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Managing the impact of Solvency II on your credit rating

Countdown to Solvency II

Assessing what rating agencies make of Solvency II and how it will affect your credit rating

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The overlaps between Solvency II and rating agency analysis suggest that your implementation plans and strategic response to the Directive may have an important influence on your credit rating. However, achieving an improvement in your credit rating as a result of your investment in more effective risk management may be harder than many would hope. So how are rating agencies responding to Solvency II and how can you seek to ensure that the impact on your rating is not negative?

Rating agencies are sometimes described as quasi-regulators because they have such a strong influence on how much capital you, as an insurer, are required to hold. Formal regulation and rating agency assessments are set to converge more closely in the post-Solvency II environment, though it is regulation that is moving towards the key areas of rating agency analysis, rather than the other way round.

Indeed, rating agencies having already set the bar for many of the areas of analytical focus that Solvency II will introduce across Europe.

Solvency II is built around a risk-based capital requirement. Regulators are also going to be placing much more emphasis on the effectiveness of enterprise risk management (ERM). This includes the systems and processes

that make up the ERM framework and the risk understanding and risk culture within the organisation that underpin this. Although the analytical approaches of the various rating agencies vary, the link between risk and capital is an important element of their quantitative evaluations. In turn, the effectiveness of ERM is considered within their qualitative assessments.

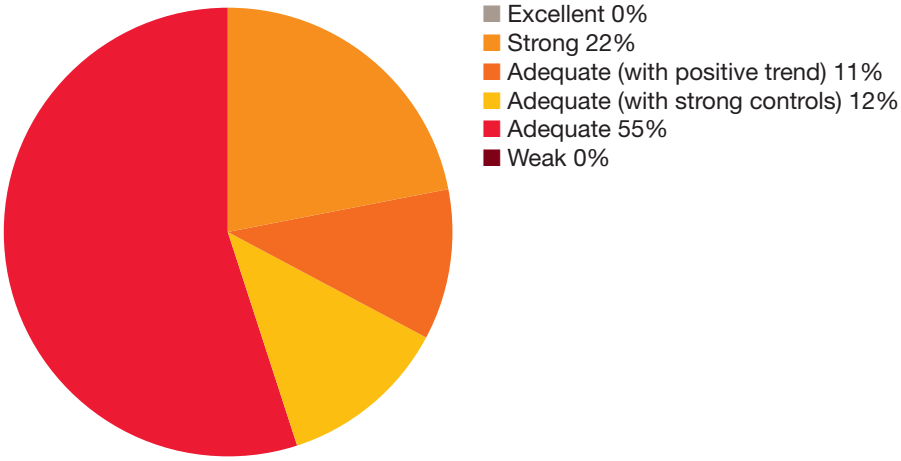
Evaluating risk management

It is likely that your company is strengthening its ERM framework and possibly investing in more sophisticated risk and capital evaluation systems in preparation for Solvency II. As is currently the case, rating agency analysis will consider tangible improvements to ERM. However, rating agencies believe that the guidance on Solvency II is still not clear-cut and the way it is applied may vary from country to country. Solvency II compliance is therefore unlikely in itself to have a significant impact on your rating agency assessment.

The ERM scores assigned by Standard and Poor's (S&P) provide a telling indication of the interplay between Solvency II and your ERM rating. S&P expects that if you achieve a 'strong' ERM score your risk management framework will meet Solvency II compliance standards (only around 20% of European insurers had achieved a strong rating as at June 2011, though the overall adequate designation does include companies with a positive trend towards strong – see Figure 1[1]). It is important to note, however, that S&P will not automatically assign a strong ERM score if your ERM framework complies with the Directive.[2]

Figure 1: How insurers rate under the S&P ERM scores?

S&P's 2010/11 ERM assessments for European companies as at 10 June 2011



The same logic applies to internal models. Based on the rating agencies' assessments of your internal model, they may allow you to hold less capital than would be required under their proprietary model analysis. However, even if you achieve supervisory approval for your model, this judgement will still be based on the rating agencies' own assessments of the credibility of your capital model.

The likely questions

So do rating agencies care about Solvency II if it is so close to what they are doing already? They are not going to ignore it. Solvency II is the biggest ever shake-up in the European insurance industry, and rating agencies want to know how it will affect your business. They want to know how the new regime will affect your solvency requirements. This includes whether you will need to raise additional capital and whether the composition of funds you hold for regulatory capital purposes may have to change.

The rating agencies also want to know how Solvency II will affect your strategy. If you are well capitalised, they may ask how are you going to take advantage of this. This might include whether you are planning to make acquisitions, for example. Conversely, if you are facing capital pressures, they will want to understand your contingency plans. This might include whether you may choose to withdraw from certain lines of business, for example.

Many insurers are known to be concerned about whether Solvency II will require them to provide more information to their rating agencies. It could, as a result, add to their workload at a time when resources are already stretched. They are also worried that rating agencies could move the analytical goalposts as a result of Solvency II.

Rating agencies have so far given limited indication of what extra information they will expect as a result of Solvency II. Some insurers believe this will make what they see as an already opaque evaluation process, even less transparent. Rating agencies have argued that the lack of detail stems from the continuing uncertainty over the exact terms and timings of various aspects of the Directive. Rating agencies say that Solvency II will not fundamentally change the way they assess insurers, though the ratings of some companies might change as a result.

'An insurer that can demonstrate strong risk-management practices integrated into its core operating processes, and effectively execute its business plan, will maintain favourable ratings in an increasingly dynamic operating environment.'

'Risk management and the rating process for insurance companies' published by A.M. Best in January 2008

1 'Embracing enterprise risk management makes a difference for insurers in EMEA' published by S&P in June 2011

2 'Solvency II could help European insurers improve their risk management, if they fully embrace its principles' published by S&P in July 2010

'Risk management is at the heart of what Standard & Poor's Ratings Services does when analysing insurers and reinsurers…The companies that are seen to be the best performers in this category [of Standard & Poor's analysis] will be those that have robust risk-management processes that are carried across the entire enterprise and that form a basis for informing and directing the firm's fundamental decision making.'

'Evaluating the enterprise risk management practices of insurance companies' published by S&P in October 2005

As a consequence of Solvency II, smaller and/or less well-diversified companies are those most likely to face capital pressures and to therefore be forced to modify their strategy defensively as a result, which may lead to rating downgrades. Conversely, well-capitalised and/or larger groups may gain a competitive advantage that would result in opportunistic strategic options, though these are less likely to affect their ratings.

Engaging with your rating agency

So what do you need to do to manage the impact of Solvency II on your rating or indeed turn it into a competitive advantage? First and foremost, it is important to engage with your rating agency sooner, rather than later, and with appropriate frequency. This includes explaining how Solvency II implementation has strengthened your ERM capabilities and what last year's quantitative impact study (QIS 5) revealed about the likely impact of the Directive. It is also important to explain what adjustments to the strategy and make-up of the business you are planning.

Following the draft Omnibus II Directive and the latest expected delay to Solvency II implementation, another key area of dialogue will be how the proposed transitional measures might affect the timings of your Solvency II preparations including submission of implementation plans by 2013. A dedicated rating agency workstream can help you to assess the implications for your rating and how best to engage with your rating agency.

The amount of information and supporting evidence you have to provide is likely to increase, but there is no need to go overboard. Typically, much of the information required by the rating agencies will be what is provided to the regulator – this is about changing the tyres rather than reinventing the wheel itself. Rating agencies may be resource-constrained if confronted with a huge extra weight of data and analysis, and therefore the quality rather than quantity of information will be important.

You can also look at how the work you are carrying out for Solvency II could be used to enhance the rating agencies' understanding of your financial strength. In particular, your Own Risk and Solvency Assessment (ORSA) will provide a useful showcase for demonstrating how ERM is embedded within the business, and how it supports capital efficiency. The ORSA could also help to facilitate broader discussions in areas such as business development, the thinking behind your risk appetite and your response to possible future scenarios.

Important priority

ERM is fundamental to both Solvency II and rating agency assessments. However, while rating agencies recognise that the Directive is likely to have a positive impact on the way insurers manage their risks, their evaluation criteria are unlikely to significantly change or be influenced to any great extent by regulatory assessments. What is more important for your rating is how Solvency II will affect your business. It is therefore essential that rating agency communication is an important priority. What you cannot afford to do is leave your rating agency out of the loop as you prepare for Solvency II. Your rating agency is a significant stakeholder in your business. The new regime may affect your capital position or may lead to strategic change. It is better to be upfront and explain to the rating agencies how you are going to address these challenges. Poor communication could potentially negatively impact your rating.

Giving you the edge

PwC is helping a range of insurers to get to grips with the practicalities of Solvency II. If you would like to know more about how to proactively manage the impact of Solvency II on your credit rating, please contact:

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