

Beware Solvency II: As The 2010 Implementation Date Looms Closer, European Insurers Should Ignore It At Their Peril

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Insurance is experiencing a revolution globally, which is changing the competitive landscape. Solvency II promises much for market efficiency in Europe, but insurers and supervisors are far from ready.

Quantitative Impact Study 3 (QIS3) is under way, and the Framework Directive is likely to be published in July. With no sign yet of slippage in the planned 2010 implementation date, Solvency II is beginning to loom large. Standard & Poor's Ratings Services believes it will have a profound impact, although many insurers have yet to evaluate its effect on them, feeling that it is not sufficiently imminent to warrant a full analysis. This is a stance they may come to regret.

The European Commission (EC), European Parliament, Council of Ministers, and Europe's supervisors will need to proceed cautiously with Solvency II's implementation to allow an orderly transition. Further quantitative impact studies, with fully representative participation, will be crucial in determining the financial and operational readiness of Europe's insurers.

This article incorporates comments made by Standard & Poor's at the European Parliamentary Financial Services Forum meeting on Solvency II on May 8, 2007.

Solvency II Drives Pace Of Change In Europe

We consider that the global insurance industry is in the midst of a revolution. This is driven by:

- Improved risk management practices,
- Capital markets developments,

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- Much improved transparency,
- Accounting convergence, and
- Supervisory convergence.

The pace of change is most rapid in Europe, partly because of the specter of Solvency II. Europe promises to set a global standard, surpassing the U.S. (which held the lead until the late 1990s), as well as Canada, Australia, the current U.K. model, and arguably the global banking model too.

Solvency II will certainly provide much more intelligent and risk-sensitive supervision than Solvency I, although it will require much more calibration of capital requirements and provoke much more debate before the finished product is delivered. In a recent speech, Thomas Steffen, the new chairman of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), mentioned the possibility of a QIS6.

Solvency II has given rise to many issues so far, including:

- The likely level of insolvencies under Solvency II,
- Its impact on market consolidation,
- The readiness of insurers and their supervisors,
- The impact on policyholders,
- The impact on transparency,
- The interaction with accounting developments, and
- The supervision of insurance groups.

Insolvencies May Increase

Perhaps surprisingly to the casual observer, Solvency II will probably result in more insurer failures than in the past. A number of countries seem to have operated a zero tolerance of failure under Solvency I. Under Solvency II, this will change to an explicit tolerance, which crudely equates on average to 0.5% of Europe's insurers failing each year. This gives rise to the need for debate on policyholder compensation schemes.

Market Consolidation Will Likely Accelerate

In the medium term, Solvency II will probably accelerate consolidation, especially in Germany and southern Europe. Small and undiversified groups rightly feel particularly threatened. These insurers have reason to be concerned based on the QIS2 calibration, although somewhat less so under QIS3. Because of the low level of participation of this type of entity in quantitative impact studies so far, their voice is not being heard. They need to participate and make their case soon, before it is too late.

Larger Insurers Are Well Prepared, But Not So The Smaller Players

The threat is not limited to relatively high capital requirements for smaller companies—arising from lower diversification benefits compared with larger groups, many of which will be assessed against their internal models—and

consequent implications for price competitiveness. It is also about having the skills, resources, and systems in place to respond to Solvency II-style supervision. The people with the necessary skills are scarce and are being pursued by insurers, consultants, accountancy firms, investment banks, rating agencies, and supervisors. This raises major concerns about insurer and supervisory readiness for Solvency II.

The largest insurers are relatively well prepared, but this is not the case for most insurers nor, in our opinion, supervisory bodies. Many have a heritage of legalistic desk-based retrospective analysis. They will have to transform the way that they operate in a fairly short space of time to accommodate a more prospective outlook, where substance takes precedence over form.

Solvency II requires extensive actuarial skills in establishing insurers' available capital and capital requirements. Some of the required techniques are only in use at Europe's larger groups today. This is exacerbated by the fact that the actuarial profession is not well established in some parts of Europe. Even where it is well established in Europe, the skills required are held by relatively few.

Many companies will also need to rapidly enhance their core computer systems to provide the data and analysis that Solvency II will require. The IT spend will run into hundreds of millions of euros.

We do not think that Solvency II itself should be blamed for this consolidation, however. It is down to market forces and will happen anyway—admittedly spurred on by Solvency II, along with improving product transparency meaning that consumer choices are becoming clearer.

Much of the insurance market is already highly consolidated: the global reinsurance market, the global large industrial lines market, and personal lines markets in the U.K., Ireland, the Nordic countries, and Benelux. Ultimately, and regardless of Solvency II, insurers' survival depends on being good at what they do and either having scale and diversity or a defensible niche product or niche distribution platform. If insurers do not possess these characteristics, it will be hard for them to remain in business in their current form.

Policyholders Will Be Directly Affected

Under Solvency II, premiums will be calculated in an increasingly scientific and risk-sensitive way. More risks (such as flood) may become unaffordable, or even uninsurable.

There will also be less incentive for insurers to hold equity investments under Solvency II. QIS2 included a 40% charge for equity holdings, albeit reduced to 32% in QIS3, compared with zero in most countries under Solvency I. Consequently, there will be less equity backing of nonlinked life insurance products

offered to consumers, thereby limiting future retirement financing through insurance-based pension products.

Transparency Will Improve Further

Transparency has already improved vastly in Europe in recent years, and market pressure has transformed some of Europe's former laggards into global leaders of transparency initiatives. The supervisory standard on transparency in Europe is poor, however. Currently, there is little or no public disclosure of supervisory returns outside the U.K./Ireland. Solvency II will change this. Pillar III proposals are expected to include a requirement for public Solvency & Financial Condition Reports, which will elevate disclosure to a new level, inclusive of Pillar II capital add-ons, although this particular disclosure concerns many supervisors. Such information will be very useful for users of financial information, whether consumers, financial analysts, or investors.

Late Implementation Of IFRS Forces The European Commission To Set The Standard

Things have not gone quite according to plan. IFRS for insurance was originally meant to be fully bedded down by now, in readiness for Solvency II, but in our view it is unlikely to be live before 2012.

This has meant that the EC will have to prescribe an approach of its own. The principles for doing so are likely to include valuing assets and liabilities in a manner that is fairly closely aligned with the IASB's so-called "current exit value" and the views of the International Association of Insurance Supervisors (IAIS). On the face of it, there does seem to be a converging path, which is positive.

The IASB is now working separately on its fair value principles, however. There is no guarantee that the current exit value framework included in its recent discussion paper will qualify as fair value. If it does not, that would be a very unfortunate outcome.

The objections of Europe's larger insurers to the IASB's proposals have waned, partly because they want to avoid separate accounting systems for reporting to shareholders and to supervisors. If the EC's proposals are accepted, it will make the IASB's job easier. It was meant to be the other way around, however!

With the IASB's discussion paper having just been published, the U.S. now starts its involvement in the debate in a meaningful way. The U.S. property/casualty insurance industry's objections to the use of risk margins and discount for non-life liabilities (advocated by the IASB, the EC, and the IAIS) are already well known. This could easily result in pushing IFRS Phase II implementation beyond 2012 if a unified standard is pursued.

Supervision Of International Insurance Groups' Capital Adequacy May Prove Problematic

The future supervision of Europe's insurance groups is one of the most controversial aspects of the Solvency II proposals. Most parties expect the lead supervisor of an insurance group to have greater responsibilities, but the controversy starts where this relates to subsidiaries beyond the lead supervisors' national borders.

A significant proportion of the real economic diversification benefits enjoyed by insurance groups, and measured by their internal models, are derived from geographic diversification. Groups will only be able to realize those benefits in a meaningful way if they can allocate them to their subsidiaries, and carry less local capital as a result. This may mean that subsidiaries will carry less than a stand-alone solvency capital requirement. In light of their statutory obligations, many supervisors are uncomfortable with the loss of control that this implies.

In terms of market efficiency, it would seem unreasonable for supervisors to ignore this level of diversification, albeit derived from somewhere outside their direct control. This is where the mutual recognition and trust between European supervisors, which Solvency II is meant to create, starts to bite.

Nevertheless, it is fair to acknowledge that if large groups are allowed to benefit in this way, as a consequence, it will further reinforce their competitive position relative to smaller insurers across Europe.

The McGraw-Hill Companies