

# Solvency II: In bed with the regulations

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Solvency II is all about embedding a risk model into the management process of an insurance business. There is much theoretical debate on what this means. BRAVE Partners explores the practical implications. All but a few insurers are losing sight of the impending change in the competitive landscape that Solvency II will bring.

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Sailing is a favourite pastime of many of the BRAVE Partners. A marvelous sailing story puts the usefulness of numbers into context. The story is that a large motor yacht was a little lost off the SE coast of the USA. Spotting a sailing boat the motor yacht cruises up and shouts over: "Say, which way is it to Miami?". Diligently the yacht crew go to the charts, plot their position, lay a course from there to Miami; correct the course for tides and magnetic variation – and shout back: "Steer 086 degrees magnetic". The man on the motor yacht shouts back: "Gee, buddy – forget the numbers – just point!".

To bring the discussion back to Solvency II – there is a balance to be struck between the detailed modelling work required to comply with Solvency II and making time to step back and look at the strategic options that the change in regulation will bring. It is quite possible that an insurer can find itself in a position where it has impeccable compliance with Solvency II, but that its business model is at a significant competitive dis-advantage post 2012.

## Solvency II and embeddedness

Models, reports and figures are useful tools in risk management. However, all too often sophisticated models are used more as risk management bling. There to impress, but not understood and therefore not used. Solvency II seeks to change this with the embeddedness test.

## Embeddedness vs Use

BRAVE Partners is firmly in the camp that thinks that the Solvency II embeddedness test for risk models is a fundamental step in regulation compared with the Basel II use test.

One of the more interesting questions that BRAVE Partners has seen raised about embeddedness is: "Does that mean that we will have to run our risk model in house?". The question came from a highly successful Lloyd's syndicate. The answer is technically not – but the management need to understand

The Solvency II concept of embedded risk models is a fundamental step forward in regulation that goes beyond the Basel II use test.

**An embedded model must not only be used, it must be understood by the senior management.**

the model fully. However, given the consistent solid results that that business clocks up, the truth is probably more along the lines that the business has a solid risk management framework, that just needs

to be correctly embodied into a Solvency II compliant framework. In the opinion of BRAVE Partners' – just running industry standard models that happen to have the nod from the regulators does not really equate to true Solvency II compliance. Embeddedness is truly a different regulatory concept which places the onus on the key management at the highest level to also understand the modeling process. Whilst this might seem like a huge task, in the opinion of BRAVE Partners it is only such a major task because many modeling techniques are not at all transparent – even to the actuaries and mathematicians that construct them. Choosing a modeling framework is thus a crucial first step in a practical implementation of Solvency II.

A truly practical response to Solvency II must include a strategic review of the competitive landscape post 2012.

Compliance with Solvency II is not enough, insurers must remain competitive in a truly changed business environment.

## Practical implementation

BRAVE Partners has already commented on the practical steps to implementing Solvency II in "[Don't let it become insolvency too.](#)" Within this commentary, BRAVE Partners outlines seven activities that are required:

1. Identifying the individuals and structures required internally to satisfy the Solvency II criteria.
2. Identifying the key risk drivers for the business.
3. Building the data infrastructure to feed the model.
4. Buying or building a risk model.
  - a. Documenting the model.
  - b. Developing the maintenance and upgrade plan for the model.
5. Integrating the model into the business and management processes.
  - a. Identifying risks.
  - b. Developing risk management and mitigation strategies.
6. Reporting.
7. Ongoing maintenance and advice.
  - a. Model upgrades.
  - b. Risk identification.
  - c. Risk mitigation.
  - d. System maintenance.

## A truly practical response to Solvency II

Most insurers in Europe are focused on the Quantitative Impact Studies (QIS – now QIS5 with the prospect of QIS6). Whilst it is important to understand the capital requirements that an insurance

business will face under the new rules, it is equally – if not more – important to understand how Solvency II will alter the structural and competitive landscape of the insurance industry.

A truly practical response to Solvency II has two prongs:

- A robust, practical implementation of an embedded risk model. BRAVE Partners can advise on transparent, effective structures for building such a model.
- A practical business response to the post-Solvency II competitive landscape. BRAVE Partners seeks to address this issue in this commentary.

Within the scramble to comply with Solvency II and participate in the QIS, European insurers also need to review the strategic landscape for their business.

Failure to do this could mean that a company is highly Solvency II compliant, but highly uncompetitive in a fundamentally changed business environment.

BRAVE Partners has commented on this second point, but it is one that is not widely discussed. It would appear that many EU insurers are more concerned about straight compliance with Solvency II than the far reaching implications for the industry going forward. One of the only, and best, analyses that the firm has seen comes from our friends at [Boston Consulting Group](#).

### Back to the future

BRAVE Partners believes that Solvency II will fundamentally change the competitive landscape of the insurance industry in Europe. The more progressive companies are already changing their legal and operational structures to plan for Solvency II.

### Practical planning for Solvency II

The main issues that BRAVE Partners believes companies need to review in the light of Solvency II are:

1. Legal structure. Solvency II will be implemented on a legal entity basis. Diversification benefits will thus only be available if all of the business lines are written out of the same legal entity.
2. Product design. Solvency II will change the capital requirement significantly for certain product features. Savings products sold by life insurance businesses will see substantially more capital against guaranteed returns and other features that transfer investment risk from the policyholder to the insurer.
3. Legacy portfolios. Certain lines of business will simply become too capital intensive to retain. These will need to be closed and sold on. Lifetime annuity business is in doubt as both the tax driven requirement to buy an annuity in the UK is likely to be changed, together with increased capital needs, despite the illiquidity premium.
4. Reinsurance strategy. Solvency II will alter the size, scope and target jurisdiction of the outbound reinsurance for insurance companies. Both the credit rating and the jurisdiction of reinsurers will become more important. Those jurisdictions that gain equivalence status, currently most likely to be Bermuda and Switzerland, will be of most interest. ( See BRAVE Partners' commentary "[All Solvency II implementations are equal](#)").

5. M&A and business lines. Solvency II favours diversification. Small specialist insurers will require proportionately more capital than larger, diversified groups. Such businesses might consider the advantages of becoming a managing general agency (MGA) and placing the risk with a larger, diversified group.

## Legal structure

Companies need to review two issues:

- Underwriting entities.
- Domicile.

## Underwriting entities

Solvency II will be applied at a legal entity level. Companies that write different lines and different geographic regions of business from different legal entities will not take the full benefit of the diversification of its lines of business. There are two approaches to taking this:

- i. Consolidate all EU underwriting in a single legal entity and make all other offices a branch of this entity. At least one leading Swiss insurer has successfully done this, but as its underwriting is consolidated in Ireland, some might take the view that there is too much country risk.
- ii. Continue to have separate underwriting entities, but reinsure a majority of the business to a central reinsurer.

## Domicile

Solvency II will apply to all subsidiaries of an EU domiciled insurer. There is therefore a question as to whether large insurance groups will wish to remain domiciled within the EU. If the holding company is domiciled within the EU this will preclude the business from reducing capital by reinsuring risks into a non-EU subsidiary (because all subsidiaries will consolidate for Solvency II). In contrast a non-EU group, with a large EU presence can still save capital by reinsuring into a non-EU subsidiary. Solvency II seeks to address this issue through reinsurance credit and the concept of equivalence, but it is likely that loopholes will exist. There is thus, an incentive to redomicile out of the EU.

**The impact of Solvency II on the competitive landscape is still not fully understood.**

**BRAVE Partners believes that one result might be for smaller, specialized insurers to convert to Managing General Agencies (MGAs). This would allow the management to maintain their independence, but to take advantage of the capital efficiency of writing business through a large diversified group.**

## Product design

The US life business has designed products for capital efficiency for many years. In many ways the triple-X regulation, which has created what is often seen as draconian reserving requirements, is the result of the regulators clamping down as the life insurers became too sophisticated at designing product to minimise capital.

Within the EU, simpler reserving and capital rules have meant that there has been less scope to design products to minimise capital. However, Solvency II changes this landscape. The regulation has emerged at a time when certain policy features, such as guarantees on investment products, are under extensive scrutiny from

regulators. The Solvency II regulation has been used to penalize certain features and products with which the regulators have issues.

### Legacy portfolios

Solvency II will render certain lines of insurance business uneconomic. For example, UK annuity business potentially faces becoming obsolete post-Solvency II. It is under pressure from two sides. Firstly, there is growing pressure in the UK to change the laws that place a significant tax on pension savings that are not used to buy an annuity before the owner's 75<sup>th</sup> birthday. Demand for insurance company annuities in the UK is therefore likely to fall. Secondly, the asset rules of Solvency II are likely to increase the capital requirements for these lines of business, despite the acceptance of the illiquidity premium. It is highly possible that a number of insurers will exit this business and not wish to keep capital allocated to the long-tailed run-off books. Other, more volatile, long tailed lines could fall into this category.

### Reinsurance strategy

Solvency II is likely to increase demand for reinsurance, especially on peak risks. The diversification benefit on capital will be greatest where all risks are roughly balanced. Furthermore there will be a more risk based approach to assessing the capital and reserve relief that arises from reinsurance. This will generally make reinsurance as a more available and attractive strategy for managing risks and capital.

### Counterparty risk

However, Solvency II will focus insurers' attention on the counterparty risk associated with reinsurance. Currently many EU jurisdictions, such as the UK, have no formal capital need associated with the counterparty risk of reinsurance. From a regulatory perspective, reinsuring with a 'AAA' reinsurer is no different to reinsuring with an unrated reinsurer.

Solvency II will bring in direct capital charges for the counterparty risk of reinsurance through both explicit rules and the need to model this risk in the firm's enterprise risk model. BRAVE Partners is highly experienced in this area. The firm's partners have put together an innovative transaction to hedge the counterparty risk on a portfolio of reinsurance recoverables.

The impact of Solvency II on the competitive landscape will be immense and far reaching.

EU insurers must start to practically analyse and act upon these consequences.

### M&A and business lines

Solvency II will bring pressure for small, specialised insurers to merge with larger groups. The larger groups will also be glad to acquire specialised lines to the extent that these businesses add Solvency II diversification to them. BRAVE Partners is aware of a few companies that are already assessing a large range of potential targets.

This dynamic will change the business landscape. Clearly, the large insurance groups will have a significant advantage over specialised businesses in terms of the capital that they need to write business. One option is just to sell the entire business to a larger insurer. However, often the management and processes of a small insurer will not necessarily fit well within a large, international

group. One solution would be for the insurance management to convert from an insurer to a managing general agency (MGA). An MGA is a business that underwrites and processes claims, but that does not have risk capital. The risk capital, or to use industry terminology – “the paper”, is provided by an insurance company. BRAVE Partners foresees that Solvency II will push a large number of niche insurers to return their risk capital to investors and to re-emerge as MGAs to the large insurance groups.

**EU insurance groups need to begin the process of understanding their competitive position and strategy post-Solvency II.**

### **BRAVE Partners’ services**

Solvency II will have profound changes on the competitive landscape for EU insurance and reinsurance businesses. Most firms currently seem to be wholly pre-occupied with the Quantitative Impact Studies (QIS5+). Whilst this is an important activity, it should not be all consuming for companies. The businesses must also commit resource to positioning themselves within the competitive landscape post-solvency II.

BRAVE Partners would suggest that insurers commence the following process as a part of their Solvency II programme:

1. An immediate review of the legal structure of the firm to ensure that it will derive its full diversification benefit under Solvency II.
2. An immediate review of all product lines. The impact of Solvency II on individual lines is reasonably well understood. Companies need to understand the capital need of their products under Solvency II for two purposes:
  - a. To develop changes to the product to increase its capital efficiency under Solvency II.
  - b. To identify lines that are uneconomic under Solvency II and to develop a capital efficient run-off plan. This review should also include existing run-off books.
3. An immediate review of the firm’s competitive position in its main lines of business. In particular specialised businesses should begin to review whether their business is still viable in an environment where other firms have a significant advantage in terms of capital allocation. Those firms that believe that their business will become uncompetitive need to explore three options and develop a strategy around their favourite of:

- a. Sell to a major group.
- b. Convert to an MGA and write for some major group(s).
- c. Merge with other similar businesses.

### Interaction

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- Solvency II is set to have far reaching effects on the insurance industry in Europe and beyond.
- Most EU domiciled insurers are currently preoccupied with complying with Solvency II.
  - In particular implementing internal models is taking a lot of time, effort and expense.
- BRAVE Partners believes that insurers must also analyse the post-Solvency II competitive landscape as a matter of urgency.
- BRAVE Partners has mapped out three practical steps that EU domiciled insurers should take in order to position their business within the post-Solvency II competitive landscape.
- BRAVE Partners LLP can advise and assist insurers in analysing and optimising the position of their business in a post-Solvency II environment

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