

Insurance

Bridging risk and capital*

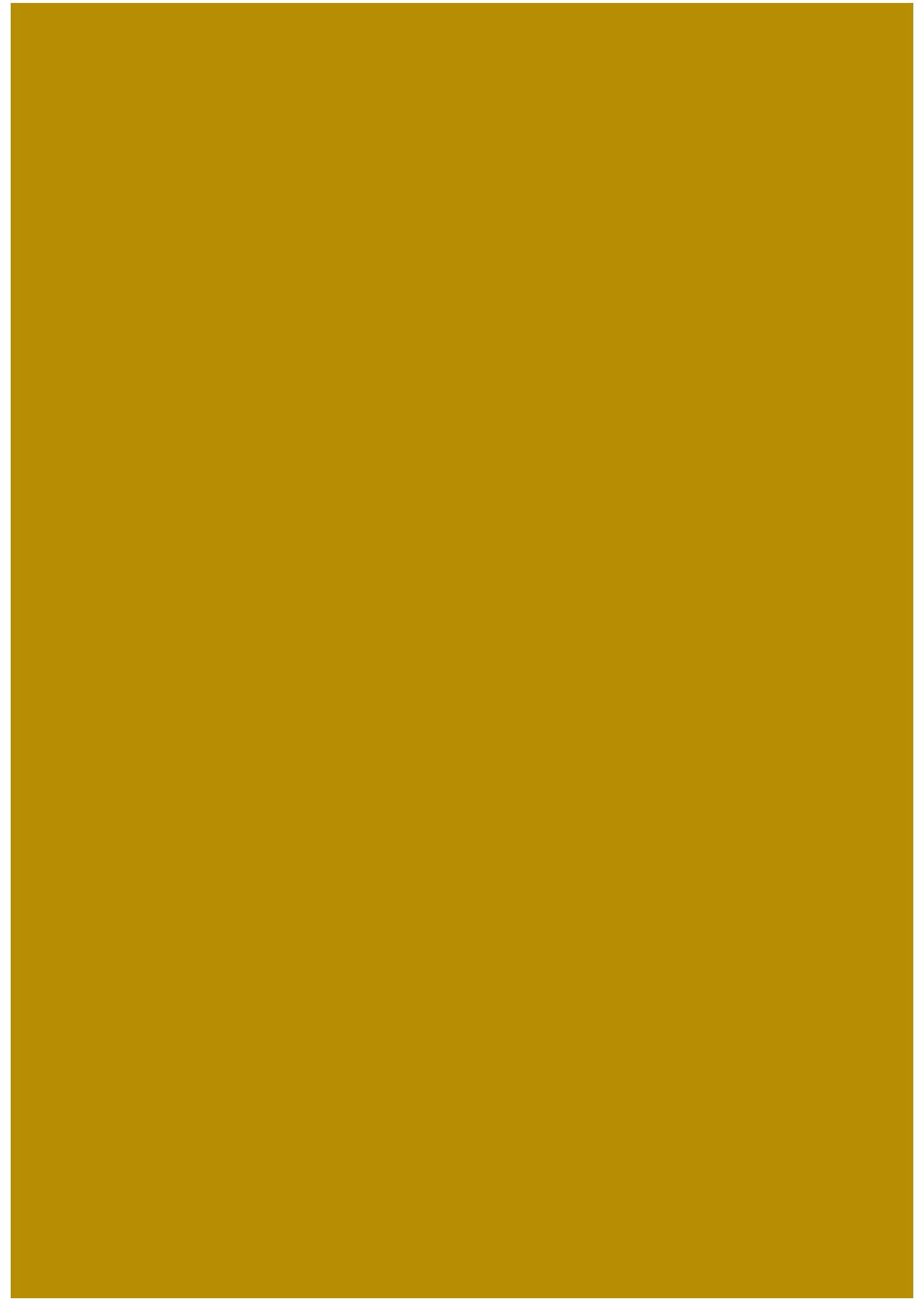
Countdown to Solvency II

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Foreword



Welcome to the second edition of Countdown to Solvency II, the PricewaterhouseCoopers¹ newsletter examining the latest developments in the planned reform of prudential regulation for European insurers.

Solvency II aims to map the regulatory capital requirements of each company against its individual risk profile. This will encourage, if not require, companies to enhance risk management, upgrade information systems and embed risk awareness more closely into the governance, strategy and operations of their business. While it presents a significant implementation challenge, the move to Solvency II could also provide an opportunity to develop a more informed and forward-looking basis for decision-making.

The foundations for the Directive have now been laid with the publication of the draft legislative framework in July. This is the opening stage of what could be a long period of debate, lobbying and political negotiation. Yet the key principles and their implications are now emerging and it is therefore essential that insurers assess how Solvency II will affect their company both operationally and strategically, along with the competitive impact on the marketplace as a whole.

This edition of Countdown to Solvency II examines the political process and the likely commercial ramifications of the Directive. It also looks at the challenges and opportunities opened up by the crossovers and conflicts between Solvency II and the proposed new International Financial Reporting Standard for insurance contracts (IFRS Phase II).

We hope that this and future editions provide insights that can help insurers and the key stakeholders to assess the implications of the Directive and assist them in preparing for the changes ahead. The subjects covered are based on feedback from our clients. If you have any comments or there are any issues you would like to be covered by our subject-matter experts in future editions, please let me know.

Ian Dilks
Global Insurance Leader
PricewaterhouseCoopers (UK)

¹ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

01

The draft framework unveiled

ANNETTE OLESEN, GARVAN O'NEILL AND WENDY REED

The draft framework Directive for Solvency II has now been presented to the European Parliament. While much had already been in the public domain, a number of what could prove to be 'ambitious' proposals go further than many expected in areas such as group supervision.



The draft framework Directive also provides important new insights into how the regime is likely to operate. Annette Olesen, Garvan O'Neill and Wendy Reed outline the key aspects of the framework, their potential implications and the challenges ahead for EU insurers.

'This is an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers,' said Charlie McCreevy, European Commissioner for Internal Market and Services, speaking at the launch of the Solvency II draft framework directive in July. The proposals are indeed 'ambitious', with far-reaching implications for the way European insurers manage their businesses and communicate with the markets.

The Solvency II directive forms part of the European Commission's drive for a single European market and the modernisation of regulation (Financial Services Action Plan). It will recast 13 existing directives and national rules on insurance prudential supervision into a single risk-sensitive EU-wide framework. It will apply to all EU-based (re)insurers with annual premiums of more than €5 million (smaller entities can choose to opt in) and EU branches of non EU-based groups. No special provisions have been provided for

captives and other niche operations. However, entities in run-off before 10 December 2007 will be exempt.

The draft Directive moves away from formulaic solvency evaluations. Instead, capital requirements will reflect the risks being run within the business and the effectiveness of the procedures in place to monitor, manage and mitigate them. The foundations are the three pillars of quantitative capital requirements, supervisory review and public disclosure. These pillars are conceptually comparable with Basel II for banks, which will help to improve cross-sector comparability. However, Solvency II takes some of the principles and practical details of Basel II a stage further.

Evaluation

The standard solvency capital requirement (SCR) will be based on a 99.5% confidence level of remaining solvent within the next 12 months. Falling below the SCR would require companies to restore their capital ('own funds') to the SCR level or adjust their risk profile (to ensure the own funds are sufficient) within six months. Eligible capital will be divided into one of three quality tiers reflecting such factors as its availability, permanence and efficacy in absorbing losses. Under the modular approach to risk assessment,

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the SCR evaluation should include all material risks facing the company, including operational risk, along with underwriting, credit, market and other financial risks. Companies can use an internal model to calculate the SCR, subject to supervisory approval. For most companies this is likely to result in a lower regulatory capital requirement.

The safety floor will be a minimum capital requirement (MCR). Breaching the MCR would elicit immediate intervention by the supervisor and possible closure. Surprisingly, however, the precise mechanism for calculating the MCR is not included in the draft directive and will therefore need to form part of the subsequent 'implementing measures'.

Assets and liabilities will be valued on an 'economic' market-consistent basis, conceptually in line with the latest proposals for a future International Financial Reporting Standard for insurance contracts (IFRS Phase II). The proposed timings of the twin solvency and financial reporting frameworks have also converged, following the postponement of the introduction of Solvency II to 2012. While these parallels could help companies to realise operational synergies, key details diverge, as we outline in the article on pages 6-9.

SCR evaluation should include all material risks facing the company, including operational risk, along with underwriting, credit, market and other financial risks. Companies can use an internal model to calculate the SCR, subject to supervisory approval.

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The market-consistent approach to risk assessment will help to bring regulatory capital more into line with economic capital systems and the systematic enterprise-wide risk management requirements that underpin them. However, economic valuation will be a challenge for many insurers, heightening the potential for volatility in the balance sheet and, in many cases, requiring a significant upgrade of modelling capabilities, analysis and communication.

Behaviour

Critically, 'Solvency II is not just about capital. It is a change of behaviour', as Thomas Steffen, Chairman of the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), a key advisor to the EC, said at the launch of the draft framework Directive.

The principal aim is to ensure that effective risk management and policyholder protection are embedded into the mindset of the business, including its governance, operational and decision-making procedures. This will require a systematic and formalised approach to corporate governance that includes written policies and clear lines of responsibility, underpinned by an audit trail of oversight and formalised documentation. Companies will need to maintain certain core functions including actuarial and risk management teams. These key personnel, along with senior managers, will need to meet 'fit and proper' standards of integrity and professionalism.

The chief mechanisms for enforcement include the requirement to carry out an ongoing 'Own risk and solvency assessment' (ORSA), which takes into account the company's risk profile, approved risk tolerance and overall solvency needs. The results of the ORSA should form part of the firm's procedures

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for setting and updating its strategy and must be disclosed to the regulator. As such, the ORSA will be the primary vehicle for embedding the principles of Solvency II into the organisation.

The validity of companies' risk measurement and the quality of their risk management, along with the effectiveness of the embedding and governance procedures that underscore them, will be subject to supervisory review. If supervisors are dissatisfied, they are likely to take enforcement action and, in exceptional cases, require the company to set aside additional capital.

The move from a primarily rules-based to a principles-based approach to supervision will transform the relationship between supervisors and regulated entities in many member states. Companies are likely to find themselves working more closely with supervisors as part of a more hands-on system of review, in particular when seeking internal model approval. Insurers and their supervisors, be they at home country or group level, are likely to need to exchange information

and ideas to help them progress through what could be a steep learning curve for both.

Disclosure

The final pillar of Solvency II is the 'market discipline' of disclosure. Each year, companies will be required to publicly disclose details from their solvency and financial condition reports. Gathering and validating the necessary data and analysis needed to prepare these highly detailed reports will be a challenge in itself, underlining the desirability of close co-ordination with financial reporting systems.

Clearly, more extensive disclosure will intensify the spotlight of scrutiny on the effectiveness of each company's risk management systems and processes, along with the viability and validity of the underlying tolerances and assumptions. This is a critical development at a time when analysts, rating agencies and other key stakeholders are taking an ever keener interest in such information as part of their evaluation of the strength of the business and the sustainability of its returns.

Sea-change

Solvency II takes a number of important further steps towards bringing prudential regulation more closely into line with the way businesses are run and the development of innovative risk

The principal aim is to ensure that effective risk management and policyholder protection are embedded into the mindset of the business, including its governance, operational and decision-making procedures.

mitigation techniques. This includes allowing greater use of derivatives and securitisation strategies.

Companies will also have greater freedom in their choice of investments, as long as portfolios are managed prudently and in the interests of policyholders. However, the risk loading on potentially volatile instruments such as equities could affect investment strategies (see article 03).

One of the most fundamental developments is the proposed streamlining of group supervision through the introduction of a lead supervisor for each European group. This could reduce compliance costs and potentially lower capital charges through the recognition of group-wide risk diversification. However, this proposal is likely to prove quite contentious.

Solvency II aims to be 'proportionate' in the demands placed on smaller businesses and in particular seeks to avoid putting them at a competitive disadvantage. As we discuss in article 03, however, it is important to consider how lower capital charges through the use of internal models and other sources of differentiation might affect the market.

The journey ahead

The final details of Solvency II are subject to a complex, uncertain and potentially lengthy political process. However, while much may change between now and 2012, the key foundations of Solvency II are now in place and companies should consider the objectives and direction of their implementation strategies. In particular, while this is likely to be a costly and demanding exercise, it does offer opportunities to embed best practice in governance and risk management and develop a more informed and assured basis for decision-making.

Figure 1 The critical questions for CEOs, CFOs, CROs and Chief Actuaries

What is the impact of the new valuation basis on our balance sheet and solvency position?
Will we need to raise capital?
How will this impact on my daily activities?
Are all Solvency II key business risks captured in our internal risk assessment?
Can I manage and continuously report on risks at an individual and aggregate level?
What is the potential impact on the operational and organisational structure of the business?
What will it take for public disclosure of: <ul style="list-style-type: none"> • Governance system • Risk profile, mitigation and sensitivity • Solvency and financial condition
What are the implications for our corporate structure?
Are there implications for my business strategy for growth in/outside the EU?
What will Solvency II implementation cost?
How can I manage costs effectively?
When should we establish the project team?

Source: PricewaterhouseCoopers

A key consideration in defining companies' ambitions for Solvency II is deciding whether this is primarily a compliance project or an opportunity to embed enterprise-wide risk management techniques more closely into the fabric of the business. The objectives need to draw on a consideration of how the Directive will affect the company operationally and strategically, including any particular threats or opportunities, and how it should respond in the most effective and proactive way. Figure 1 sets out some of the critical questions that organisations will need to address.

Articles in this and future editions of Countdown to Solvency II will look in more detail at the developments, challenges and opportunities of Solvency II. PricewaterhouseCoopers has also produced a white paper examining the key requirements of the draft framework directive, their implications and what companies should consider doing now (for free copies please visit www.pwc.com/solvencyII). ■

02

The common front: A comparison between IFRS and Solvency II

VIBEKE BAK-PEDERSEN, ERICA NICHOLSON AND JULIA SCHÜLLER

The timings and underlying principles of Solvency II and the planned new International Financial Reporting Standard for insurance contracts (IFRS Phase II) are moving ever closer, opening up valuable opportunities for synergies in systems, organisation and market communications.



However, the latest proposals for both Solvency II and IFRS Phase II reveal some important differences in scope, approach and application. Vibeke Bak-Pedersen, Erica Nicholson and Julia Schüller examine the convergence, divergence and possible areas of integration.

As we outlined in the previous edition of Countdown to Solvency II, the bodies responsible for drawing up the draft blueprints for Solvency II and IFRS Phase II have developed fundamentally similar conceptual bases for these closely-related frameworks.¹ The convergence reflects both a philosophical meeting of minds and a desire to limit any unnecessary cost and upheaval.

The common ground includes an emphasis on principles rather than rules that aims to reflect the real 'economic' performance and risk profile of the enterprise. As Figure 1 outlines, the resulting similarities include a market-consistent current 'best estimate' of projected cash flows, taking into account the time value of money ('discounted'), plus a risk margin.

The disclosure principles of Pillar 3 seek to improve transparency and encourage market discipline, with similarities to the provisions already in place under IFRS 4 and IFRS 7. In particular, insurers would be required to provide quantitative and qualitative details of the risks they face, their sensitivity to market movements and the procedures in place to manage and mitigate these exposures.

It is equally notable that the timings are converging following the recently announced postponement of the planned implementation of Solvency II to 2012 (see Figure 2). However, the parallel timeline could make it easier to realise the synergies, reduce the overall application costs and maximise the potential benefits,

Figure 1 Comparison of Solvency II with IFRS Phase II

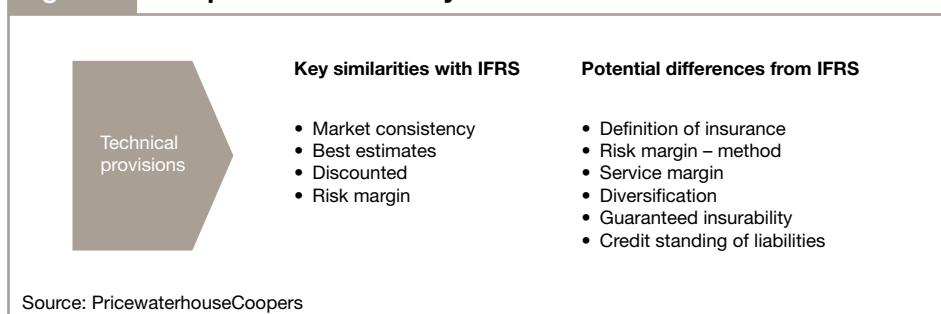
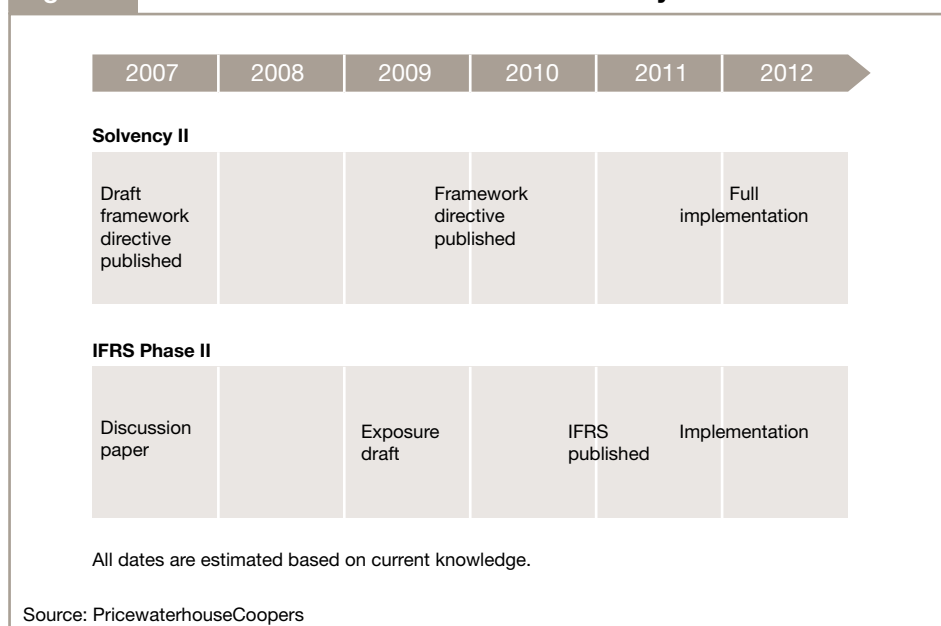


Figure 2 Timetable for IFRS Phase II and Solvency II



'Valuation standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings.'

From Solvency II draft framework Directive: Introductory note 28, 10.07.07.

¹ Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) for Solvency II and International Accounting Standards Board (IASB) for IFRS Phase II.

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including improved internal management information and more coherent and co-ordinated market communications.

Fundamental differences

However, beneath the 'surface' principles lie important variations in detail and practice, reflecting the inherent differences in application, scope and objectives of prudential regulation and financial reporting. The publication of the discussion paper on IFRS Phase II in May 2007 (www.iasb.org) and draft framework for Solvency II in July (www.europa.eu) provide the first concrete opportunity to compare and contrast the details and their practical implications.

Only listed companies are required to report under IFRS. Solvency II would apply to virtually all European insurance undertakings (annual premium income of more than €5 million).

IFRS seeks to measure the value of insurance contracts that are defined by their substance rather than their form. In contrast, Solvency II focuses on the broader legal form in seeking to ensure the solvency of the entity. Therefore policies that do not meet the IFRS definition of an insurance contract, including many types of pension and savings plan sold by life insurers, would still fall under Solvency II.

By focusing on the entity, Solvency II would allow companies to take into account the potential benefits of risk diversification. In contrast, the 'unit of account' for IFRS is the portfolio and what this means in practice is still the subject of debate and comment.

IFRS Phase II aims to provide users of accounts with a balanced evaluation of the performance and value potential of the business. As such it is 'weighted' towards what is in essence the mean point of the

risk and reward curve. In contrast, the design of the Solvency II Solvency Capital Requirement (SCR) focuses more closely on the extreme 'tail' end of the curve in seeking to guarantee that the entity will meet its obligations to policyholders.

Technical provisions

IFRS and Solvency II make no distinction between life, non-life and reinsurance contracts. In the absence of a liquid market upon which to base valuation under IFRS, the IASB's proposals are that the measurement of liabilities would be based on the hypothetical transfer price for taking on the rights and obligations of the contract ('current exit value'). Where there is no reference market price, the current exit value would be based on a best estimate plus margins for risk and service.

In contrast, Solvency II would in general break down liabilities into those that can be hedged (mark-to-market valuation) and those that cannot (discounted best estimate plus risk margin using a cost-of-capital approach).

Although both frameworks would include a risk margin, the presence of clearly defined and in some cases specified actuarial assumptions and discount rates within Solvency II would mean that the calculations could differ from IFRS. The current IFRS proposals also draw a distinction between a margin for the provision of services and a margin for bearing risk, while Solvency II only refers to a risk margin.

In seeking market consistency, IFRS might look towards assumptions that reflect a market average rather than what is pertinent to the particular company. However, Solvency II is predicated on management's best estimate. In turn, the IFRS proposals would only recognise

future premiums that a policyholder must pay to 'guarantee insurability' at the current premium, while Solvency II applies no such restriction. In addition, IFRS proposes an adjustment for the credit standing of the insurance liabilities, reflecting both the own credit standing of the insurer (explicitly excluded in the draft framework directive) and other factors such as the regulatory environment.

Disclosure

While some of the points of divergence might seem largely semantic, they could make provisions and other key evaluations difficult to reconcile. Moreover, while CEIOPS accepts that IFRS could provide a foundation for the annual solvency and financial condition reports required under Solvency II,² the scope and detail are likely to be far more substantial than under IFRS. In addition, insurers would need to provide a breakdown of eligible capital and possible explanation of any disparities with their financial statements. Where accredited, companies would also need to provide a description of their internal model.

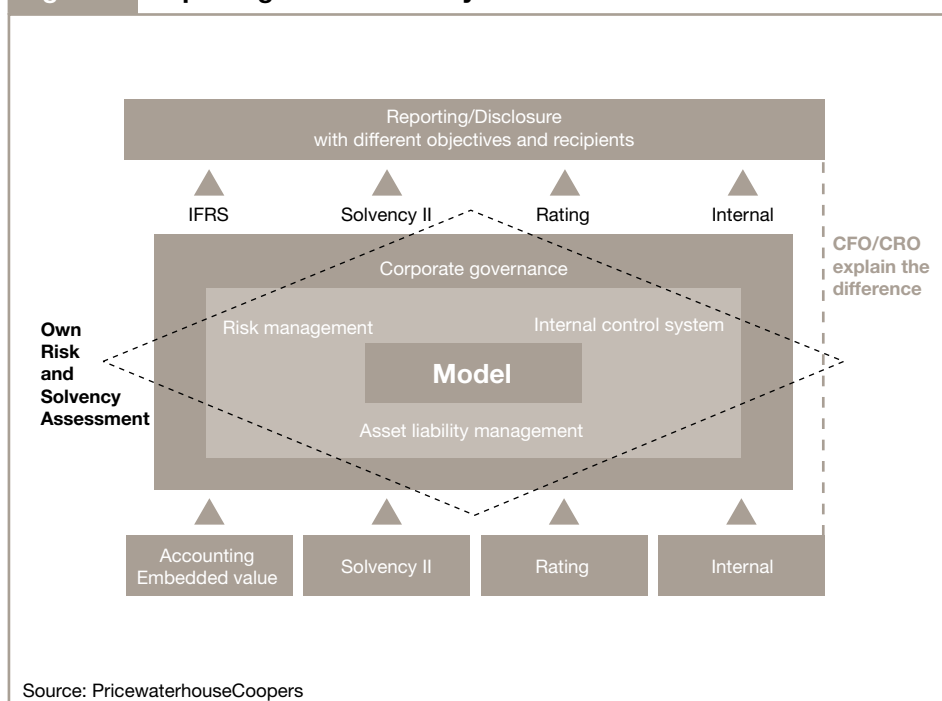
Common platform

While these differences clearly need to be addressed, the underlying similarities do open up the possibility of creating and integrating common finance and actuarial systems capable of meeting compliance demands and enhancing the basis for decision-making (see Figure 3). In contrast, separate implementation and operation of IFRS and Solvency II could be both needlessly costly and ultimately far harder to reconcile.

Key overlaps include the modelling of prospective cash flows, which is at the heart of both frameworks. Some of the required data capture and analytical capabilities may already be available,

² CEIOPS consultation paper published in December 2005.

Figure 3 Reporting under Solvency II and IFRS



Source: PricewaterhouseCoopers

especially if companies use embedded value or economic capital techniques. Although companies that do not possess such capabilities clearly face tougher demands, they have the opportunity to develop purpose-designed systems that could enable them to integrate and enhance their reporting and overtake their competitors.

The overriding challenge will be how to integrate what could be an actuarial 'black box' of data and analysis into the general ledger and bringing it up to an auditable standard for IFRS. Systems and operations would clearly need to be flexible enough to underpin solvency evaluation and disclosure. Although reconciliation and explanation of any differences between financial and solvency disclosure can be difficult, the resulting information would gain in credibility from its auditable basis.

Effective operation will require close co-ordination between finance, actuarial and risk management teams. There are clearly challenges in developing and managing the necessary cross-functional co-operation and potential challenges in implementation of new IT/data warehouse requirements. However, closer integration could help these teams to add more value to the business. As future cash-flow modelling becomes more widely deployed in internal and external reporting, for example, there could not only be considerable room for systems and operational synergies, there would also be opportunities to develop more consistent metrics and analysis for management. The ultimate aim is a common language of risk and reward that aligns risk, reward and compliance considerations.

The supply of quality-consistent data from around the enterprise will be equally critical. To achieve this, finance and

actuarial teams will need to ensure the support of underwriters, claims and other business teams. To meet the demands of both IFRS and Solvency II compliance, their buy-in will help to ensure that disclosure reflects the perceptions of management. The competitive payback for the business is a more informed and forward-looking basis for decision-making that identifies the real risk-adjusted returns that are being made or should be targeted.

Meeting in the middle

IFRS and Solvency II build from common foundations, yet the detail of the twin structures will reflect important differences in objectives and application.

While compliance may be the primary consideration for many companies, the extension of IFRS and solvency disclosure is likely to intensify market and consumer scrutiny on the effectiveness of risk management and the validity of the underlying assumptions.

A proactive integrated approach to organisational and systems design that takes advantage of the convergence, while being flexible enough to take account of the practical differences, could help to ease implementation, streamline operations and seize opportunities to enhance management information. It could also provide a more coherent and credible basis for communicating the strengths and potential of the business.

Assessing the financial and operational implications now rather than later could help to realise the potential synergies and help reduce the potential burdens of parallel implementation in 2012. ■

03

Changing the competitive landscape: The commercial implications of Solvency II

ELIZABETH ABRAHAM, MONICA CORNALL AND THIERRY MADINIER

Far from being merely a technical compliance issue, Solvency II could have major commercial implications in areas ranging from pricing and product design to investment strategy and market communications. Elizabeth Abraham, Monica Cornall and Thierry Madinier look at the key considerations for survival and success in what could be a very different competitive landscape.



Solvency II 'is a real opportunity to improve the international competitiveness of European insurers,' said Charlie McCreevy, European Commissioner for Internal Market Services, at the official presentation of the draft framework Directive for Solvency II in July 2007.¹ 'We are setting a world-leading standard that requires insurers to focus on managing all the risks they face and enables them to operate much more efficiently. It's good news for consumers, for the insurance industry and the EU economy as a whole.'

Solvency II could indeed provide clear competitive advantages for European insurers by simplifying access to each other's markets and providing incentives for improved risk measurement and management. However, while the directive is designed to be 'proportionate', particularly in the way it affects smaller firms,² companies with the most diversified businesses and most effective systems and controls may reap the greatest competitive benefits. In many cases, these will be larger groups.

Larger groups will have more resources to invest in the sophisticated risk and capital management systems that could help them to gauge and control their risks more effectively and so lower their capital charges. Their overall solvency levels could also be reduced by diversification of product lines and geographical operations. Any capital savings could then be passed on to policyholders in lower premiums.

These potential advantages could sharpen the differentiation between sophisticated and less sophisticated companies. Nonetheless, smaller and niche insurance companies will remain an important feature of the market on account of their knowledge and ability to add value to specific products.

More generally, Solvency II will encourage companies to consider the efficiency of their group structures, along with the profitability and viability of individual portfolios. The EC has itself recognised that there may be 'short-term side effects'.³ For example, taking account of the 'true economic cost' of some types of policies, such as traditional financial guarantees, may lead to a reduction in coverage (see panel for more details about the potential impact on participating business). Equally, greater transparency may reduce cross-subsidies and therefore increase the prices of some more risk- and capital-intensive lines of business. Moreover, the impact on entry costs for new players and existing niche sectors, such as captives, will need to be monitored.

Cost of capital

Credit rating will continue to be the ultimate benchmark for the amount of capital being held. The standard solvency capital requirement (SCR) under Solvency II will be based on a 99.5% confidence level of remaining solvent within the next 12 months. This broadly equates to a Standard & Poor's 'BBB' rating, which is lower than the 'A' or higher required by most insurers.

However, rating agency assessments are now converging with Solvency II's prospective risk-based focus. For example, Standard & Poor's now includes assessments of the risk culture, risk tolerances and emerging risks in its counterparty credit and financial strength evaluations for insurers.⁴

Moreover, Simon Harris, Moody's Team Managing Director for European Insurance, has said that 'the purpose of Solvency II is not necessarily to strengthen the industry's capital base, but more to ensure

Impact on participating policies

Solvency II could have important implications for the reserving and performance of participating and with-profit type policies around Europe.

The market-consistent pricing of options and guarantees required under Solvency II is something already taken into account under the UK 'Twin Peaks' regime. However in some countries this may require a change in valuation and strengthening of reserves. In addition, the different arrangements for allocated bonuses and interpretations of 'fairness to customers' around Europe could heighten the complexities and challenges of moving to Solvency II.

Changes in reserving could in turn result in Solvency II affecting the level of policyholder bonuses. Current bonus levels may prove unaffordable when priced 'economically' and products may therefore be withdrawn.

The draft framework Directive implies that insurers will be permitted to build management actions into their solvency calculations. However, it is not clear whether this would be restricted to a reduction in the bonus or could also include modifications to investment strategies, such as a move from equities to gilts. It is difficult to fit this 'reduction for profit sharing' into the standard formula.

If the wider definition of 'management actions' is not included, then the UK business model of 'with-profits' business, in particular, may no longer be viable.

¹ European Commission media release, 10.07.07.

² Solvency II: Frequently Asked Questions 29 and 30, 10.07.07.

³ Solvency II: Explanatory Memorandum, section 2b.

⁴ 'Insurance criteria: Summary of recent enhancements to insurer enterprise risk management criteria', published by Standard & Poor's on 02.06.06.

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Solvency II aims to provide greater freedom in the choice of assets.

that sufficient regulatory and internal risk management controls are in place to enable management and regulators to more fully understand and control the dynamics of the industry's risk profile⁵ Mr Harris' comments echo the statement of Thomas Steffen, Chairman of CEIOPS, when he said that 'Solvency II is not just about capital. It is a change of behaviour'⁶ (see article on pages 2-5 for more details).

Insurers that have developed and embedded effective risk management into their organisations will be able to demonstrate this to analysts, rating agencies and other key stakeholders through the publicly available annual solvency and financial condition reports required under Solvency II. Those with less effective capabilities may face the 'market discipline' of a risk premium and higher costs of capital.

Asset-liability management (ALM)

Market-consistent valuation could heighten balance sheet volatility. In turn, as capital charges will reflect the volatility of a particular class of assets, this may affect investment preferences. The Explanatory Memorandum to the draft framework Directive states that the 'impact of Solvency II on life insurers' investment behaviour is not expected to

be significant'.⁷ Nonetheless, a number of companies have indicated that the high risk and capital loadings highlighted by their quantitative impact studies may force them to switch much of their equity investment to bonds.

Solvency II aims to provide greater freedom in the choice of assets. This includes holding unlisted securities. Derivatives can also be used to reduce risk or as part of a strategy of efficient portfolio management. However, investment management strategies need to maintain sufficient prudence ('prudent person' principle), diversification and matching. Failure to uphold the prudent person principle (a concept largely borrowed from the Reinsurance Directive) could be met with supervisory action. Failure to match assets and liabilities, in particular duration, will increase capital requirements.

Relinquishing risk

By increasing the capital charges for more volatile business and heightening the spotlight on capital-intensive risks, Solvency II will encourage insurers to look at new ways to offload risk or close uneconomic portfolios.

One option is transferring risk off the balance sheet through securitisation. The issuance of catastrophe bonds reached record levels in 2006,⁸ highlighting the growing capital market appetite for insurance risk. The development of more sophisticated debt markets is also bringing other classes of business onto the securitisation radar, including life insurance. At a time when many insurers are reaching the ceiling on the amount of subordinated debt that can be used in

solvency evaluations, securitisation has the additional virtue of qualifying as core Tier One capital. However, the main benefits may once again accrue to the larger and more sophisticated players, as securitisation is not only expensive to place, but also requires precise and verifiable valuation and projection.

Some insurers may simply choose to close their less capital-efficient portfolios. However, even once the business is discontinued, insurers may face pressure to relinquish it altogether, especially as management may find it difficult to justify the potentially costly and unproductive use of capital arising from legacy portfolios. Exit options include some form of commutation or sale to one of the new breed of closed book consolidators. EU directives have also made it easier to consolidate closed portfolios from different countries into a single cost- and capital-efficient operation.

A broader trend could be greater outsourcing of capital-intensive areas of the business to 'wholesale' providers able to manage the capital requirements more efficiently. This might include either specific products or, to take account of operational risk, particular services. However, any outsourcing would require prior approval from supervisors and regulatory responsibility would be retained within the insurer holding the policyholder contracts. Companies will also need to carry out regular monitoring and review to ensure that outsourced activities are being properly controlled and conform to regulatory standards.

⁵ 'Solvency II for European insurers: No widespread rating actions expected, but major improvements to companies' risk management', published by Moody's on 18 June 2006.

⁶ Mr Steffen was speaking at the Official presentation of the Solvency II Directive on 10.07.07.

⁷ Solvency II: Explanatory Memorandum, section 2b.

⁸ Benfield Global Reinsurance Market Review, January 2007.

Organisational impact

Solvency II will require a more formal approach to governance, organisation and decision-making that necessitates insurers to demonstrate that risk awareness has been embedded into the fabric of the business. This includes having risk management, internal control, internal audit and actuarial functions in place if they do not already. The framework will also require more complex and extensive analysis, along with a more systematic approach to risk management, which is likely to increase demand for actuarial and risk management personnel. It would be wise to begin preparing for this now, through extension of graduate training programmes or more attractive retention packages, for example, rather than waiting for the inevitable demand surge and salary escalation in the lead up to implementation.

Companies will also need to look at how to co-ordinate actuarial, finance, risk management and wider business functions more closely. In particular, the data and analysis used in group solvency calculations will need to reflect the information and management approach being used within the business, and vice-versa. To sustain market credibility, investor relations teams will also need to ensure that financial and regulatory disclosures are compatible and, where they are not, explain why. Ultimately, boards will need to understand and endorse what could be new and unfamiliar quantitative and qualitative information as part of their responsibilities as 'fit and proper' managers of the business and policyholders' interests.

Gold standard or gold-plating

Commissioner McCreevy sees Solvency II as a 'global benchmark' and an 'opportunity to give EU insurers a head start in the global economy'.⁹ 'We are already seeing great interest from the US, Japan and China in this project. There is growing nervousness in the US about the EU surging ahead while the US itself is stuck with highly fragmented insurance regulation,' he continued.

However, some insurers may be concerned that the scale and complexity of implementation and ongoing operation of Solvency II may put them at a disadvantage in relation to non-EU competitors. It is notable that regulatory overload topped the list of risks facing insurers in the recent PricewaterhouseCoopers-sponsored 'Banana Skins' survey.¹⁰ Solvency II was a particular focus of concern for some respondents. The head of group risk at a large life company said that 'the main risk is that Solvency II (despite great promise initially that it would be a truly risk-based and economic framework) turns out to be a political compromise that ends up costing billions to implement and results in perverse incentives and unintended consequences for the industry'.

Whether Solvency II becomes a costly burden or a global benchmark for best practice largely depends on the flexibility and responsiveness of its operation. The Association of British Insurers (ABI) has for one warned against 'arbitrary constraints that frustrate innovation and inhibit competition'.¹¹ The ABI has been particularly keen to promote a single group supervisor and a 'principles-based regime that provides a secure framework for

policyholder protection, while giving insurers the freedom to manage their own business as they see fit'. The move to group supervision is indeed enshrined in the draft framework Directive (see pages 2-5).

Ultimately, the boost for the development of advanced analytical systems capable of providing a more informed basis for decision-making and control may prove to be the most telling business impact of Solvency II, rather than its actual supervision. 'The insights from an economic risk-based view will change the name of the game,' said the head of group risk at a leading reinsurance company interviewed as part of the 'Banana Skins' survey.

Gauging behaviour

Having focused on the calibration of solvency calculations, the future quantitative impact studies for Solvency II are likely to look more closely at its potential impact on businesses and wider market behaviour. The ramifications for the industry, including the potential impact on the competitive position of smaller companies, are also likely to become a key focus of political lobbying as the framework passes through the legislative process.

What is already clear is that Solvency II will change the ground rules for European insurers by bringing risk awareness to the forefront of how businesses are managed and judged by regulators, investors and customers. This is already the case within many successful companies. Others will have to make up considerable competitive ground. ■

⁹ European Commission media release, 10.07.07.

¹⁰ Insurance Banana Skins 2007 was published in May 2007 by the Centre for Financial Services Innovation in association with PricewaterhouseCoopers. For copies please visit www.pwc.com/insurance.

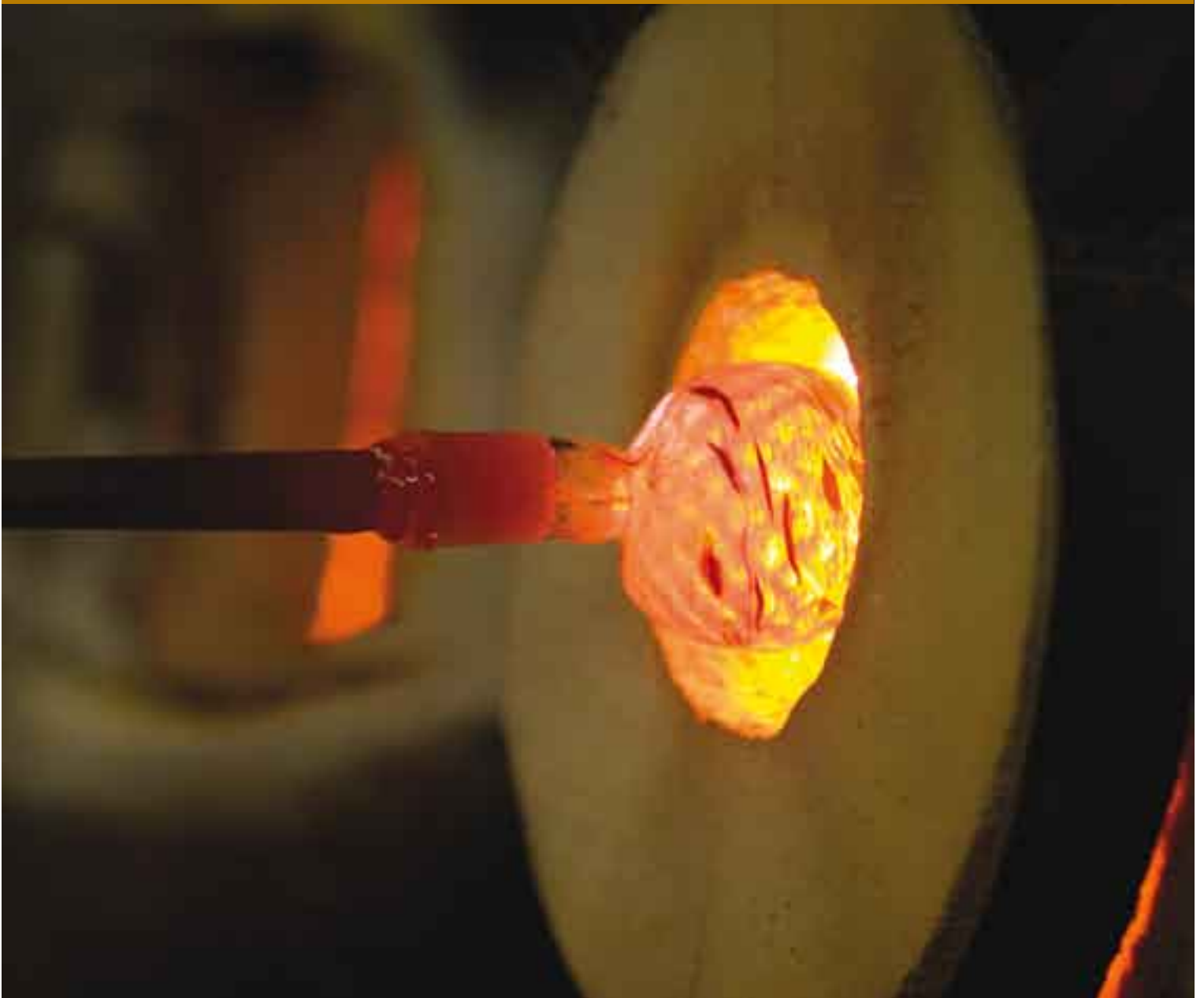
¹¹ Media release following 'ICAS 2007 and the path to Solvency II' on 06.03.07.

04

Making it happen: The political process

ANNETTE OLESEN AND WENDY REED

July's publication of the draft Solvency II framework marks the first stage of what could be a demanding process of EU legislative enactment, technical formulation and eventual application. Annette Olesen and Wendy Reed examine the political hurdles ahead and how insurers can influence the process.



Politics is the art of the possible. However, seeking to reach EU-wide agreement on a complex solvency directive among 27 member states with very different regulatory structures could stretch the realms of possibility to their limits. In an interview with the UK's Life & Pensions magazine earlier in the year, Peter Skinner MEP, Chairman of the European Parliamentary Insurance Caucus and the 'rapporteur' responsible for corraling Parliament's views on Solvency II, accepted that this 'is an incredibly difficult beast to grapple with'.¹ The challenges ahead are reflected in July's announcement of the postponement of planned implementation from 2010 to 2012.

Solvency II forms an important extension to the European Commission's (EC) Financial Services Action Plan. The preparation, consultation and enactment of the directive are being speeded up through the Lamfalussy Process, a four-stage framework designed to break down national and bureaucratic barriers to integration (see Figure 1).

It is a testament to the urgency and importance attached to Solvency II that the council has scheduled two two-day meetings per month up until December to help move the process forward.

The main time-saving feature of the Lamfalussy Process is that much of the detailed technical design draws on the expert advice of committees of supervisors working in consultation with businesses, consumers and other stakeholders (in the case of Solvency II this is the Committee of European Insurance and Occupational Pensions Supervisors – CEIOPS). This should ideally leave the politicians to

concentrate on the higher level principles and their implications, rather than expending valuable time hammering out the small print.

Legislation

Drafting directives or other legislation is the responsibility of the EC. The European Parliament's (EP) job is to provide democratic scrutiny, amendment and assent in parallel with a Council of Ministers drawn directly from national governments. This process of mutual deliberation, modification and ratification is known as 'co-decision-making'.

The draft Solvency II framework Directive was presented to the EP for its first reading in July. To move forward, Peter Skinner MEP and his team will need to balance a multitude of different local perspectives and rationalise what could be dozens or even hundreds of proposed amendments emanating from lobbying of MEPs across Europe.

Following debate and amendment, the revised draft will be passed to the Council of Ministers. In practice, there tends to be considerable behind-the-scenes negotiation prior to this point to help forge a consensus among the different member states and between the Council and the EP.

It is a testament to the urgency and importance attached to Solvency II that the Council has scheduled two two-day meetings per month up until December to help move the process forward. The Council had also requested that all countries submit issues and suggested amendments by the beginning of September. If countries have not raised their concerns already, it may now prove difficult to have them added to the agenda.

If the Council is unhappy with any element of the revised draft it will send it back to the EP with its comments for a second reading

Figure 1 The Lamfalussy Process

Level 1:

'**Framework Directive**' setting out basic enduring principles, or political choices, underpinning the solvency system.

Level 2:

'**Implementing Measures**' formulating more detailed, technical rules.

Level 3:

'**Supervisory Standards**' setting out guidelines for national supervisors to ensure a consistent interpretation and application.

Level 4:

'**Evaluation**' enabling the European Commission to monitor compliance and enforcement.

Source: PricewaterhouseCoopers

¹ Life & Pensions, 01.04.07.

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and further amendment. If the Council is still not satisfied after the second reading, the last resort is conciliation. If that fails, it is back to the drawing board.

Even with the aid of the Lamfalussy provisions, legislative enactment can be a long and arduous process. Although significantly faster than in the past, it still took 17 months of intensive debate to pass the primary legislation for the Markets in Financial Instruments Directive (MiFID). Admittedly, MiFID is the most complex and extensive Lamfalussy directive to date, though Solvency II promises to be even more so.

Technical preparatory work on Solvency II will be well underway by the time the Level 1 directive is passed, though nothing will be set in stone until the primary legislation is on the statute books. An understanding of the detail is proving essential in the design of such a complex framework, though this shows that Lamfalussy is itself an evolving political process.

Potential tensions

Prior to the introduction of the Lamfalussy process, a draft directive would be out of the hands of MEPs once the primary legislation was passed, leaving them with little influence over the subsequent technical formulation. Therefore, the EP often pushed for more technical details in the primary legislation.

Although Lamfalussy sought to address this potential difficulty, the Council retained the right of 'call-back' on all

Level 2 measures. As a result, the EP has been fighting a determined rearguard action against this continuing institutional imbalance through such mechanisms as 'sunset clauses' designed to ensure that delegation of its powers is only temporary. This has led to tension between the EC, the Council and a Parliament that is keen to put itself on an equal footing with its co-decision-making counterpart.

Enactment of Solvency II would ideally be achieved ahead of the campaigning for the European Parliamentary elections in June 2009. If the process of finalisation slips into the campaign season and subsequent vote then the local political pressures on MEPs will inevitably be heightened. The particular EU presidency in place at the time could also be an important factor, as the views and priority given to this legislation may differ from country to country (see Figure 2).

Figure 2 EU Presidencies

July – December 2007	Portugal
January – June 2008	Slovenia
July – December 2008	France
January – June 2009	Czech Republic
July – December 2009	Sweden

Source: European Commission

Preparing for implementation

The experience of MiFID also highlights the potential challenges facing Solvency II once it moves into its interpretation, implementation and enforcement phases. Once again, this is an evolving process.

MiFID embodies the concept of 'maximum harmonisation', which aims to impose a level playing field by setting a relatively high regulatory bar and expecting member states to adhere to it closely. This is a radical move away from the 'minimum harmonisation/mutual recognition' approach, which left the door open to a range of protectionist measures.

To reinforce maximum harmonisation, MiFID's requirements relating to record-keeping and interaction with financial markets, where a common approach at the outset is feasible, were enacted as a regulation that is automatically binding on member states. While other provisions still require implementation at the national level, both the EC and the Committee of European Securities Regulators (the relevant Level 3 committee) have worked hard to ensure consistent interpretation. Moreover, any additional requirements in relation to key organisational and conduct of business issues are prohibited unless they can be fully justified.

How far Solvency II goes down the road of maximum harmonisation is difficult to say at this stage. Smaller firms may find themselves at odds with their larger counterparts, who naturally seek economies of scale. Yet the interests of smaller insurers and retail policyholders are certain to top the EP's agenda.

The balance of home and host supervision could prove another source of contention. The draft Directive sets out proposals for the streamlining of group oversight that would allow a single authority to take the

Enactment of Solvency II would ideally be achieved ahead of the campaigning for the European Parliamentary elections in June 2009.

lead in the supervision of European groups. This could potentially reduce compliance costs and lower capital charges by enabling companies to take account of group-wide risk diversification. This position has been championed by supervisors and industry groups from a number of large and well-developed markets, such as the UK. However, some other countries contend that local operations which may be relatively insignificant to a large international group could be critical to the financial health of their particular market. Allowing national supervisors to impose additional capital requirements may assuage some of the concerns, though further debate is likely.

A briefing published by the European Parliamentary Financial Services Forum in July 2006 concluded that 'tough problems may be ahead, as some European insurance supervisors have fundamentally different approaches to the supervision of insurance companies that may be difficult to resolve without political guidance'.²

Targeted lobbying

There is no doubting the importance and urgency attached to Solvency II by both the EC and its political masters in the EP and Council of Ministers. However, progress and development will inevitably

be subject to political manoeuvring, delay and difficulty within what is in itself an evolving political process.

As the publication of the draft Directive extends opportunities for comment and influence beyond the CEIOPS consultation papers and quantitative impact studies, insurers need to understand how this complex political process works. They need to monitor developments to ensure that they make their voices heard by the right people at the right time. ■



² European Parliamentary Financial Services Forum Solvency II Briefing, 12 July 2006.

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Local Solvency II experts

If you would like to discuss any aspect of this document, please speak to your usual contact within the network of member firms of PricewaterhouseCoopers International Limited or one of those listed below:

Pan-European

Charles Ilako
44 20 7804 2103
charles.ilako@uk.pwc.com

Garvan O'Neill
353 1 662 6218
garvan.o'neill@ie.pwc.com

Wendy Reed
32 2 710 7245
wendy.reed@pwc.be

Austria

Peter Pessenlehner
43 1 50188 1300
peter.pessenlehner@at.pwc.com

Thomas Stiglmayr
43 1 50188 1300
thomas.stiglmayr@at.pwc.com

Belgium

Jacques Tison
32 2 710 7139
jacques.tison@pwc.be

Sabine Wuiame
32 2 710 7119
sabine.wuiame@pwc.be

Cyprus

Androulla Pittas
357 22 555 564
androulla.pittas@cy.pwc.com

Czech Republic

Jiri Klumpar
420 251 152 077
jiri.klumpar@cz.pwc.com

Denmark

Hans Jørgen Andresen
45 3945 9964
han@pwc.dk

Jesper Otto Edelbo
45 3945 9275
joe@pwc.dk

Estonia

Relika Mell
372 614 1800
relika.mell@ee.pwc.com

Finland

Juha Wahlroos
358 9 2280 1437
juha.wahlroos@fi.pwc.com

France

Patrick Frotié
33 1 56 57 10 68
patrice.frotie@fr.pwc.com

Gilles Pestre
33 1 56 57 72 66
gilles.pestre@fr.pwc.com

Jimmy Zou
33 1 56 57 72 13
jimmy.zou@fr.pwc.com

Germany

Werner Hölzl
49 89 5790 5248
werner.hoelzl@de.pwc.com

Andreas Sanner
49 211 981 2129
andreas.sanner@de.pwc.com

Julia Schüller
49 69 9585 2667
julia.schueller@de.pwc.com

Greece

Nick Papadopoulos
30 210 6874 740
nick.papadopoulos@gr.pwc.com

Hungary

Arpad Balazs
36 1 461 9163
arpad.balazs@hu.pwc.com

Ireland

Garvan O'Neill
353 1 662 6218
garvan.o'neill@ie.pwc.com

Italy

Luca Cibien
39 02 7785 286
luca.cibien@it.pwc.com

Antonio Dogliotti
39 02 7785 513
antonio.dogliotti@it.pwc.com

Dario Troja
39 02 7785 609
d.troja@it.pwc.com

Latvia

Juris Lapshe
371 709 4400
juris.lapshe@lv.pwc.com

Lithuania

Chris Butler
370 5 239 2303
chris.butler@lt.pwc.com

Luxembourg

Thierry Flamand
352 49 4848 4170
thierry.flamand@lu.pwc.com

Claude Jacoby
352 49 4848 2114
claude.jacoby@lu.pwc.com

Malta

Simon Flynn
356 212 47000
simon.flynn@mt.pwc.com

The Netherlands

Emmy Aangenendt
31 20 568 7376
emmy.aangenendt@nl.pwc.com

Hans Haamke
31 20 568 5869
hans.haamke@nl.pwc.com

Albert Zoon
31 20 568 6456
albert.zoon@nl.pwc.com

Poland

Artur Pikula
48 22 523 43 01
artur.pikula@pl.pwc.com

Pawel Splawski
48 22 523 43 56
pawel.splawski@pl.pwc.com

Portugal

António Lopes
351 213 599 440
antonio.lopes@pt.pwc.com

Russia

Alex Bertolotti
7 495 232 5635
alex.bertolotti@ru.pwc.com

Slovak Republic

Eva Hupková
421 2 59 350 414
eva.hupkova@sk.pwc.com

Slovenia

Joze Plevnik
386 1 5836 000
joze.plevnik@si.pwc.com

Spain

Juan José Noguera
34 91 568 5783
juanjo.noguera@es.pwc.com

Sweden

Karin Hjalmers
46 8 555 333 52
karin.hjalmers@se.pwc.com

Harry Wide
46 8 555 339 38
harry.wide@se.pwc.com

UK

Jim Bichard
44 20 7804 3187
jim.bichard@uk.pwc.com

Annette Olesen
44 20 7213 3394
annette.olesen@uk.pwc.com

Mark Train
44 20 7804 6279
mark.train@uk.pwc.com

For additional copies of Countdown to Solvency II, please contact
Alpa Patel, PricewaterhouseCoopers (UK) at alpa.patel@uk.pwc.com

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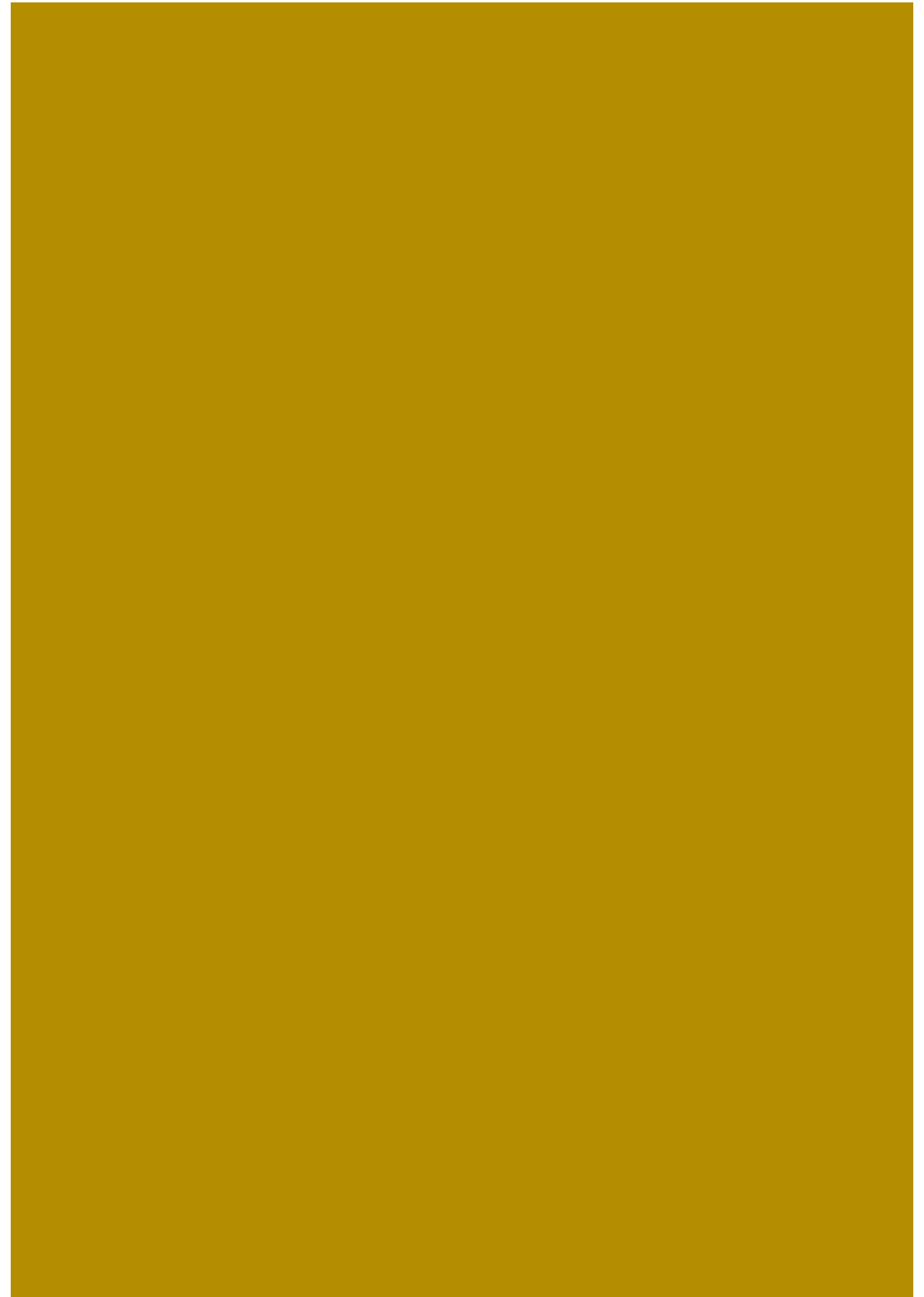
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