

## Increasing speed

Solvency II set to accelerate broking market developments

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‘The impact of Solvency II on brokers, including greater transparency and the extra demands on information and risk management systems, will accelerate strategic developments already gaining ground in the broking sector.’

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Solvency II will spur insurers to reassess what kind of risks they are prepared to accept and to re-evaluate their return expectations and capital needs. As a result, they will demand more and better quality data from their brokers, suppliers and agents, a knock-on impact of Solvency II, which will accelerate strategic developments already gaining ground in the broking sector. Roy Clark and Bryan Joseph look at the likely winners and losers.



As brokers tend not to carry underwriting risk, many might assume that they will be largely unaffected by Solvency II. However, brokers are key providers of risk data and advice to underwriters and, in some cases, underwrite directly for their customers. With insurers facing sweeping changes in the way they manage their exposures and judge performance, brokers are bound to be affected in one way or another, some quite profoundly. This article examines the implications for three main areas: Reinsurance broking; direct broking and agency relationships; and captive management.

### Reinsurance broking

By promoting more effective evaluation of risk concentrations and overall aggregations, Solvency II will provide insurers with a clearer understanding of their exposures and capital efficiency. A key consequence will be a more informed and finely tuned approach to reinsurance buying.

Insurers will naturally look to their brokers to help optimise the use of reinsurance as a key capital management tool. Reinsurance brokers already play a crucial role in programme design, not only ensuring adequate coverage, but also providing additional benefits such as credit risk minimisation through choice of market and liquidity risk management through contract terms. This will be even more important under Solvency II.

‘The broking market is evolving and Solvency II will provide further impetus for these changes.’

Clients will also be looking to their brokers to provide more effective quantification of the capital benefits of reinsurance for solvency and business purposes. Such input is likely to become a core proposition for brokers in much the same way as they are currently expected to provide expertise in catastrophe modelling. An example of where broker support is likely to be important is proportional reinsurance. It is widely recognised that sophisticated modelling tools are needed to demonstrate the impact of non-proportional reinsurance, but proportional reinsurance also requires careful consideration as its benefits should not be assumed to be directly proportional (e.g. risk and event limits, sliding scale or profit commissions).

Brokers will need to work with clients to develop a better appreciation of their risk profile, risk appetite and capital requirements, and how to match this with the risk appetite of the reinsurer. Reinsurance brokers will need to be able to demonstrate to their clients the capital benefits of each option – and will also need to provide clearly documented evidence of their analysis and recommendations.

Some larger brokers have developed internal catastrophe modelling, actuarial and corporate finance teams to enhance the advice they provide to their clients. The largest have developed in-house software, which they market externally and use to advise existing clients and attract new ones. Smaller broking firms may not have the resources to follow suit, and may struggle to compete against their better-resourced competitors.

### Direct broking and agency relationships

Insurers will need to meet much more exacting standards of risk and capital evaluation under Solvency II. As a result, they will demand more detailed information about the risks they are accepting from their brokers, be this directly or via an agency or delegated authority arrangement.

As a result of the greater transparency and changing risk and capital management dynamics ushered in by Solvency II, insurers and reinsurers may decide that they no longer wish to underwrite particular risks or that the prevailing rates are unviable. Some may seek a more favourable split of risk and return with their agents or simply pull the plug on less favourable delegated authorities. Examples of business that some insurers might see as exerting too much of a drain on their capital could include certain long-tail casualty classes, particular types of motor risk and some professional indemnity policies where excessive or unanticipated losses have emerged on the portfolio. Recently, for example, there have been high-profile withdrawals from lawyers’ professional indemnity cover and we expect to see more exits from other schemes in the future.

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The second challenge is logistical. Solvency II will place much tougher demands on the completeness, accuracy and appropriateness of data. Insurers will be required to enforce the same exacting quality standards for information coming in from external sources, including brokers and agents, as would apply to internally generated data. Although some brokers have already been raising the bar by providing more effective risk information to their insurer partners, the data others deliver is often quite sparse. This means that many brokers will have to improve their own data capture and analysis systems to meet the needs of insurers. They must also ensure that the analytical techniques they use as underwriting agents stand up to rigorous scrutiny. As agents provide outsourced underwriting services, they may also need to bring in or develop better risk management capabilities. These extra demands may favour larger brokers with the economies of scale to provide the necessary personnel and systems in an efficient and cost-effective way.

### Captive management

Most captives within the EU are subject to Solvency II. Brokers offering captive management services therefore need to ensure their activities meet all the requirements of the directive and its implementing measures. Captive boards will also need to meet the risk management and governance standards set out in Solvency II as the directive insists that outsourcing day-to-day management does not mean any abrogation of executive responsibility.

The additional demands on EU-based captives could encourage some to relocate to non-EU domiciles such as the Channel Islands, though certain classes of business such as employer's liability and worker's compensation may need to remain within the EU.

Moreover, some non-EU jurisdictions, notably Bermuda, are seeking 'equivalence' with Solvency II and therefore some captives may become subject to comparable requirements. Captive managers covered by the terms of the directive, either directly or under equivalent arrangements, therefore need to consider their capital arrangements in light of Solvency II. In particular, they may have to allocate more funds to protected cell/segregated asset companies as these tend to be thinly capitalised at present and the capital held within any individual cell is not fungible across the remaining cells of the structure.

### Impetus for change

The broking market is evolving and Solvency II will provide further impetus for these changes. Improved understanding of the impact of inwards business on a reinsurer's economic and regulatory capital – and even on its earnings volatility – is likely to influence its willingness to supply particular types or classes of reinsurance. In turn, insurers will expect their brokers to match the higher standards of risk and capital evaluation being imposed on them, which will stretch the resources and technical capabilities of many smaller brokers and make it harder for them to compete. Solvency II is therefore likely to encourage further consolidation within the broking sector.

For brokers, existing best practice will struggle to meet more exacting client expectations and therefore the bar will rise. However, there will be huge competitive opportunities for the firms that are first to rise to the challenges created by Solvency II.

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