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Financial Services

The strategic impact of Solvency II

Success in 2012 will depend on how you define your Solvency II ambition

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Introduction

With Solvency II only two years away, you probably already know whether the cards have been stacked in your favour. Your business model, existing product portfolio and risk profile already define you as a winner or loser under Solvency II. Yet starting with a relative advantage will not guarantee success come 2012. Ultimately, success will depend on how you set and then realise your Solvency II ambition.

Solvency II is viewed by some as an expensive compliance exercise. Others see it as an even more expensive "re-platforming" exercise for their entire risk and capital management architecture. Both views concern us. The first, narrow view, risks failing to take advantage of opportunities created by the regulators. The second risks over-investment in relatively low-yield initiatives.

By considering key business levers, such as asset-liability management (ALM), risk profile optimisation and product strategy, insurers can manage the impact of Solvency II on their business. An integrated economic balance sheet combined with risk-based decision-making will yield tangible benefits. The size of these benefits will depend on the insurer's business model, the markets in which they compete and the Solvency II infrastructure they decide to build. In this paper we reflect upon some of the dimensions to this decision: how do you decide what is in scope for your Solvency II implementation?

Winners and losers

The potential spread of solvency surpluses between different players before and after Solvency II is significant. You should consider where your organisation currently ranks and where you might stand following the arrival of Solvency II.

Understanding your capital requirements is only part of the answer. Insurers need to understand how they will shape up come 2012. What do relative outperformers look like?

- The characteristics of the current winners are:
- They manage their business using an economic balance sheet
- Their balance sheet is large and diversified
- A Solvency II-friendly product mix.

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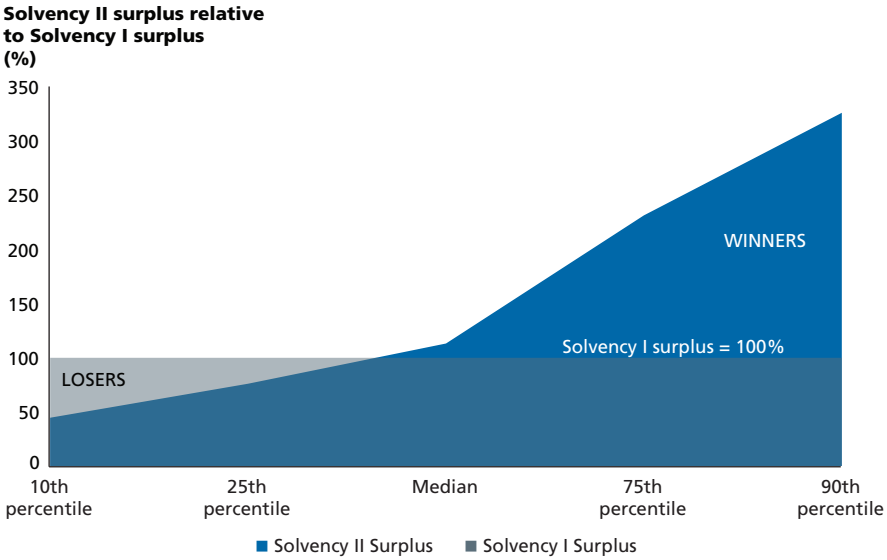
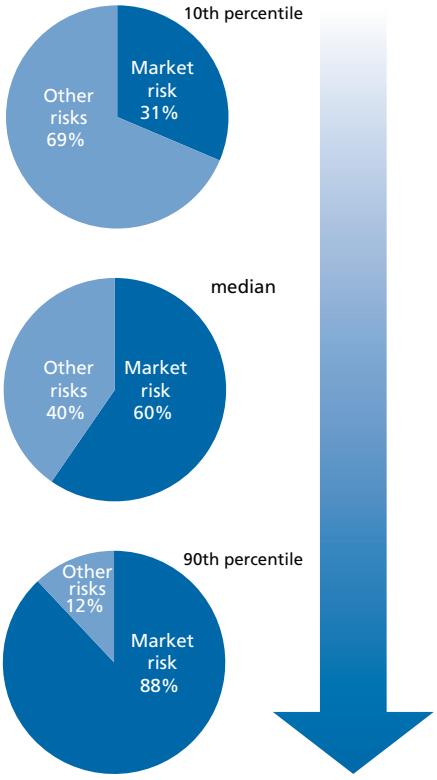
Exhibit 1: Winners and losers in absolute terms (Solvency I = 100%)



Source: QIS4 and Oliver Wyman analysis

Players who will outperform their peers in 2012 are investing in the building blocks of ALM, risk profile optimisation and product strategy. Each of the building blocks of an upgraded business architecture allows insurers to allocate capital more efficiently, which in turn results in benefits to the organisation. These are discussed in turn below:

Exhibit 2: Market risk as % of



1. Asset-liability management (ALM)

Market risk gives rise to a substantial proportion of the capital requirements under Solvency II (see Exhibit 2). Making efficient decisions that put you on the optimal risk-return trajectory will help make the most of your capital. Market risk could account for 30% to 90% of your total capital requirement, so understanding the levers here will be critical to success in the Solvency II world.

It is no longer acceptable to be content with a long-term approach reliant on earning credit spreads, or on the mean reversion in other asset classes. Solvency II forces insurers to consider the short-term balance sheet implications of all long-term decisions.

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Solvency II changes the capital requirements for individual asset classes and hence their relative returns. New returns on capital need to be estimated and the investment strategy optimised based on this. Optimising strategic asset allocation relative to liabilities and capital requirements for different asset classes will be an important differentiator.

Market leaders are already changing their investment strategy and here there is definitely a first-mover advantage. Managing ALM means managing your balance sheet across the whole institution, and at the pace at which the capital market operates. Producing your economic balance sheet, entity by entity, with six weeks' hard work each time, does not enable you to manage ALM actively. Developing the operating model and technology to do so, though, will be expensive and demanding.

The benefits arising from efficient investment in ALM typically amount to an increase of 1% per annum in return on embedded value, but the range is much larger, from nil to 4% or more.

2. Risk profile optimisation

Diversification matters. We expect risk portfolio optimisation to become a key theme in the run up to 2012. Sophisticated units will take the risks and opportunities offering good value to them.

Front-runners have already taken organisational steps towards integrating the way they manage risk and capital. They have a plan in place as to how they will progress beyond risk measurement to a point where they are managing the business' risk profile based on the economic balance sheet. In some organisations parts of the business are already managed in this way, but we are unaware of any European Insurers where this capability is being used across the board.

Diversification benefits means that the marginal cost of risk will differ across the market. For example, our internal calculations show that the marginal capital cost of an annuity writer taking on lapse risk is small relative to most other companies. In fact, some Insurers could add certain risks for almost no capital cost. We expect financial engineering to lead to substantial benefits for those best placed to understand the economic consequences of their various risk transfer or retention decisions.

The benefits arising from efficient investment in risk optimisation typically amount to an increase of 0.5% per annum in return on embedded value, but the range is much larger, from nil to 2% or more.

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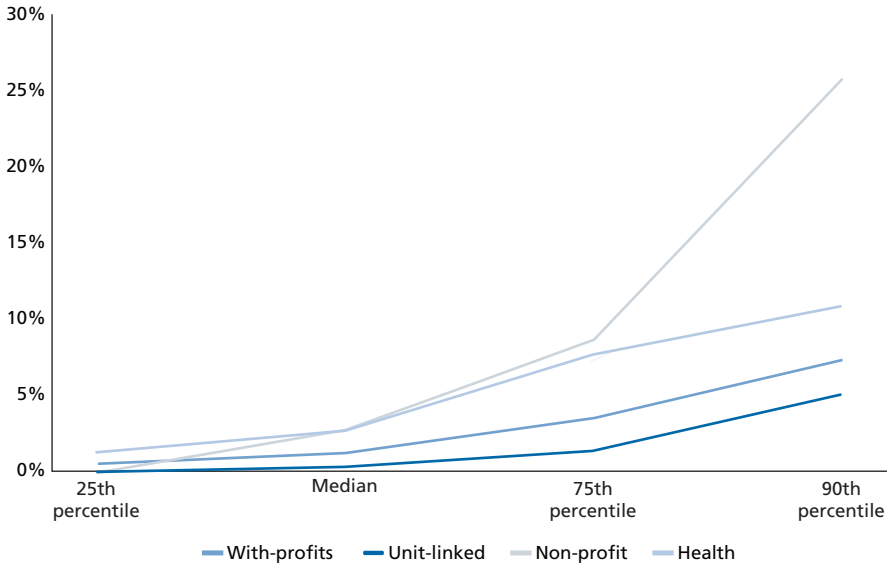
3. Product strategy

Solvency II will make some products unsustainable, while others will be unaffected and, therefore, in relative terms, more attractive. Such divergent effects occur even *within* product classes (see Exhibit 3 below)

Exhibit 3: Risk margin uplift to best-estimate for different products



Source: QIS4 results

Exhibit 3 shows the risk margin required for different product classes. Solvency II will require that such a risk margin be added to the best-estimate reserves. The risk margin will reflect the total amount of capital the product will require over its lifetime: the bigger the requirement over the product lifetime, the higher the risk margin at outset. Long-dated products with guarantees are the worst off here. Firms wishing to adjust their product mixes may find it costly as competition in the preferred product classes intensifies.

The benefits arising from an efficient investment in product strategy typically amount to an increase of 0.5% per annum in return on embedded value.

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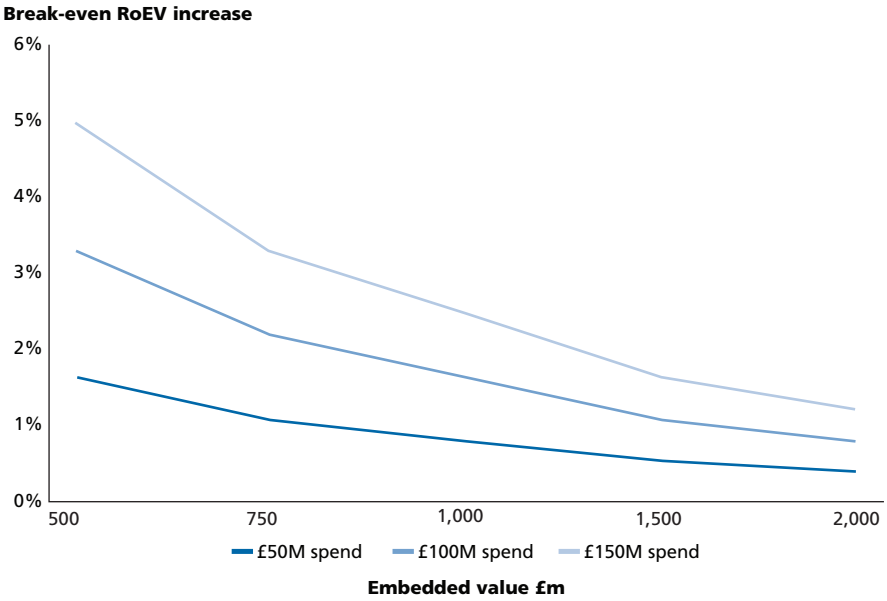
How to set your Solvency II ambition

Different products, investments and even operating models will come out on top under Solvency II. CEOs should be engaged with deciding their firm's strategic response to Solvency II.

Not every firm can or should be market-leading on every piece of architecture. How much you spend should depend on how much you stand to gain. For example, our analysis shows that by managing their business on an economic basis the largest firms would create value that far exceeds the cost of the necessary infrastructure. These firms need to decide what they can achieve. Can they make the changes necessary in operations and culture to manage their global economic balance sheet? Can they explain to investors how they have optimised their risk profile? Can they manage a volatile balance sheet effectively enough to be able to remove excess capital?

Exhibit 4: Indicative cost-benefit profile for a group of large insurers



Smaller insurers face questions that are almost as complex. For them, the benefits to be gained from strengthening different parts of the organisation differ, and the rate of gain (measured as additional profits arising due to increased sophistication in a key area) may tail off quickly as spend increases. However, these different applications are all to some extent inter-dependent. These insurers therefore need to find the set of initiatives that optimises their competitive position.

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Conclusion

Insurers must understand their post-Solvency II positions relative to their peers, and the measures they might take to improve it. And they must use this understanding to make their architecture decisions on Solvency II before the programme is too far along the road to change direction.

The Solvency II ambition should be set at the top of the organisation and be clear enough to execute: managers must know what is being targeted, how much it will cost and what benefits it will deliver compared to the minimum compliance baseline.

Solvency II presents perhaps the most dramatic opportunity ever for insurers to change the pecking order in their markets. The success of your organisation in the years after 2012 may depend on whether you can define and realise your Solvency II ambition.

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