Solvency II horizon: challenges and strategic impact

After a long period of discussion and many delays, the new European insurance regulatory regime Solvency II will commence in January 2016.

The rules will be compulsory for all insurance and reinsurance companies and groups in the European Economic Area. The Solvency II rules were developed over a period of more than 15 years, and there are many reasons for the long delay. Two notable factors are differing business models from country to country, and pressure on long-term guarantee products in the private pension system created by the low interest rate environment.

Challenges

To calculate the Pillar 1 (quantitative capital requirements) solvency position, (re)insurers in Europe may use a standard formula approach provided by the European Insurance and Occupational Pensions Authority, or they may develop a full internal model or partial internal model, which will need to be certified by the national regulator.

So far, only a few (re)insurance companies and groups have applied for internal model certification and many of those are large international insurance groups. The submission of internal model applications was due in the second quarter of this year, and so far only one company – Hannover Re – has had its internal model approved by regulators. Feedback and comments on the internal model approval process indicate that national regulators may ask (re)insurers to toughen the assumptions and calibrations, driving up the amount of required capital.

Most companies are relying on the standard formula approach, at least for the start of Solvency II. While many companies have developed internal modelling approaches to improve their management capabilities, they are currently not willing to enter the certification process with national regulators.

One of the major hurdles in this certification process is the extensive documentation requirements for the model description, the validation process and the use test. In some cases the companies have to interpret unclear rules and the internal model results are also vulnerable to last-minute decisions on calibrations.

This uncertainty, together with the occasionally limited capital savings opportunities achieved by using an internal model compared to the standard formula, have steered many (re)insurance companies and groups away from entering the certification process. This, of course, may change after Solvency II begins next year, when the uncertainty around calibrations and the certification requirements will likely disappear.

> "The chief financial officer increasingly recognises reinsurance as a risk and capital management instrument"

To deal with differing capital regimes between the European Union and the rest of the world, Solvency II introduces the concept of "equivalence" instead of forcing Solvency II standards upon a third country. In June 2015, the European Commission confirmed "provisional" equivalence for a period of 10 years for six countries – Australia, Bermuda, Brazil, Canada, Mexico and the US. Only Switzerland was granted "full and permanent" equivalence status.

To calculate the group solvency position, European insurance groups are permitted to use the local capital requirement rules of the corresponding country for subsidiaries within these seven countries. However, there is still a lot of uncertainty around the extent to which the different risk-based capital ratios should be used.

For subsidiaries in other countries, European insurance groups are still in the dark as to which capital requirement rules should apply. The same is true for possible group supervisory requirements for European subsidiaries of overseas groups and the requirements for reinsurance contracts bought from reinsurers outside Europe. A second round of equivalence decisions by the European Commission is expected in autumn 2015. It is believed that other countries, such as China, Hong Kong and Singapore, are also interested in "provisional" equivalence status.

Strategic impacts

(Re)insurance companies and groups use different measures to deal with the issues and challenges of Solvency II. To eliminate the risks associated with the low interest rate environment, there is a common trend across the industry to move away from traditional saving products that include guarantee rates into more capital-efficient annuities and unit-linked products.

Some analysts expect that (re)insurers will be forced to raise more capital through shares or sub-debt issuances, especially if national authorities ask for tighter interpretations and calibrations of the Solvency II rules. Alternatively, companies will use reinsurance as a capital management instrument to reduce the capital requirements in an efficient way.

Recently, we have seen a change in the way reinsurance is viewed in some companies and groups. The chief financial officer increasingly recognises reinsurance as a risk and capital management instrument, rather than using capital measures like equity and sub-debt issuances.

Reinsurance is now also used more often to optimise the diversification benefit, either between different lines of business or between insurance and market risks. For this, some insurance groups have implemented an Internal Reinsurance Vehicle to manage the diversification benefit in a more efficient way, and to increase the transferability and fungibility of capital within an insurance group.

Retrospective reinsurance solutions – loss portfolio transfer and adverse development covers – have been used for capital management purposes to free up capital, either to increase the solvency ratio up to a competitive level of risk tolerance described in the risk strategy or to invest the capital in areas with higher return opportunities.

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