



A trigger for consolidation



Consolidation, restructuring and the disposal of discontinued lines are all on the agenda for European re/insurance groups. For this Solvency II is partly but not wholly responsible, says **Dr Hubertus Labes** of Chilton International *

Solvency II was initiated in response to the stock-market crisis in 2001/2002 and subsequently the financial crisis in 2008. Its aim is to achieve more transparency and to arm companies in the event of similar crises in the future. Solvency II will provide more intelligent and risk-sensitive supervision but will at the same time require more calibration of capital requirements.

By implementing Solvency II,

Europe will establish a harmonised standard surpassing the US as well as other jurisdictions. Large parts of the re/insurance industry, however, seem to be swamped by Solvency II, due partly to the sheer complexity of these regulations, but also due to the limited

time left until rollout of Solvency II in 2013.

There may be further adjustments necessary and transitional grace periods granted but Solvency II will come soon. And its implementation will be a considerable burden for the insur-

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ance industry, especially for smaller and mid-size companies – on the one hand due to increased capital requirements, on the other hand because of (implied) technical and human resource requirements.

Particularly contentious are the new rules with regard to net capital required. Re/insurers will have to capitalise risks emanating from their insurance portfolio as well as risks emanating from their assets. The more risky an insurance contract or a capital investment the more capital needs to be allocated. The risk modelling

Some smaller players claim that such an impact on competitiveness is the intrinsic meaning of Solvency II – to their disadvantage, of course.

On the other hand, big players like Allianz are already preparing for consolidation. According to its CEO, Michael Diekmann, consolidation will come. There are several hundred insurers which have the size of an Allianz branch office, he notes. Therefore, Allianz is already looking at potential acquisitions.***

But insurers and reinsurers might also consider reducing the impact of

over many years guaranteed interest rates at an average of 3 per cent and beyond to millions of insureds. However, this interest rate has been difficult to achieve by standard capital investments in recent years. And to realise capital gains will be even more difficult in the future.

For stock market share investments, for example, which promise higher income, Solvency II regulations require capitalisation of 39 per cent for EU based shares and 49 per cent for shares originating from emerging markets. This might even increase for growing markets due to the risk of depreciation. It is obvious that such capitalisation will be affordable for big groups but will be hard to achieve for smaller players.

Another driver for consolidation might also be the disadvantageous standard model for evaluating a company's risks. Big players will in all probability not use the standard model but will develop customised models, whilst smaller companies will have to stick with the standard model due to the lack of resource and data, resulting in an expected increasing need for capital allocation. Furthermore, the standard model is highly unlikely to be suitable for run-off, particularly international reinsurance run-off.

Run-off

The need for run-off solutions will most probably increase under the auspices of Solvency II. So far, under the existing legal regulations, portfolios including run-off portfolios must be supported by capital based on the present volume of premiums and claims expenditure. In default of income from premiums, claims expenditure therefore is essential for run-off portfolios in the process of transaction. Should sufficient reserves be available, only marginal additional capital commitment is required for such portfolios.

This will change under the new regulations as run-off portfolios will then require significant higher funding with

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company Perils, for example, calculated a €37 million additional capital requirement for a significant storm risk which statistically emerges every 200 years.**

Consolidation

It remains to be seen which companies fulfil the requirements under Solvency II and which do not. Most likely it will be the smaller to mid-size range of companies which will have difficulties complying with the capital allocation regulations under Solvency II. Consequently, these companies will have to raise more capital, buy more reinsurance, reduce business or be acquired by bigger players – alternatively going into run-off if none of the above options are possible. An accelerated consolidation process, therefore, is one scenario that seems to be likely as a consequence of Solvency II in the medium term.

High complexity and therefore high costs, but also a relatively higher capital allocation arising from lower diversification benefits compared with larger groups, might particularly threaten smaller and mid-size companies.

risk diversification by combining various portfolios into a single carrier. Such a consolidation could also be achieved through corporate redevelopment and liquidity acquisition measures which increase capital use and efficiency. The latter can be achieved by reducing the number of subsidiaries, resulting in capital release, eg. by making greater use of branches replacing separate subsidiaries.

There is no concept of relying on parent capital under Solvency II. All companies have to be sufficiently capitalised on their own, which makes a parent/subsidiary structure inefficient. A solution is to switch to a branch structure, where only one company has to hold the capital. Such stock transfers are already used for fiscal optimisation and reduction of opportunity costs as well as a reduction of required management time, but might become even more significant in view of Solvency II. Furthermore, single line insurers are disadvantaged since diversity seems to attract lower capital requirement.

Among the first to suffer from Solvency II may be life insurers which

capital, without this additional capital being mirrored by respective benefits. Whilst under Solvency I capital requirements for a non-life portfolio of €100 million gross reserves had to be capitalised with a minimum of €3 million, this will have to be €30 million under Solvency II. This, however, only represents the minimum capital requirement; in reality the capital requirement could easily increase to €45 or 50 million.****

Therefore, capital allocation will

off might be under pressure. Insurers therefore need to consider future opportunities for their old reinsurance books of business in run-off.

An additional reason for doing so may be that staff with corresponding historic knowledge in respect of these books are close to retirement or retired already, and companies wish to avoid building up a new workforce for business from the past but not needed for future development. It is to be expected that companies will rather want

be the sole trigger. Takeovers, mergers, and cessation of business are natural parts of the industry life cycle. That happens every year. Markets will continue to work properly albeit with a smaller number of players.

More likely is that insurers will reconsider their old discontinued reinsurance books of business. Finality is the key in order to avoid respective capitalisation requirements. There are various options when it comes to achieving finality, eg. retrospective solutions, portfolio transfers, and solvent schemes of arrangements. It is crucial to find the best way for the specific needs of the portfolio in question.

What is clear is that Solvency II will be a burden for the insurance industry, affecting smaller companies much more than large groups. Even today in the preparatory phase, everyday work is suffering.

It needs to be stressed that despite its complexity Solvency II remains practicable. This involves necessary simplifications and interim arrangements to address the needs of smaller players; despite the necessity of regulated reporting requirements, Solvency II should not become a bureaucratic monster. Furthermore, despite European harmonisation, to some degree local market specifications should be considered. And the problem remains: Solvency II is a chance for large groups to generate business advantages over smaller companies.

Footnotes

* Dr Hubertus Labes is a partner and member of the board of Chilmington International Holding and an executive board member of Hamburger Internationale Rückversicherung AG

** Krieger, FTD 2.11.2010, p.A2

*** Fromme, FTD 22.10.2010, p. 20.

**** Endres/Villeroy

de Galhau, *Solvency II and the capital charge for run-offs, run off & restructuring 2010*, issue 32, p. 21, 22

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become a true business factor and will have to be considered when writing a certain line of business. This will no longer only be dependent on profitability, premium volume, or combined ratios. Annex lines with only little volume but high capital requirements might be consequently put into run-off or sold.

This affects particularly direct insurers with discontinued reinsurance lines, since discontinued lines attract a disproportionate capital requirement for ongoing entities, which should lead to more transfers and schemes. Companies which fail MCR might well still be legally solvent and it may not be in policyholders' interests for such companies to be put into liquidation. Solvency II will probably even result in more insurer failures than in the past.

But also existing run-off operations – administered internally or outsourced – will be heavily affected by Solvency II due to mandatory functions required for all companies. This again might lead to further outsourcing and consolidation opportunities.

It is likely that these kinds of decisions will be made prior to the implementation of Solvency II since afterwards, due to the impact on capital charges, prices for portfolios in run-

to increase active business instead of capitalising old run-off portfolios which can have no impact on future strategies.

Consequently, these old discontinued books need to be finalised, by way of commutation, solvent scheme of arrangement, or by sale and portfolio transfer. Alternatively, a positive impact on the portfolio can be achieved through retrospective solutions offered by a strongly rated reinsurer.

Conclusion

The question of whether consolidation will arise as a consequence of the implementation of Solvency II is often raised. The challenge is about having the skills, resources, and systems in place to be ready for Solvency II. Larger companies may be well prepared. Solvency II requires extensive actuarial skills in establishing companies' available capital and capital requirements. But Solvency II alone is not to be blamed for these requirements.

Global markets are demanding products, systems, skills, and resources anyway, admittedly spurred on by Solvency II. Therefore, Solvency II might indeed cause some consolidation in the insurance industry but there are reasonable doubts that Solvency II will