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Solvency II – What insurance companies need to know about the new regulatory regime

As preparations for the introduction of Solvency II reach a crucial phase, Clifford Chance partners Katherine Coates, Hilary Evenett and Clare Swirski examine the aims behind Solvency II, whether it is likely to achieve them in its current form, what the new regime will mean for insurers and those who deal with them and what they should be doing to respond to the latest challenges and opportunities for the industry.

Aims of Solvency II

On the publication of the draft Solvency II Directive in 2006, the European Commission described the new regime as "a world leading standard that requires insurers to focus on managing the risks they run to enable them to operate more efficiently". Among its aims, Solvency II looks to deepen the integration and harmonisation of the European insurance market and to improve the international competitiveness of its insurance and reinsurance industry. Policyholders should be better served by an industry that has a greater understanding of how to measure, monitor and manage the risks faced by each individual insurer, rather than the current regime which provides for liabilities to be calculated with a considerable amount of prudence and then requires a formulaic amount of capital to be held above that level.

Another aim of the directive is to improve policyholder choice by providing access to the widest possible range of insurance products available. Increased transparency will help policyholders to compare insurers and products against each other.

Solvency II aims also to incentivise insurers, enabling the better managed ones to hold less capital in the future than they are obliged to do under the current regime.

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The final directive has now been published. Draft Level 2 implementation measures have been consulted upon and tested through various quantitative impact studies (QIS) and the industry awaits draft rules from the European Commission any time now to take into account the results of QIS5 as well as the extensive and ongoing consultations with the industry.

Basic structure of Solvency II

The Solvency II Directive replaces 14 separate insurance directives. It draws heavily on the Basel II approach for banks, in particular the division of insurance regulation into three pillars:

- Quantitative capital resources requirements for insurers and the types of capital which will qualify to meet them
- Supervisory review, including governance and risk management
- Market disclosure

The directive itself provides a framework (Level 1). Detailed implementing provisions will be contained in so called Level 2 regulations. Level 3 sets out guidance.

Do the current proposals achieve the policy aims of Solvency II?

The Solvency II proposals offer considerably more focus on risk than is found under Solvency I. Solvency II also provides incentives to manage risk through the use of diversification benefits, risk mitigation techniques and the use of partial and full internal models.

However, there is still considerable debate in the industry over Solvency II's capital requirements, including a number of issues identified in QIS5. The study indicated that the proposed approach is not yet thought to be suitably tailored to all risks, either because the methodology is inappropriate or too complex or some of the calibrations are too high.

The original intention behind Solvency II was to create a principles-based regime that would reward good risk management, give insurers flexibility in their approach to its implementation, as well as support innovation and product development. However, since the financial crisis, there has been a move away from principles towards more detailed rules, which, in some cases, incorporate additional margins of prudence.

The Committee of European Insurance and Pensions Supervisors (CEIOPS) has been instrumental in advising the European Commission on the content of the Level 2 implementation measures. Its 2009 Level 2 proposals were distinctly conservative and were much criticised by the industry. Some elements of the proposals were also criticised by the Commission as contrary to both the directive and the intention of the regime.

In reaction to the financial crisis, CEIOPS has since been transformed into EIOPA, the European Insurance and Occupational Pensions Authority. EIOPA has greater powers to propose Level 3 rules not just issue advice and guidance.

EIOPA will also issue binding technical standards together with Level 3 guidance to supervisors (although the timing of these is currently very unclear). The guidance will be given on a "comply or explain" basis, which in practice tends to enforce compliance. The introduction of binding technical standards in important areas should result in increased harmonisation among regulators, although there will still be opportunities for gold-plating.

Capital requirements under the Solvency II standard formula are generally more onerous than under current regulation. The higher requirements result mainly from the market risk and non-life underwriting modules of the standard formula for calculating the Solvency Capital Requirement (SCR) although other areas are also more onerous, notably the treatment of annuity business under Solvency II. Whilst the Commission has said the intention was not to increase capital requirements as a whole across the industry, it seems likely that capital requirements for certain individual insurers will increase and QIS5 did indeed show a decrease in surplus across the industry with around 15% of insurers failing to meet their SCR. Nevertheless, the conclusions from QIS5 suggest that the industry will, overall, still show a healthy surplus over the new requirements. There is also a fear that, particularly because of the inclusion of non-EU group companies in the SCR calculation, Solvency II will put EU insurers at a disadvantage in non-EU markets in which other insurers can operate with significantly less capital.

The use of internal models to calculate the SCR, which is permitted as an alternative to the standard approach, should ameliorate some of the issues concerning the standard formula as the specifications will be more appropriate to individual businesses. However, any such internal model will need to be approved. The regulator must be satisfied that the model meets the standards set out in the directive and, significantly, that it will be properly used and embedded in the business. Any departure from the standard model will have to be properly justified.

The calculation of the SCR is also expected to be very volatile. This is perhaps inevitable, given the focus on

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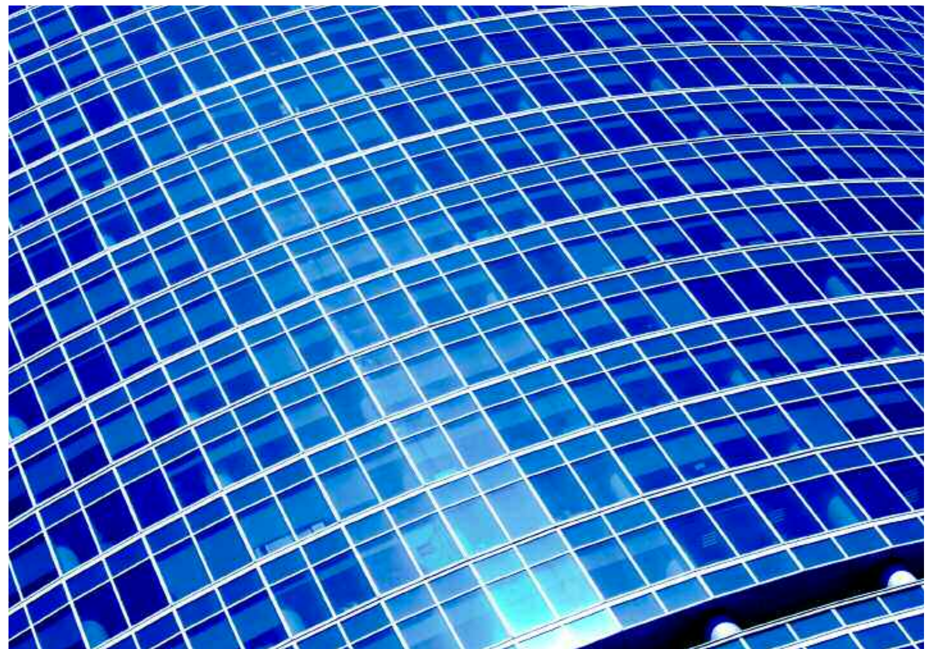
market risk and the use of market consistent valuations. Groups are likely to take steps to try to minimise this volatility and its potential impact on investors.

Another potentially challenging issue is the transparency and consistency objectives of Solvency II. As part of the new disclosure requirements, insurers will have to disclose a large amount of information, including sensitive information which UK insurers currently only share with the regulator on a confidential basis. The preparation of information to fulfil the new disclosure requirements will undoubtedly be onerous for insurers – and for consumers, too much detail may be as unhelpful as too little.

To some extent consistency and transparency will increase particularly as insurers will need to comply with the market consistency principles and the removal of hidden reserves and arbitrary prudential margins. But there is also a concern that transparency and consistency may be reduced if internal models are being used because, even though all insurers will be required to follow the same basic rules on the main issues, the detail of the models will not always be clear or consistent.

On a broader level, issues remain regarding the degree to which Solvency II will create harmonisation across member states. Differences between regulatory approaches are likely to remain in practice and much will depend on the effective operation of the colleges of supervisors and effective oversight by EIOPA.

These issues show that there are still areas where the Solvency II requirements do not allow insurers to maximise capital efficiency which may mean that Solvency II may not achieve its objective of setting a world-leading standard.



Will there be a beneficial effect on consumers?

While security for consumers may improve, we question if, overall, the additional benefits to consumers will justify the costs. Although insurers generally did not fail in the last crisis, they are likely to need to hold more capital under Solvency II. Insurers are also likely to change their investment behaviour and business models, which consumers will potentially pay for in increased costs, and in an increase in risk in the life and pensions sector, as more products are switched to those where the consumer bears the market risk and insurers need to hold less capital. There may also be less choice in providers and products as the market consolidates.

EIOPA's views on QIS5

EIOPA and various regulators including the UK's Financial Services Authority (FSA) have published reports on the outcome of QIS5.

Both the FSA and EIOPA are generally positive about the results of QIS5, saying that the industry is clearly engaged and broadly supportive of the proposals. EIOPA concludes that the financial position of the sector is sound when assessed against the new requirements. Surplus at a group level remains at €114bn using the standard model, which is a fall of just over €86bn (40%) compared with the aggregate surplus on the current basis. The reduction in surplus is expected to be much lower in practice as most larger groups will use internal models.

At a solo level, the fall in surplus across Europe is about €56bn (to just under €400bn) and in 13 countries, surplus actually increases. However, there is a significant range within the results with 15% of companies failing to meet their SCRs. The main factor in surplus reduction for life companies is the market risk component of the SCR whereas for non life it is the underwriting component.

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The EIOPA report also highlights continuing issues, including the treatment of unrated reinsurance, and the catastrophe risk charge for non-life underwriters, as well as various other areas of undue complexity, such as counterparty risk, some elements of market risk (such as the spread risk calculation and the application of look through principles) and the effect of non-proportional reinsurance. In addition, EIOPA believes insurers have been "optimistic" in assuming that existing hybrids and subordinated debt will continue to qualify as eligible own funds under Solvency II.

EIOPA highlights difficulties caused by inconsistent valuation approaches, such as the differing approaches to how deferred taxes, contingent liabilities and intangibles are recognised and valued across different member states.

The report also indicates that, in EIOPA's view, several aspects of the technical provisions calculation may need further consideration, in particular:

- the risk margin calculation is overly complicated, especially the definition of the risk free rate and the application of the illiquidity premium
- the definition of contract boundaries remains unclear with resulting uncertainty about the extent of the recognition of future profits. In QIS5 future profits represents some 20% of Tier 1 own funds across the industry and therefore achieving clarity on the treatment of future profits under Solvency II is critical, particularly for life insurers.

As for groups, the QIS5 results demonstrate the importance of equivalence. The results using local requirements for non EU group companies showed a significantly higher surplus than those using the preferred accounting consolidation method with applications of EU rules to all group members. EIOPA acknowledges the importance of suitable transitional provisions.

The FSA report is broadly consistent with the EIOPA report. On a practical level, the FSA notes that firms experienced difficulties in interpreting some of the requirements set out in the technical specifications, and that, even after clarification, some areas remained difficult to apply in practice. The report highlights the treatment of expected profits in future premiums and the treatment of reinsurance in the catastrophe risk module. There also seemed to be a lack of appreciation among UK insurers that many current hybrid and sub-debt instruments would not qualify under Solvency II.

Is everything still on track for implementation in January 2013?

The draft Omnibus Directive which is expected to formally confirm the expected revised commencement date of 1 January 2013 (which is only a two-month delay from the original date of October 2012) has itself been delayed amongst increasing speculation that the timetable for implementation of Solvency II will be extended.

The European Council has proposed a delay in implementation of the Solvency II provisions to 1 January 2014, although various permutations of delaying provisions are still being discussed and to be effective would need to be adopted by the European Parliament.

EIOPA has suggested implementation on 1 January 2013 but with the use of transitional provisions in various areas and Carlos Montalvo, executive director of EIOPA, has said there will be no delay in Solvency II coming into force. The FSA has also confirmed that it continues to work towards an implementation date of 1 January 2013 and warned the industry not to delay its preparations. The UK insurance industry is better prepared than others and therefore many are against further delay, which could mean reversal of current plans and the requirement to produce another year of ICA calculations.

Nevertheless the timetable is tight; the Level 2 implementing measures have been delayed pending the outcome of QIS5 but are expected sometime this summer. Consultation on Level 3 Binding Technical Standards (BTS) and guidance cannot formally begin until the Level 2 measures are ready, so a process of informal pre-consultation has started. However, BTS, originally scheduled for adoption in 2012 appear to have been internally re-prioritised with BTS covering issues such as valuation of technical provisions and own funds proposed for adoption in 2012 but others being pushed out as far as 2016 or even 2017.

The most damaging issue over implementation appears to be the uncertainty – the industry has been waiting for Solvency II for some years and now needs certainty both as to the detail of the regime and when it will take effect.

How will the remaining issues and uncertainties be dealt with if implementation is not delayed?

One of the original criticisms of the Solvency II Directive was that there was an almost complete lack of transitional provisions or "grandfathering". In light of the concerns raised by EIOPA, insurers will be relieved to see that the need for transitional provisions has been recognised by the draft Omnibus II Directive intended to amend the Solvency II Directive. The

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proposals allow (but do not require) the Commission to apply a potentially wide range of transitional measures:

- for up to three years in relation to supervisory information
- for up to five years in relation to third country equivalence
- for a maximum of 10 years in relation to capital add ons, valuation of assets and liabilities, own funds, SCR calculation and group requirements.

Insurers should not, however, see the transitional provisions as a mechanism to impose a general delay of Solvency II for 10 years. The transitional provisions are intended to work on a targeted basis to deal with particular issues that have been highlighted as likely to effect the Commission's objective to establish a smooth transition to the new regime.

Impact of Solvency II on the insurance industry over the next 12 months?

Solvency II has to some extent caused a slowdown in corporate and M&A activity in the sector over the last few years as it has introduced uncertainty around the valuation of insurance companies, making it difficult to predict the long-term implications of transactions. Some large players have stated that, although they wish to grow organically, M&A activity would be suspended until the consequences of doing deals has become more predictable.

In the longer term, the greater regulatory and compliance burden on insurers resulting from Solvency II is likely to stimulate M&A activity in the sector and indeed some activity is now being observed. Smaller insurers may find it difficult to raise the additional regulatory capital, fund the increased compliance and reporting burden and yet remain competitive. Many insurers will focus on identified profitable, low-capital business and some will divest themselves of less profitable or more capital intensive businesses. This was, for example, one of the major factors in Axa's disposal of its UK life and pension business to Resolution last year. Other insurers may opt to put such businesses into run-off (such as Sun Life's decision to stop writing new business earlier this year). This should then act as a spur to increased activity among the run-off consolidators.

One aspect of Solvency II that will undoubtedly affect how insurers structure their businesses is the fact that there will be a regulatory capital benefit for businesses that are more diversified on either a portfolio or geographical basis. This issue should encourage firms to pool diverse portfolios in a single entity and to acquire new businesses which increase diversification. Groups may also find it is attractive to desubsidiarise and move to a branch and passporting model. Such plans may, however, encounter resistance from some regulators which may be concerned about their loss of influence. Insurance groups will also need to look carefully at their group structures and it is likely that groups will move to flatter group structures to avoid trapping capital in subsidiaries.

Another interesting development has been the decision by some insurance groups to consider creating group reinsurance companies that will effectively pool the different group businesses through reinsurance to get the diversification benefit. Unless the SCR rules in QIS5 are relaxed, any such step will lead to a very high counterparty risk charge for unrated reinsurers, which may militate against the capital efficiency of this option.

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International groups will also have to consider the impact of Solvency II on their global operations. Only Bermuda and Switzerland are likely to achieve equivalence by 2013. Equivalence is important because the need to apply EU calculations to group companies in non equivalent countries may make them less competitive.

The consequential extra-jurisdictional effect of Solvency II may encourage exits by groups from jurisdictions not given equivalence of Solvency II.

It will possibly also lead to attempts to create separate EU and non-EU sub-groups within a global group. This is an area, however, where the Commission has recognised the need for appropriate transitional provisions to avoid putting EU insurers at a competitive disadvantage so the need to take swift action may be receding.

Implications of Solvency II for insurers' investment policies

Under Solvency I, insurers can only use investments which are on a specified list of "admissible assets" to support their technical provisions and capital resources. Non-admissible assets are deducted from capital resources. Solvency II changes this approach significantly.

Under Solvency II, there will be no prescriptive rules. The "prudent investor" principle will give insurers the freedom to invest, provided the investments are in assets in which risks can be properly monitored and that other basic criteria for the safety, quality, maturity profile and diversification of the assets are met. Under the new rules insurers will, however, have to assess a variety of specific categories of risks, as relevant to each asset held, to support their technical provisions and their capital requirements. Having assessed the risks, they are required to hold additional capital to cover such risks.

For example, for listed or unlisted equity investments, insurers have to calculate the amount of capital that will be required to allow them to withstand a fall in equity values of 49% (unlisted) or 39% (listed). This is a provision which is also likely to have a significant impact on insurers' investments in private equity funds since in keeping with Solvency II's focus on "substance over form", collective investment schemes and some structured products will have to be "looked through" to identify the risks associated with the underlying investments.

There is an exception to the general principle of freedom to invest for repackaged loans in the nature of securitisations, where there has been the adoption of requirements applicable to the banking sector which effectively prohibits investment in such products unless they satisfy specified criteria. These loans are also treated more harshly in the capital requirements applicable to them as against their unstructured equivalents, reflecting perhaps more the political hysteria over the credit crisis than the true reflection of risk.

Likely effect on insurers' investment strategies

The result of this approach is that insurers will focus on obtaining appropriate capital weighted returns from their portfolios.

There is likely to be lower equity investment, which will have a knock on effect on companies looking to raise capital, as insurers make up a large proportion of stock market investors. Long-dated corporate bonds, most

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structured finance products, real estate, and private equity investment will now all carry higher risk charges than government securities and shorter dated corporate bonds. Higher-rated instruments will generally be preferred when compared with lower rated or unrated instruments of similar duration.

There is likely to be increased investment in gilts which is good news for governments looking to raise money although there will surely need to be some differentiation between EEA governments which was not the case in QIS5. We are also seeing increased interest in some forms of property investment (in particular secured loans), in shorter-dated, good-quality corporate bonds and certain securitisation instruments provided that they and the underlying portfolio assets are highly rated and not too long term. Another consequence is likely to be the greater use of derivatives to decrease volatility which will benefit insurers with a sophisticated asset and liability matching strategy.

Broader impact of Solvency II

For corporates and banks looking for sources of funding, Solvency II could potentially severely curtail insurers' traditional role as long-term investors in both debt and equity and their stabilising role on markets in times of crisis.

For insurers, it seems increasingly clear from the need for complex modelling, the benefits attaching to internal models, diversification and the impact on capital requirements that larger insurers will be at a distinct advantage under Solvency II. These factors are likely to lead to further consolidation in the industry. Insurers should by now be fairly comfortable with the construction and operation of their internal models and senior management teams should be turning their attention to more strategic issues arising from Solvency II so that they are well placed to grasp the opportunities which these changes will present as well as meeting the challenges which the new regime will bring for the industry.

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