a range for perspectives from capital markets through corporate finance to legal.


Predicting is a dangerous game with many a prediction haunting the predictor in years to come. The following from the Tampa Bay Times highlights the issue:

"Every year around Christmas, two of the country's top hurricane experts offer Floridians a gift nobody seems to want: next year's hurricane season predictions.

Coming at the end of a six-month hurricane season, the numbers long have been criticized for stoking hurricane anxiety and having little practical value.

Now, after 20 years, forecasters Bill Gray and Phil Klotzbach have decided to drop the December forecast, acknowledging what Floridians have suspected for a long time: The early forecast isn't very accurate."

However, in the spirit of adventure for the New Year BRAVE Partners makes a single prediction for 2012.

 The UK will implement Solvency II during 2012, whereas the rest of Europe will delay further than 2013

### 2012: Prediction

Solvency II has appeared to be a never ending treadmill. From the passing of the EU Directive in 2009 the process has rumbled on with a 2012 target date. Over 2011 that date began to slip

BRAVE Partners predicts that in 2012 the UK will implement Solvency II, but the rest of Europe will further delay implementation.

## UK insurance regulation

Insurance regulation in the UK took a significant step forward at the end of 2004 with the introduction of “the twin peaks approach” to life insurer regulation by the Financial Services Authority. The Individual Capital Assessment (ICA) introduced the notion of model based capital and the Enhanced Capital Requirements (ECR) developed a concept of a market consistent balance sheet. All of these concepts are precursors of items contained in the Solvency II rules and were implemented in anticipation of the regulation being introduced. UK insurers therefore have some familiarity with and infrastructure to run this type of process.

## Insurance regulation in Europe

During this period Denmark also adopted some similar concepts into its insurance regulation following the new insolvency of a number of the pension funds (effectively life insurers) in the country. Sweden and Finland followed to some degree.

Whilst outside the EU, Switzerland as a major insurance centre adopted the model and market based Swiss Solvency Test.

Outside of the UK, Scandinavia and Switzerland insurance regulation in most of core Europe did not change from the existing form of reasonably basic risk charges based upon fairly blunt measures, such as premium income.

## Market structure

This is possibly due to some striking structural differences in the various markets. The countries that pushed ahead with the model based regulation have a relatively small number of larger insurance companies – which allows more sophistication within the market. The UK market had also gone through a period of consolidation and run-offs – particularly of life insurance businesses for which most need market-consistent model based capital allocation. Core Europe, namely France and Germany, have far deeper insurance markets with many smaller carriers. Whilst the exact statistics are unlikely to be correct, a rough guide for Germany is that there are around 2,000 life insurers. The top five carriers between them have an 80% market share. Of the top five, the largest Allianz Leben has a market share of around the size of the other four put together. This means that there must be a lot of very small life

offices in Germany. Getting a sophisticated solvency regime established in such a market is challenging as there are a large number of insurers that do not have the resource to implement it.

## Solvency II

Solvency II has ushered in a plethora of new concepts. Perhaps the most hotly debated is that of “embeddedness”. This means that an insurer must not just run a capital model, but that its senior management and board must understand, discuss and utilise its output.

BRAVE Partners is in the camp which views this embeddedness condition as a step change in the regulation. Previous regulation has implicitly required managements to review model output, but this has been worded such that the only real requirement was to have the model run and look at the output – there was no requirement to understand the report, or to discuss its implications in decision making. In banks under Basel II this led to an awful lot of trees dying to produce glossy management reports that were disregarded. Solvency II is different – the management cannot disregard the report. They must attend night school and understand it.

## Implications of embeddedness

The Solvency II embeddedness test means that insurers can no longer get away with what one insurer was clearly doing. When BRAVE Partners discussed the concept of embeddedness with a particular insurance business, their response was: “Does that mean that we will run it in house rather than have [top 4 accountant / consultancy] run it and send us the number each quarter?” Given the repeated successful track record of the business – they must be doing something right in the risk management department in house. It is almost a tragedy of Solvency II that they cannot think to capture and formalize that process. One of the most advanced insurance businesses that the firm knows has managed to do that – effectively capture their internal control processes into a Solvency II compliant framework.

The notion of embeddedness is perhaps the single most debated issue in Solvency II. BRAVE Partners sees this as a significant departure from previous regulatory structures in both insurance and banking and a template for the future.

Moving on from the “embeddedness” awards – the implications of embeddedness are that, even if financial resource allows, it is not sufficient to have a third party take on the modeling needs of Solvency II. There is a real onus on the firm to adopt sophisticated practices. This will take significant time and change within some small, less sophisticated insurers.

The UK has two advantages. Firstly, there is already a track record and a familiarity with model based capital allocation. Secondly, it simply does not have the tail of very small, local businesses. The regulator can afford to allow those that do exist to be consumed by larger more sophisticated competitors. This is simply not the case in Germany, France and Italy.

Therefore, it is highly likely that the UK will be ready for Solvency II ahead of continental Europe. As a major insurance centre, the businesses in the UK will be seeking to push ahead and realise the value of their significant investment in Solvency II. The UK is therefore likely to adopt Solvency II within the initial timeframe. Europe will struggle with the smaller players. The markets will not be able to be reformed overnight and, with the other economic woes there will be more than just new regulation of which to think.

BRAVE Partners believes that the UK will implement Solvency II in some form during 2012 and the European timetable will slip during 2012 beyond the current target of 1 Jan, 2013.

### BRAVE Partners' services

BRAVE Partners is a boutique investment bank that serves the (re)insurance, alternative energy and pensions sectors.

The firm has particular skills in risk modeling which allow it to provide excellent advice to insurers on embedding their own model, or building or buying an embedded risk model. BRAVE Partners has already provided risk modeling services to a major European insurer to satisfy their auditors of the level of risk in a particular position.

Moreover, the partners were highly involved in assessing the likely capital impact of the ICA on a major UK life insurance business ahead of an acquisition and run-off. Their predictions proved to be remarkably accurate.

The firm excels where clients are seeking advice on issues and transactions that lie outside the ordinary. The partners developed the first successful transfer of the credit risk on reinsurance recoverables to the capital markets.

### Interaction

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If you would like to comment on the content of this piece, then please send an E-Mail to [discussions@bravepartners.com](mailto:discussions@bravepartners.com)

- BRAVE Partners is a boutique investment bank serving the insurance and reinsurance sectors.

- Current projects include:

- Arranging the transfer of an annuity block to capital markets ahead of Solvency II implementation.
  - Identifying and arranging Solvency II optimized investments for life insurers.
  - Arranging for the capital markets to provide significant volumes of extreme mortality cover for a US life business.
  - Advising and arranging investment in catastrophe exposed personal lines business in the USA.

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