

Insurance

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# Solvency II: A competitive advantage for European insurers?

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Despite the fact Solvency II in its current form will apply only to the European Union, North American insurers are encouraged to pay attention to the factors underlying its development. If, as anticipated, Solvency II leads to markedly lower capital charges for EU-based companies, then the Europeans will have a significant competitive advantage over North American companies.

SOLVENCY II: A COMPETITIVE ADVANTAGE FOR EUROPEAN INSURERS?

In May 2007, the IASB issued a discussion paper, 'Preliminary Views on Insurance Contracts,' which advocates a 'current exit value' approach to the measurement of insurance contracts. The market-consistent approach advocated in the discussion paper is broadly in line with recent developments in prudential regulation, including the UK's Individual Capital Adequacy Standards (ICAS) and the anticipated EU Solvency II. As such, it forms part of the accelerating convergence toward an economic framework for evaluating solvency, reporting earnings, and measuring performance.

The asset and liability requirements included in the draft framework for Solvency II, published by the European Commission in July 2007 and updated in February 2008, are in many respects conceptually consistent with the current IASB proposals. Under Solvency II, insurance assets and liabilities would be measured using economic principles, with the resulting capital requirements based directly on risk-based measures. Although Solvency II would at present apply only to European Union insurers, many other jurisdictions are monitoring its developments to assess the competitive impacts and determine what elements might be more widely applied.

**The competitive impact of Solvency II**

Despite the fact Solvency II in its current form will apply only to the European Union, US insurers are encouraged to pay attention to the factors underlying its development, particularly those that potentially have a competitive impact.

Solvency II seeks to map insurers' regulatory capital requirements against their individual risk profile. This will encourage, if not actually require, companies to enhance risk management, upgrade information systems, and embed risk awareness more closely into the governance, strategy, and business operations. Although it presents a significant implementation challenge, moving to Solvency II could help develop a more informed and forward-looking economic basis for decision-making.

The foundation of the new regime consists of three pillars that are conceptually comparable to Basel II:

1. Quantitative requirements;
2. Governance and risk management requirements; and
3. Disclosure and transparency requirements.

Assets and liabilities will be valued on a market-consistent basis, conceptually in line with the latest proposals for IFRS Phase II. The standard solvency capital requirement (SCR) will be based on a 99.5% confidence level of remaining solvent within the next 12 months (equivalent to being able to absorb a 1-in-200-year event). The SCR evaluation, which is broadly equated to a BBB rating, should include all material financial and non-financial risks facing the company. Companies then can determine the amount of capital appropriate to a true economic level and calibrate to the target level to meet their desired rating.

In keeping with Basel II's underlying advanced approach, it is likely that many larger companies will take advantage of the option to use an internal model to calculate their SCR, subject to supervisory approval. For most companies this is expected to result in a lower regulatory capital requirement. Last year's quantitative impact study for Solvency II (QIS 3) found that non-life companies entering SCRs based on their own models achieved on average a 25% reduction in SCR over the standard formula. For life companies the comparable reduction was 15%.<sup>1</sup> Larger groups also can take advantage



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<sup>1</sup> 'Solvency II – QIS 3 Report,' published by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) on 21.11.07.

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of lower compliance costs and more flexible capital arrangements by opting for group supervision under Solvency II.

Many industry stakeholders have argued that there has been a disparity between true economic capital and the capital required by traditional regulatory frameworks. In particular, regulatory capital often has been derived from formulas intended to cover a wide range of companies and risk profiles. These factor-based calculations do not reflect the specific risks associated with individual insurers and the effectiveness of the management at them; as a result, capital levels may exceed what is appropriate for many companies. This results in an additional cost (or 'capital drag') because companies are compelled to hold more capital than their risk portfolio otherwise would require on a purely economic basis.

By using their own models, companies can incorporate their portfolios' diversity and diversification with their own experience into a unique but credible capital assessment. They then can apply solvency requirements that are more appropriate to their risks, as well as reduce the disparity between regulatory requirements and the true economic capital they believe they must hold to support their risks. In contrast to Solvency II, US capital requirements are typically based on standard

formulas or include calculations based on prescribed assumptions that may be significantly different from the assumption of a 1-in-200-year event. There are limited provisions to reduce capital based on risk mitigation or diversification between products or marketplaces. Where these risk mitigation provisions exist, their application may be subject to approval by various state regulators. This results in limited and inconsistent application and may impose a significantly larger capital drag than would be expected under the harmonized Solvency II.

The companies most likely to benefit from lower capital charges under Solvency II are larger, diversified insurance groups with effective risk management. Their smaller, less sophisticated mono-line counterparts may find their capital requirements increase on a relative scale. As a result, European companies may face mounting pressure to restructure – shuffling existing groups, moving to a branch structure, or exiting high risk or discontinued lines that may absorb too much capital – to obtain benefits from Solvency II.

Capital drag affects the pricing and profitability of insurance products. For example, if a company prices a product to achieve a 15% return on economic capital and earn 5% on any capital in excess of economic capital, then a solvency regime

that requires only 100% of economic capital would realize this 15% return, while provisions requiring 110% of economic capital would result in a 14.1% return on invested capital. If a company subject to US regulations and a company subject to Solvency II were to offer a life insurance product with identical assumptions and features, then the return on investment for the US-regulated company would be lower or the company would have to charge a higher price to realize the same return. This would be solely due to the costs associated with holding a higher-than-necessary amount of capital.

Companies naturally will seek ways to take advantage of less onerous capital regimes. For years, they also have been entering into financial treaties or agreements in order to avoid or defer high liability or tax requirements; this has been the primary factor behind the growth of the reinsurance sector in Bermuda, the Cayman Islands, Ireland, Luxembourg and Vermont.

However, certain costs, including the expense of establishing and maintaining subsidiary companies, fees paid to other entities, charges associated with the treaties themselves, and possible lack of transparency, have accompanied relocation to these markets. In addition, the level of available credit is another



constraint with respect to liabilities. Many treaties or agreements are accompanied by a letter of credit or surplus note equal to the liability credit. The availability of credit can be limited in jurisdictions with more favorable regulatory arrangements, which, coupled with the recent credit crunch, have increased costs and slowed transactions.

Despite the costs, letters of credit, surplus notes, and other arrangements are increasingly used in situations in which additional expenses are more than offset by the savings associated with removal of unnecessarily high liability or capital requirements. If insurers that sell products in the United States efficiently transfer risk and capital requirements to a subsidiary operating under Solvency II requirements, then they may be able to reduce

excess capital requirements and increase overall profitability and return on equity.

#### The potential effects of Solvency II in the US

Developments in the pipeline in the United States may help some insurers to reduce the costs of more onerous domestic capital requirements, but they may not be sufficient to offset the advantages European insurers may realize under Solvency II. If, as anticipated, Solvency II leads to markedly lower capital charges for EU-based companies, then the Europeans will have a significant competitive advantage over US companies.

Effective and forward-thinking US reform could eliminate these disparities. Although this may seem unlikely to many in the industry, there are encouraging signs. Recent developments, such as the Variable Annuity

Commissioners Annuity Reserve Valuation Method (VA CARVM) and NAIC participation in Solvency II discussions indicate that US regulators are interested in certain aspects of Solvency II. In addition, the concept of a federal insurance company charter – something which former US Treasury Secretary Henry Paulson supported – once again is a topic of serious discussion.

The combination of external competitive pressures, internal pressures for financial reform, and insurers' increased discipline in assessing and measuring risks indicates that the industry's and regulators' risk management focus is evolving toward more flexible and less onerous capital requirements. Successful Solvency II implementation may be enough to push US regulators to seriously consider an approach with comparable advantages. □

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