

BUSINESS OPTIMIZATION HEADING INTO SOLVENCY II

AUTHORS

Jan-Hendrik Erasmus, Head of UK Insurance Practice

Astrid Jaekel, Partner

Chris Leach, Principal

On 1st January 2016, the Solvency II regulatory regime will become mandatory for all European insurance companies, concluding the process that had begun back in 2003.

The primary objective is to improve the level of protection afforded to policyholders by linking regulatory capital requirements more closely to the underlying risks insurers are exposed to. For example, insurers with a higher proportion of risky assets will need to hold a higher amount of regulatory capital than insurers investing very conservatively. This ties into a secondary but equally important objective namely to create a level playing field for insurance businesses across Europe.

SIGNIFICANT CHALLENGES AND OPPORTUNITIES REMAIN FOR INSURERS

Whether or not the final Solvency II rules, and the way in which national regulators choose to interpret them, fully achieve these objectives is a matter for debate. What is clear, however, is that the calculation approach followed by insurers does vary – for example, in whether to use an internal model or a standard formula, or whether to apply the matching adjustment or volatility adjustment or transitional measures.

On the whole, these differences are probably not well understood by the investor and analyst community and detailed disclosures from insurers have been sparse. To date it has been difficult to focus on anything other than the headline solvency ratios. Consequently, the industry faces both communication challenges and pressure to improve their solvency position, regardless of the calculation approach used. At the same time, it is clear to the investor and analyst community that Solvency II and its mark-to-market valuation approach and risk-based capital assessment should trigger changes to the business model across the industry. We observe significant interest among this community to see how individual insurers are adapting their business and processes in response to Solvency II.

Perhaps the most significant difference in approach between firms is the use of an internal model or partial internal model as opposed to the standard formula prescribed in the Solvency II text. In our experience, there is significant balance sheet and business optimization potential in response to Solvency II for both types of firms.

For many internal model (or partial internal model) insurers, the focus over the last 36 months has been model building, model calibration and the internal model application process. This has required intensive regulatory dialogue and significant effort to meet not only the requirements outlined in the Solvency II text, but also to address the points raised in these discussions.

Given both the challenge of getting the model ‘over the line’ and the challenging business environment of recent years (low interest rates, renewed conduct focus, etc.) it is perhaps not surprising that many insurers have been unable to dedicate significant time to considering what their business should look like under Solvency II.

This is both a challenge and an opportunity: in most cases, significant improvements to how the business is run in a Solvency II world could still be made through changes in the balance sheet or in various aspects of the business model, like ALM and investments, product design or management actions in adverse scenarios. The typical benefits are increases in the solvency ratio, improvements in the underlying stability of the solvency ratio and an increased awareness around how and where future profits and cashflow will arise under Solvency II.

For standard formula companies, preparation of the modelling tools has been comparatively more straightforward. However, there have been some regulatory challenges over the appropriateness of their results and the calculation approach. The challenges faced by many firms using the standard formula centre on the absolute level of solvency calculated with this simplified approach, and the potential volatility in this number over time.

This can be seen from available industry-wide data (relating to the European Insurance and Occupational Pensions Authority (EIOPA) stress test performed during 2014). The smaller companies (i.e. those more likely to be using the standard formula) making up the core sample showed a solvency ratio lower than 150% in almost half the cases (and lower than 100% in 15% of the cases.)¹

PROVEN AND TANGIBLE RESULTS FROM BUSINESS OPTIMIZATION PROGRAMS

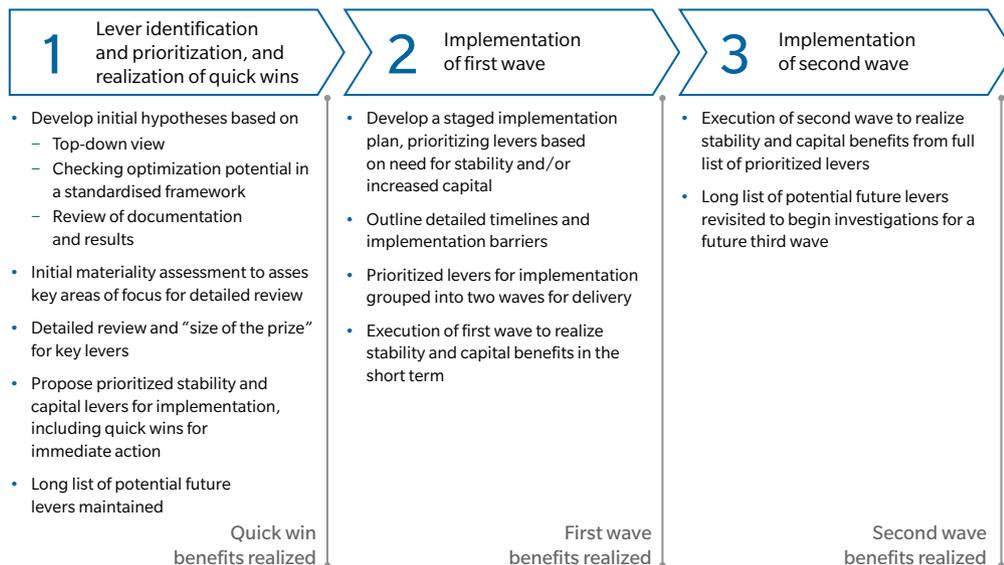
Both standard formula and internal model firms can benefit from a renewed focus on optimizing the business and the balance sheet for capital and stability heading into Solvency II. We have completed more than a dozen balance sheet, capital and business optimization programs for our clients throughout Europe and the UK and covering both internal model and standard formula firms. In all cases viable capital and stability levers have been identified with the average increase being around 15 percentage points of solvency ratio within nine months, together with stability benefits. If and where identified, quick wins are often realised in a matter of weeks.

We have developed a standardized approach for such projects that has allowed us to identify the key levers quickly and exhaustively. A methodical process following a structured framework and assessing a comprehensive set of levers greatly aids prioritization and several of our clients have now completed benefit delivery programs in advance of Solvency II arriving. The philosophy is to identify and develop measures that have a lasting and positive impact on the risk profile, balance sheet and regulatory solvency position (including on its volatility over time).

¹ EIOPA Insurance stress test 2014, 28 November 2014). Reference data are shown on page 7: “unweighted distribution of pre-stress SCR ratios”

For insurers looking to initiate their own balance sheet and capital optimization program we would recommend dividing this into three main stages. Programs can typically be completed over a period of six to seven months, with benefits realised throughout this process. The stages for such a program are outlined below:

Exhibit 1: Suggested structure for balance sheet and capital optimization programs



At the start of any work we would recommend an initial triage to quickly narrow down the focus to those areas with greatest potential.

The first step involves the identification and prioritization of levers suitable for optimizing the balance sheet and business models of the insurer, taking into consideration the expected benefits to the firm. The work is usually completed top-down with a focus on the most material areas, checking optimization potential of levers in a structured framework, making use of external benchmarks (where available) and a review of documentation and the latest results. The process includes identifying the potential impact across different optimization levers, and prioritising these for implementation, including any quick wins that can be put into practice with comparatively little effort and cost. Figure 2 below provides an example of the types of levers and underlying actions insurers we have worked with have implemented but is by no means exhaustive.

Exhibit 2: Example levers for consideration

LEVER	DESCRIPTION	POTENTIAL SOLEVENCY IMPACTS	TYPICAL STRENGTH FOR VOLATILITY MANAGEMENT
Solvency II calculation approach	Use of (partial) internal models for relevant parts of the business, and potential use of matching adjustment, volatility adjustment or transitional measures where appropriate	Reduces SCR and increases own funds	Medium
	Optimizing base balance sheet calculation, e.g. removing prudence from best estimate assumptions	Increases own funds	Weak
	Ensuring stresses are appropriately calibrated and assets exposures are shocked correctly, i.e. not too conservatively	Reduces SCR	Weak
Management actions	Embedding management actions in models can improve solvency but can also reduce management discretion, e.g. contingent actions under stress	Reduces SCR and increases own funds	Strong
ALM and investment strategy	Investment portfolio optimization for Solvency II, e.g. hedging strategies to reduce market risk SCR	Reduces SCR	Strong
Balance sheet structure	Range of potential actions to improve solvency, e.g. changes to legal entity structure, changes in capital structure, reinsurance, etc.	Reduces SCR and increases own funds	Medium
Product optimization	Capital efficient product design, including review and re-design of existing products where appropriate, e.g. restructure fees on in	Reduces SCR and increases own funds	Strong, but takes time to replace business

During the second step, the first wave of prioritized levers is implemented to achieve stability and capital benefits in the short term. Detailed implementation plans for all levers are developed, with implementation scheduled for multiple stages or waves based on the relative benefit and complexity of the levers.

In the third step, the remaining, more complex optimization levers are implemented. This often requires the joint effort of different functions within the insurer, such as Risk, Finance, Actuarial, Asset Management and/or IT. Some insurers use this phase to revisit the lower priority items from step one, and investigate additional future areas of optimization.

CONCLUSION

Solvency II is virtually here and a significant number of companies will face challenges relating to the level of their solvency ratio and its volatility over time. In particular, in the face of analysts or investors focusing on headline numbers and want to understand how business models are adapted for Solvency II.

Oliver Wyman has developed and successfully implemented a proprietary approach to reviewing and optimizing insurer balance sheets and capital under Solvency II, addressing a comprehensive set of levers in a structured framework. The approach focuses on capital and stability levers and allows management to prioritise heading into 2016.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS

+1 212 541 8100

EMEA

+44 20 7333 8333

ASIA PACIFIC

+65 6510 9700

www.oliverwyman.com

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