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On the road to Solvency II:

Solvency II is a journey, but do you want to: watch it happen; be a passenger; drive the car; plan the route; or set the destination?

As the strategic consequences of Solvency II become more immediate, many senior executives are re-examining their path to Solvency II compliance.

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The merits and challenges that Solvency II presents have been around for some time now, but as the strategic consequences become more immediate, many senior executives are re-examining their views on, and response to, Solvency II.

In this discussion paper, we explore whether it is right to change direction, what the different levers are that can be adjusted and finally highlight some of the moving parts.

Why think about this now?

Put simply, the deadlines are now very close. Plans made a long time ago may need updating to get you successfully from where you are today to the final destination. This is both about learning from the experience on the journey and updating decisions based on current requirements or updated interpretations of guidance and regulatory expectations. Irrespective of the path a company has taken to date, in Europe or potentially equivalent jurisdictions; it will have things to do and a limited timeframe in which to do them.

More widely, the last three years have also been some of the most volatile in memory on the asset side of the balance sheet and companies are re-examining the Solvency II agenda in light of corporate activity, the current economic, political and the wider competitive landscape.

As deadlines close in, many senior executives are getting closer to the action on Solvency II. In some cases they are making changes to both the way their company responds and the influence they apply externally.

What levers can a senior executive still pull to change the direction?

Change the landscape

Changing the landscape is about influencing the demands of regulators and politicians. There is still time to change the landscape. Key issues remain unresolved and the European Insurance and Occupational Pensions Authority (EIOPA) continue to invite consultative input and continue to react to market pressure. Following a successful first assessment, Bermuda remains on a journey, some of which is still to be defined. This is one of the issues explored later in this article, but there are also many others.

Those that want to shape the landscape, be that in changing the final destination or changing the route, still have that opportunity. As deadlines close in, it is important that lobbying is well considered and that consequences are well thought through. For example, companies could lobby for Group Supervision to be taken to a more progressive conclusion that involve a reduction in entity level regulation, to improve efficiency, but if successful it could change expectations around the consistency of how risk is embedded in decision making across a group.

Collections of organisations can also think about how they lobby in order to maximize effectiveness, do they do it alone, with wider industry groupings or from specific jurisdictions.

Optimise your group

Equivalent does not mean identical. The approach that individual regulators take does vary and companies can organise their group structures in ways that will control which regulator takes interest in each part of the group. For example,

More than ever, senior executives who plan wisely and keep their eyes on the road ahead will get the best return from their journey.

companies should be able to limit the extent to which a European regulator is interested in non-European aspects of the group by either structuring the group such that non-European operations are supervised by an equivalent jurisdiction or by using reinsurance arrangements in equivalent jurisdictions. This is because the Solvency II rules treat equivalent jurisdictions more favourably than others. For non-equivalent jurisdictions regulators in Europe may want to look into the foreign insurer to understand how European policyholders are protected.

The quantity of capital needed to support a particular book of business will also vary between Europe and equivalent jurisdictions, particularly where the some form of standard formula is chosen rather than using a company's own model to set regulatory capital. Capital requirements in turn influence return on capital and the associated business model influences the extent of taxation exposure. As with the lobbying considered above, optimisation needs to consider the knock on impact of any changes; and careful planning should take place.

Optimising the group structure and reinsurance arrangements gives a company more control of the impact of Solvency II and equivalence than simply complying based on existing arrangements. Groups must recognise that their world remains a state of flux, with some already questioning recent changes to structure and the physical location of their head office, given the dynamic political, economic and fiscal environment and therefore should be able to maintain flexibility to adjust as required.

Comply in a cohesive way

Compliance is costly and is exacerbated by the clamour for skills in specialist areas. The differing timelines between Lloyd's managing agents and companies in different jurisdictions means that sometimes the prioritisation has meant that subsidiary compliance activities do not fit well within a cohesive, top down and group wide approach. This can lead to duplication and increased cost.

The best companies have taken the learning from one jurisdiction and applied it in others and have written group policies in a way that allows a common core approach to be applied globally, based around a common internal model, consistent governance structures, similar management information, and with a common documentation and evidencing framework. Very few companies have really done this so far and as the peak of initial compliance passes and spending burn rate decreases there is a chance that this inefficiency is lost in the rounding; but will continue to be a drag on efficiency. This, particularly, in a market where pricing is improving and thus companies are more likely to see profitable opportunities that will increase the demands on capital.

Managing the cost of compliance may not, for many, be as exciting or deliver as quick payback as more drastic changes to group structures, domicile or industry consolidation; but ultimately cost is part of the value and competitiveness equation and should not be overlooked.

An eye on the end-game

Ultimately the tools at the disposal of each senior executive will vary, a function of the markets in which they operate, the nimbleness of their company and the extent of their own personal influence over the external market.

Today the regulatory environment is a significant influence on cost, access to markets and ease of doing business, more than ever, those that deal with the challenge well have an increased chance of success.

Moving parts: Solvency II and equivalence continues to have many moving parts, some of the current topical ones on which senior executives may consider acting on and those in governance positions should ask about are explored below.

Uncertainty about equivalence

The August publication of the draft report of the European Insurance and Occupational Pensions Authority (EIOPA) on their equivalence assessment of the supervisory system in Bermuda (the EIOPA inspection report) was greeted with cautious optimism by commentators. Overall the draft suggests that Bermuda is equivalent with caveats and many of the caveats relate to areas where the regulator already had work in progress.

A consultation period has opened and market participants who wish to contribute should visit: https://eiopa.europa.eu/consultations/consultation-papers/index.html. Companies who wish to influence the equivalence debate may wish to provide comment. Ultimately, gaining equivalence is a political decision. The consequences for large insurers who are headquartered in Bermuda, or are headquartered outside the European Economic Area (EEA) with Bermuda based operations, and provide reinsurance to EEA insurers are generally significant.

Some of the caveats related to the extent of discretion that the Bermuda Monetary Authority (BMA) may apply and the extent of required notifications by companies to the BMA. The practical application of rigor in supervisory relationships in Bermuda and the extent of two way communications between companies and the regulator are topics which companies may be able to provide useful insight to.

Regardless of the consultation period, the uncertainty is something that companies should plan contingencies for. Practices, like working through a risk assessment that considers the different outcomes and consequences are a sensible step to take.

Treatment of Captives under equivalence

Many, both in Bermuda and beyond, have called for recognition of the special characteristics of a Captive Insurer. While Solvency II does recognise Captives, the Solvency II definition is far narrower than that considered by Bermuda.

The EIOPA inspection report drew an interesting distinction between Class I, II and III insurers from Class IIIA, IIIB and IV insurers, something that has reopened the discussion around whether Captives may be carved out from any equivalence confirmation.

While many in the industry would welcome such a move, some large captives may be disadvantaged by the exclusion of Captives from Solvency II equivalence. For example those who provide reinsurance to affiliated commercial insurers or other captives. Such companies may well wish to lobby for some kind of 'opt in' to being treated more like a Class IIIA, IIIB or IV company.

Group supervision

Group supervision is a topic on which many would say the BMA is leading the thinking on. It has already engaged with companies and other supervisors and has provided draft guidance to companies. It was interesting that the EIOPA inspection report highlighted some of the uncertainties in Bermuda's progress on Group Supervision when in practice Bermuda is relatively well advanced, albeit with this being a topic that remains work in progress.

The key for companies on Group Supervision is how to make it truly meaningful and something that leads to sensible, coordinated and proportionate regulation rather than simply being an extra layer of scrutiny.

To influence this, companies need to influence their own group supervisor and, importantly, other supervisors that have a legitimate interest in the group. For a group supervisor to be successful it will need the support of the regulated entity and the support and trust of other supervisors.

Re-calibration of standard capital requirements

The economic turmoil that has a direct impact on the asset side of the balance sheet highlights the importance that models are updated to reflect the realities of the world.

At various points the standard formulae defined by regulators to set the regulatory capital, for those who have not sought approval to use their own internal model for that purpose, will be re-calibrated.

Companies are well advised to analyse the sensitivity of their own capital requirements to potential changes to the model. Many companies have based their decision whether or not to seek model approval at this stage on the models deployed by relevant supervisory authorities, but the regulatory models are not a constant and companies should continue to plan for both changes to the model and changes to the economic and competitive landscape which drives the output of the models.

How much will Model Approval matter?

On the face of it, model approval is required for those operating at Lloyd's, desirable for many within Europe and irrelevant to multiline businesses operating in Bermuda. But is that really true?

For many companies the capital requirements set by the Bermuda Solvency Capital Requirement (BSCR) are less than those required to support rating agency assessments, so at the moment model approval can be seen as irrelevant.

Rating agencies are commonly quoted as saying they anticipate that businesses should be 'Solvency II compliant' to maintain a good rating or to maintain good commentary on their risk management framework, but what exactly 'compliant' means is uncertain. Gaining model approval could be a signal endorsement of the quality of risk management within an organisation, while this is not yet proven, the lead time to gain approval is such that if companies could find themselves as outliers if they do not at least prepare themselves to potentially support model approval.

The US regulatory environment

For those companies with a presence in the United States of America, an eye should remain on the changing regulatory environment, which increasingly sounds like in the long term it plans to have some similarity to the European model but that will have more differences remaining than in Bermuda, Switzerland and Japan, or the anticipated next wave of potentially equivalent regimes.

This area remains uncertain but is certainly a topic that many should take note of and where relevant act on.

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