Strategic implications of Solvency II

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Solvency II has been beset by delays in its development. However it is still moving towards implementation, albeit later than had been originally anticipated. This briefing note looks beyond the short-term time horizon to examine some of the longer-term strategic issues that are arising for companies as they continue to prepare for Solvency II.

INTRODUCTION

There is currently no publicly available revised timetable for the implementation of Solvency II. With the Long Term Guarantee Assessment taking place over the coming months it is likely that it will be summer at the earliest before such a timetable is made public. In the midst of this short-term uncertainty, insurance and reinsurance undertakings now have an opportunity to take a step back and consider the longer-term strategic implications of Solvency II for their business.

There are many strategic issues for companies to consider. Although not exhaustive, Figure 1 below outlines some of the main areas, each of which is discussed further in this briefing note.

Figure 1

VALUE PROPOSITION

The pricing of new products needs to ensure that shareholder capital is properly remunerated. Under Solvency II, certain products are likely to attract much higher levels of capital than is the case under the current solvency regime. Conversely, capital requirements are likely to reduce for other products. Therefore, undertakings will need to take a close look at the products which they currently sell in order to assess the capital implications for the business, not only in the short-term but over the life of the contracts.

Insurers and reinsurers alike, that are engaged in long-term insurance business, need to consider how best to price such business between now and the full implementation of Solvency II in order take into account the likely cost of capital once the new solvency regime comes into force. Any transitional measures that will be in place between now and full implementation of Solvency II are also likely to impact upon this cost of capital.

Existing niches – such as those which currently exist to take advantage of regulatory arbitrage across different European territories – may well cease to exist in future. Undertakings currently operating in such niches will need to consider how to adapt once the new solvency rules are implemented. In the extreme, these issues may lead firms to re-examine the viability of their current business model in order to develop a new value proposition for stakeholders. This could involve putting some lines of business (or the entire existing book) into run-off or seeking to restructure the existing business in some way.

Undertakings should also start to consider if there are new opportunities which are likely to emerge out of Solvency II, for example new product innovations or new reinsurance structures that will facilitate improved capital management, and to begin to explore them. First movers may gain a significant advantage over competitors in establishing themselves in these areas. Companies will need to review existing arrangements in order to determine their continued suitability. One such example is the use of reinsurance by Irish domiciled life insurers to mitigate capital requirements arising from the so-called “zero lapse” assumption[1]. With insurers and reinsurers set to face exactly the same regulatory capital requirements under Solvency II, there may no longer be a strong case to maintain such reinsurance.

Business mix will become an important consideration under Solvency II. For example, it may be possible for insurers that predominantly write annuity business at present to also write reasonable volumes of protection business at effectively zero or negative marginal capital requirements, owing to the diversification benefits available under Solvency II. This is likely to give such insurers a significant advantage over competitors in this market. Similar opportunities should also be available for reinsurers, who may be in a position to offer favourable longevity reinsurance rates if they have significant existing exposure to mortality risk.

With the expected levelling of the regulatory playing field within Europe, competition from undertakings in countries whose regulatory regimes are deemed to be “non-equivalent” to Solvency II may lead to distortions in the marketplace. If entities in such jurisdictions can avail of lower capital requirements they will be in a strong position to pass some of these savings on to their end-customers, thereby making it more difficult for undertakings subject to Solvency II rules to compete effectively.

For example, reinsurers domiciled in non-equivalent jurisdictions may be able to offer more attractive terms to cedants than their EU counterparts. However, it may be more difficult for cedants to obtain similar levels of capital relief from reinsurers that are based in non-equivalent territories. The important point at this stage is that undertakings begin to examine these issues in detail so as to be prepared for any implications that may arise upon implementation of the new regime.

CORPORATE STRUCTURE

Solvency II may lead undertakings to consider a number of different forms of restructuring, depending on their individual circumstances. These might include merger with, or acquisition of, a company in order to build scale or to capture the expected risk diversification benefits associated with varied books of business. Undertakings may alternatively choose to relocate, either to outside the EU (to a non-equivalent jurisdiction) or, in the case of groups, to reorganise their corporate structure to reduce reporting overheads or gain capital efficiencies.

The exact drivers of any such restructuring may be many and varied. If, for example, a group has a range of subsidiaries spread across various European markets it may make sense to set up a centralised structure whereby subsidiaries around Europe are reorganised to become branches of a single centralised pan-European entity. This is sometimes referred to as the ‘hub-and-spoke’ model, and is seen as a way by which to reap the full benefits of risk diversification under Solvency II.

On the other hand, having a local subsidiary may actually be beneficial in some instances. We understand that one of the current proposals for the application of the matching adjustment would restrict its use to business sold by a particular entity in the territory in which it is authorised. This could place providers selling cross-border at a significant disadvantage to local competitors. This, in turn, could lead to an exit from that line of business or to the establishment of a local entity in order to compete more effectively. The final outcome of certain technical debates that are ongoing at present at European level will be critical.

CAPITAL STRUCTURE

The current Solvency II proposals include rules on the tiering of Own Funds, and the limits which will apply to each tier when meeting on-going capital requirements. Therefore, there is a need for undertakings to carefully consider both their current capital structure and the way in which they raise capital.

It may become advantageous to restructure debt arrangements or to pursue other avenues in order to improve the overall quality of capital on the balance sheet. The new solvency rules may also prompt a move towards more direct involvement by insurers and reinsurers in capital markets as opposed to continuing to access capital through more traditional channels (such as accessing capital via the banking system).

Such restructuring may require quite a long lead-in time. Hence, it is important to examine the current capital structure of the undertaking and determine if any restructuring is necessary in the short-term. It

[1] This is a requirement of the European Communities (Life Assurance) Framework Regulations, 1994 that life insurers determine reserves on the basis that future lapse rates are zero (unless to assume a positive level of lapses would lead to a more prudent reserve)

is likely that some form of transitional arrangements will be put in place in order to help undertakings to move towards Solvency II and it is important to keep abreast of such proposals so as to ensure that sufficient quantities of high quality capital continue to be available to meet solvency requirements.

INVESTMENT

Changes in the regulatory balance sheet will force companies to review their investment strategy in a Solvency II world. There will be a more direct link between capital requirements and the way in which assets are invested. For example, different types of equity and bond investments will attract different capital charges, and concentrations of assets with individual counterparties will need to be closely managed. All of this will lead to the need for strategic asset allocation decisions in the coming years.

These asset allocation decisions will need to strike the right balance between risk and reward. Switching assets in a structured and timely fashion will help undertakings to avoid the need to sell at depressed prices, or buy at inflated prices, if there is general realisation within the industry that a large scale asset reallocation exercise is needed (especially if this happens late in the day). This could occur, for example, if sovereign bonds were no longer considered to be risk free when calculating solvency capital requirements.

The location of surplus assets within the overall corporate structure may also become an important consideration. For example, surplus assets that are held and invested within a subsidiary could lead to excessive currency risk capital charges at an overall group level if the reporting currency of the group is different to the currency of the investments.

Investment decisions will also need to take liquidity management considerations into account. It is important that in any reorganisation of the investment portfolio of the undertaking sufficient liquidity is maintained in order to meet any short-term obligations that may arise. This may be particularly important if, for example, the company engages in certain risk mitigation strategies, such as dynamic hedging, as significant capital flows can take place at very short notice in order to satisfy margin calls.

It is also worth noting that the current asset admissibility limits will no longer apply, which will open up additional investment strategies and product opportunities.

Another area for companies to consider is how credit for the proposed matching adjustment to the Solvency II risk-free discount rate can be obtained. It looks likely that there will be limits applied to the credit quality of assets supporting this adjustment. Undertakings will need to bear this in mind in determining their investment allocation in order to ensure continued eligibility for this adjustment. It has yet to be decided what, if any, conditions will apply in this area so it is important that undertakings intending to utilise the matching adjustment keep up to date with developments in this space.

RISK MANAGEMENT

The availability and cost of capital that undertakings will face under Solvency II will ultimately depend on market perception of the risk-return profile of the business. Therefore, management of the risk profile of the business will be of key importance. Under Solvency II, products that carry greater risk will attract additional capital requirements. If this capital is inadequately remunerated then firms may need to consider either redesigning products or implementing risk mitigation programmes.

In shaping the risk profile of the business, undertakings will need to have a functioning risk appetite statement in place. This risk appetite statement needs to complement, and help to determine, the overall strategic direction of the business.

Additionally, the effectiveness and ease of implementation of various risk mitigation strategies, such as reinsurance or hedging, will vary under Solvency II. For example, the ability to hedge the impact of movements in the Solvency II risk-free rate is something that firms will need to consider carefully as the final solvency rules take shape. If undertakings are planning to engage in such a strategy they need to begin to consider all of the possible implications of it now.

RESOURCING AND OPERATIONS

Before making decisions on investment in, for example, IT systems and teams of skilled resources to address the additional reporting demands of Solvency II, firms will need to consider the value for money that is likely to arise out of such investment. Undertakings will also need to consider whether these systems and resources should be based in-house or outsourced, either to related group entities or to specialist external providers (with ultimate control and responsibility remaining with the undertaking itself).

In the case of small to mid-sized insurance and reinsurance undertakings an outsourced model may make economic sense, whereas the investment in building an in-house capability might be beneficial for larger undertakings in the long-term. Either way, this is likely to be a key strategic decision for undertakings and one which cannot wait on the eventual implementation of the new regime.

SUMMARY

As Solvency II continues to develop and move towards implementation, the time has come to consider the wider strategic implications of the new regime. These are many and varied and their relative importance will depend on the exact circumstances of each individual undertaking. It is important that sufficient time is given to strategic considerations now in order to begin to shape the organisation such that it is ready to meet the challenges of the new regime in a way that works best for all stakeholders.

Solvency II is likely to bring with it many challenges and new opportunities. The competitive environment for many undertakings is set to transform. Current value propositions may cease to exist, new propositions will emerge and insurers and reinsurers alike will have to react accordingly. While it is true to say that there is still a lack of clarity as to when the new regime will be introduced, it is remains very important that firms fully understand the implications of Solvency II on their business strategy.

Many of the changes that will be needed to prepare for, and successfully compete in, a Solvency II world will require careful consideration and may take quite a while to successfully implement. Understanding the options and what these mean for your company is a key first step. Firms need to act now or risk being left behind.

CONTACT

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