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Solvency II: A free lunch … from the EU?

Solvency II offers a real incentive for diversifying risk, but is it quite the bonus it appears to be?

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RECEIVED WISDOM MUST CHANGE

As the deluge of figures that was QIS5 starts to subside, there is an opportunity to look beyond 2014 and search for signs of how our industry will operate once Solvency II is business as usual. There are fundamental pressures on our distribution models – the retail distribution review (RDR) and Foreign Account Tax Compliance Act (FATCA) to name but two. There is much to say on both of these but, for this article, we are focusing on what will drive the financial structures of our businesses.

The most crucial challenge is to identify the portfolio of risks that you would want to import to complement your own.

Working with our clients, the analysis has made it clear that the move away from composite offices will need to be reversed, or at least taken in a different direction, if the full benefits of risk diversification are to be realised. We are already seeing this as a driver of change.

Current regulations give little, if any, benefit for risk diversification, but Solvency II gives a real incentive to seek to maximise its effect. Taking a theoretical stance, Table 1 highlights that, in the simple situation where a monoline life or GI carrier takes on a different risk type, the capital required on a composite basis is markedly lower than for two stand-alone entities.

In practice, of course, the situation is more complex. The effect is diluted by the many different risk types – market, credit and operational as well as insurance – that the stand-alone companies will bring to the combined entity. And the effect on the risk margin, not just on the solvency capital requirement (SCR), needs to be considered. A release in insurance risk capital of the order of 50% is not an unreasonable target.

In the strictest economic terms, the real worth of the exercise is not in the immediate capital release, welcome though that usually is, but in the difference between the face value and the discounted value of the capital release. And, of course, this is different between life and GI portfolios, because of the much greater mean term of the life policies. But even with this taken into account, there is no doubt that there is a strong theoretical case for creating further risk diversification.

That's fine in theory, but…

The difficulties start to arise when the practical constraints of trying to transfer real portfolios of risk between insurers are faced.

The most crucial challenge is to identify the portfolio of risks that you would want to import to complement your own. It is essential to avoid an unprofitable book because, while the benefits of capital efficiency are well worth having, they cannot outweigh a genuinely loss-making business.

This needs to be considered alongside the volatility of the claims coming from the newly acquired portfolio. A life company's shareholders do not expect to have to suddenly cover claims for a US windstorm. And the shareholders of a GI insurer will not be amused by the strengthening of longevity reserves.

In our experience, the real success factor is the quality of the long-term relationship between the original underwriter and the ultimate risk carrier. Linking with a high-quality underwriter that can be trusted is crucial.

Achieving this stable relationship can be facilitated by a properly structured transaction. It is also partly a matter of corporate chemistry. A surefire way to achieve this is by acquiring the underwriter. If you grab a man by his wallet, his heart will surely follow.

TABLE 1: Capital required for Composite or Stand-Alone Entities

Stand-alone risk	GI company	GI company + incremental GI risk
Market	200	200
Life	–	50
GI	450	450
BSCR	514	520

Stand-alone risk	Life company	Life company +incremental GI risk
Market	800	800
Life	50	50
GI	–	50
BSCR	807	815

But acquiring a company brings with it all sorts of risks – operational, reputational and strategic. You may acquire more risk than you are able to diversify away. Unless it is a strategic direction that you wanted to follow anyway, the acquisition can become the technical tail wagging the corporate dog.

Reinsurance is a much cleaner route, but there is the ever-present chance of picking up poor-quality business. One conversation in three between insurance folk usually contains an anecdote about the worst reinsurance treaty ever entered into. A quota share treaty is preferable, because both parties have much to gain from good experience. But, in practice, these treaties work best as long-term commitments on both sides – and such relationships take time to cultivate.

At the other end of the spectrum is buying one of the various forms of derivative risk vehicles. Longevity swaps, industry loss warranties and cat bonds all fall into this category. It may also be that tailor-made insurance risk packages can be manufactured. These will perhaps be the way forward in years to come – the range of risks and their transparency mean that they are useful adjuncts to a core risk diversification process, but they are not yet that core process.

An alternative approach, and one that has already been tried and tested, albeit in rather different circumstances, is the 'sidecar', perhaps more prosaically described as a reinsurance special purpose vehicle (SPV). Originally created to raise capital for insurers that had suffered considerable losses from Hurricane Katrina and other natural disasters of the time, a 'sidecar' is a listed and rated captive reinsurer into which the direct writer places its portfolio. Investors then buy shares in the 'sidecar'. It is a short leap of the imagination to envisage a group of monoline insurers placing their business, or at least quota shares of their business, into a single reinsurance SPV and, in return, receiving shares in the performance of the entity as a whole.

The business transferred into the SPV would need only a small proportion of the risk capital that the monoline would need to provide on a stand-alone basis. The monoline insurer thus maintains its focus on the risk that it knows best how to underwrite, yet gains the capital benefits of a pooled risk approach.

WHAT WILL THE REGULATORS THINK?

All this is predicated on being able to gain a suitable licence to write both life and GI risks. Those insurers that have retained their historical composite business licence have a genuine competitive advantage. An insurer with a significant level of risk diversification will be able to achieve higher margins or, more likely, offer lower premiums for the same margin than a monoline competitor. So how can the monoline respond?

The solution is not obvious, but there do appear to be useful reinsurance SPV structures that can allow monolines to achieve the price levels that their more fortunate composite competitors can take for granted. Carefully constructed, certain reinsurance SPVs can be licensed to receive both GI and life risks, even within the terms of the EU directive. But will the regulators be accommodating?

Of course, only the regulators themselves can answer this, and their response will quite properly vary from case to case. But insurance SPVs have been championed in the past by the FSA. And it would be surprising if the regulators allowed one section of the market to maintain a structural competitive advantage for purely historical reasons. So this may prove to be a route to a more level playing field.

WHERE DOES THAT LEAVE US?

The insurance industry of the future will be dominated by pooled risk vehicles, either within the fortunate composite licence holders or, conceivably, through specially created insurance or reinsurance SPVs. The winners will, as ever, be the firms that write profitable portfolios of policies, but there will be much more attention on risk portfolio engineering to ensure that those profits are not undermined by unnecessary risk capital costs? ■