Solvency II – time to get real

Solvency II has at times seemed like an absurdist play – Waiting For Solvency II? – in which the central characters (the insurance industry) wait endlessly and in vain for the arrival of a new framework directive that will radically change the supervision of insurers and reinsurers across Europe.

But now the players have to be realists, because the curtain has risen on the final act. A quick-fix directive that came into force last year dictates that Solvency II must be transposed by Member States into national law from June 30 2013 to March 31 2015 and that it will apply from January 1 2016.

Finally, a consistent, risk-based, solvency regime intended to better reflect modern solvency and reporting requirements will come into play.

Although the industry has had years to get to grips with the new regime, the Solvency II *mise en scene* still represents unknown territory for many companies. However well prepared and on top of components like ORSA (insurers will be required to submit their Own assessment of Risk and Solvency Capital Adequacy) insurers are, the combination of higher capital demands and tougher reporting requirements will impinge on everyone's strategy.

The consulting firm Towers Watson identified a number of likely impacts of Solvency II, starting with regulators' call for more capital. The obvious corollary is that boards will likely want to take less risk. At the same time Solvency II measures will be driven by market values, meaning that individual company balance sheets will become more volatile. Company boards will become more conservative as a result, and there is already evidence of insurers increasing their capital strength, with a very significant move towards de-risking from 2011 to 2012, Towers Watson said.

Exit, stage left

As regulatory regimes have become more complicated across markets, the cost of compliance has increased. For

many insurance companies, especially those in the small- to medium-sized bracket, or those less well diversified, it could make economic sense to seek a buyer for all or selected parts of their business. In other words, in a competitive market with challenging economic conditions, Solvency II is likely to be a further driver of consolidation through mergers and acquisitions.

Linked to consolidation is the increased potential for insurers to exit certain lines of business. A high proportion of respondents to a recent PwC survey believe that Solvency II will increase the cost of capital and heighten their focus on under-performing or capital intensive business. As a result, more insurers are likely to review and possibly discontinue non-core or poorly performing portfolios, it said.

PwC's survey of discontinued insurance business in Europe revealed that the run-off market is now estimated to be worth around €235bn, an increase of €11bn from the previous study published in January 2013.

Although there is a strong move towards harmonisation of solvency standards, it is possible that an uncompetitively strong regulatory regime could drive business offshore. Towers Watson says that as Solvency II has progressed legislators have added layers of conservatism: wider economic events have made regulators nervous, resulting in little margins of safety such as potential capital add-ons and risk appetite buffers being added here and there, it said.

"At some point, it may force companies to consider whether to move their business headquarters into a less punitive regulatory jurisdiction. Alternatively, we could see business being reinsured offshore. As a result, actuaries devising regulatory and reinsurance arbitrage arrangements are likely to be busy," the Towers Watson note said.

Solvency II on tour

As Aon Benfield points out in a recent note, third country equivalence with Solvency II is an important issue. Before, non-Solvency II countries had to engage in a process with the European Insurance and Occupational Pensions Authority (EIOPA) to have their solvency framework reviewed and approved as Solvency II-equivalent. If they were deemed non-equivalent, European groups' affiliates in those countries would have to meet all Solvency II requirements in addition to local regulatory requirements.

However, the rules have now been amended so that the European Commission can grant provisional equivalence to third countries for 10 years, at which point a review is carried out with the option to extend equivalence for a further 10 years or more. The amendment is largely a response to the US and Canada formally stating that they would not enter into an equivalency review process, but it also allows EIOPA the flexibility to develop solutions with other regulatory regimes to ensure that European groups can remain globally competitive.

Although the January 1, 2016 deadline is fixed there's still a lot to do and plenty of scope for certain guidelines and rules will also change before then, as Aon Benfield has pointed out. Before March 2015, EIOPA aims to go through two sets of public consultations on the Implementing Technical Standards (ITS) and Guidelines.

The first set of ITS is on the approval process while the second will consist of the three Pillars—quantitative basis, qualitative requirements, and enhanced reporting and disclosure. The first set of Guidelines is for approval processes, including Pillar 1 and internal models. The second set of Guidelines will be for Pillars 2 and 3 and is expected to be issued in December 2014.

A final version of the Guidelines is expected to be released by July 2015, Aon Benfield says. Internal model approvals are not expected to be issued prior to Q2 2015, and even then some countries may ask companies to run capital requirements under both Standard Formula, as well as the approved Internal Model for at least a couple of years.

The risk of being systemically important

On top of Solvency II, the world's biggest insurance groups also face enhanced supervision and tougher capital requirements if they are identified as systemically important by the International Association of Insurance Supervisors. The initial list of nine GSIIs comprises Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc. The list is reviewed by the IAIS each November. A list of reinsurers is also planned for release later this year. Much uncertainty surrounds the impact of GSII accreditation on the wider market. Some believe imposing tougher requirements on certain re/insurers could lead to a "flight to GSII".