



With the 2012 Solvency II deadline looming, **Frank Achtert**, managing director of GC Securities Ltd, looks at how (re)insurers can turn the regulation to their advantage

Comply and Contain: Gaining Solvency II efficiencies through ILS

Solvency II is already reshaping attitudes toward risk transfer and capital adequacy. The spectre of higher standards—and escalating costs—will require carriers to reevaluate their approaches to risk management. Fortunately, risk-bearers are not powerless to control the cost of cover. Risk securitisation and the use of derivatives may become important tools in mitigating the expense associated with Solvency II compliance. Optimising capital with a broad range of risk transfer techniques will be crucial to meeting Solvency II's rigorous requirements, as carriers will have to secure sufficient cover without incurring disproportionate costs.

Expected to take effect in 2012, Solvency II - the EU insurance supervisory regulation - aims to establish a solvency system that is better matched to the true risks of an insurance company. Carriers must be capitalised to maintain a 99.5 percent probability of remaining solvent for the coming 12 months, which equals a targeted 1-in-200 year ruin probability. The heightened standard is likely to compel carriers to secure additional cover, implying a greater investment in risk transfer. To comply with Solvency II and manage costs, carriers should look for new ways to shift risk without sacrificing profitability.

Solvency II is expected to broaden the scope of admissible risk transfer mechanisms accepted by regulators. To calculate the future solvency capital requirement, which is at the heart of the Solvency II regulation, companies will have a choice. They can use a standard formula offered under Solvency II, an internal model approved by the carrier's supervisory authority or a combination of both. The standard model will give only limited credit for non-traditional risk mitigation instruments. However, under a sophisticated internal model, derivatives will sit alongside reinsurance as risk transfer mechanisms and show

that the carrier has an advanced risk management system. The increased use of internal models throughout the insurance industry will lead to the adoption of more sophisticated risk mitigation techniques, such as securitisation.

Planning for Solvency II compliance with today's pricing could squeeze margins mercilessly in a post-catastrophe marketplace. A long-term strategy should include consideration of an insurance linked securities (ILS) component in addition to traditional reinsurance, especially since multi-year cover locks in a cost-effective price up front. Thus, when pricing is driven higher by market conditions, the use of ILS may support

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more cost-efficient risk transfer.

To facilitate the transfer of risk and interest payment to investors, a special purpose vehicle is formed to move risk out of the carrier and make it available to investors. Thus, the transfer of insurance risk via securitisation can be structured in reinsurance contract wraps or derivatives contract wraps.

Securitized risk in a reinsurance wrap is conceptually equivalent to risk transfer via traditional reinsurance contracts in economic and regulatory capital relief terms. A reinsurance contract wrap on an indemnity loss-triggered contract combines the depth of capital markets afforded by securitisation with the familiarity of ultimate net loss treaties. Using this structure, a cedant can match coverage with actual losses, ensuring that there is no overhanging exposure in the event of a catastrophe. The difference,

though, is that the cedant can eliminate credit risk almost completely, as the securitised risk is fully funded.

Investor appetite in this approach has been limited because of a lack of transparency of the underlying exposures. This reluctance has begun to change, however, as reflected by an increasing amount of indemnity-triggered deals. Investors are continually seeking attractive, diversified investment opportunities outside the credit risk sector.

A pure derivative transaction, on the other hand, does not include any reinsurance provision. The payout is determined by specified indices, market or modeled losses. Consequently, this approach is not considered reinsurance under the International Financial Reporting Standards. Instead, it is shown as a financial instrument.

The purpose of a derivatives-based strategy is to transfer risk at as low a price as possible, without sacrificing sufficient coverage. Derivatives-based securitisation allows the cedant to access the broadest possible market, resulting in effective pricing and greater risk transfer capacity. Thus, it is likely that supervisory authorities will accept derivatives-based risk transfer, as long as the impact on economic capital can be quantified in a reliable, objective manner.

Solvency II will encourage insurers and reinsurers to adopt more sophisticated capital and risk analysis practices, resulting in the more efficient allocation of capital. Insurers and reinsurers will have to externalise exposures through the traditional reinsurance market, or they could tap financial markets via securitisation or other derivatives-based strategies. Driven by the increasing sophistication of insurers' risk management processes, risk transfer methods will coexist and converge, enhancing capital efficiency across the industry.

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