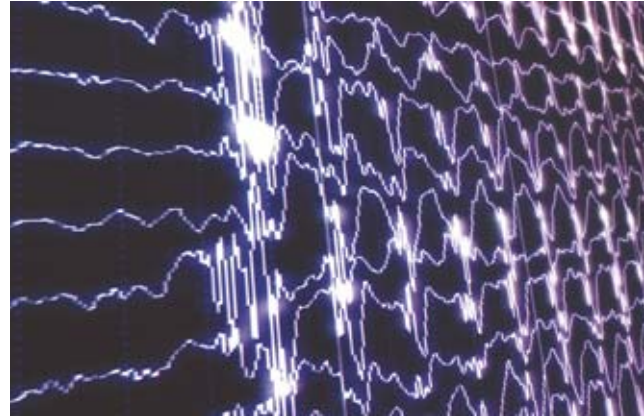


Solvency II capital The volatility challenge



The new Solvency II regime presents significant challenges for insurers in terms of managing capital volatility. But companies that succeed in doing this can obtain competitive advantage.

Solvency II, the forthcoming pan-European risk-based solvency regime for insurers and reinsurers, presents considerable challenges and opportunities in terms of how companies manage their capital and structure their businesses and products. One of the major challenges for firms arising from the new regime is managing the additional volatility that it introduces into their balance sheets.

The new approach taken by Solvency II means that insurers' capital levels could fluctuate more than they currently do over time as market conditions change. As a result, insurers could find their capital buffers eroded and their regulatory capital levels potentially threatened.

The capital volatility introduced by Solvency II is driven by the way the regulatory balance sheet and the capital requirements take into account changes in the market environment, such as fluctuations in bond or equity markets for example. It is a reflection of the inherent volatility in financial markets. For example, sensitivities assessments have shown that a drop of 25 to 30% in equity markets can typically lead to a steep fall in the Solvency II solvency capital ratio of as much as 20 percentage points.

The challenge for insurers is how to manage all aspects associated with this volatility. This presents strategic and also tactical issues for senior management. They will need to understand the particular drivers of capital volatility affecting their company; decide how much volatility they are prepared to accept; and then take the steps needed to control it. Investment banks, asset managers and intermediaries also have a role to play in managing volatility.

Combined with the added volatility of capital there is also the potential for profit volatility to be introduced through the forthcoming new accounting standard, IFRS 4 Phase II, currently expected to be implemented in 2015, which insurers will need to manage in parallel.

Additionally, senior management will need to consider how to communicate the impact of capital and profit volatility to external stakeholders, including investors and rating agencies. Solvency II and IFRS 4 Phase II introduce a new level of transparency to regulatory and financial reporting, so it will be crucial for firms to be able to explain their success and financial solidity using the new metrics, including the impact of volatility.

A market-consistent regime

The volatility in the Solvency II balance sheet arises from the way insurers must value their assets and liabilities, which determine the company's Own Funds – capital available to cover the required levels – and solvency position.

Solvency II introduces a market-consistent approach to valuing the 'economic' balance sheet and the assessment of risk which moves away from the mixed measurement model many European insurers are used to under the Solvency I requirements. Assets are valued at current market prices, while liabilities are based on the present value of a current estimate of future cash flows.

As a result, from quarter to quarter, if there is volatility in financial markets this will lead to volatility in the Solvency II balance sheet and an insurer's Own Funds. For instance, if credit spreads over risk free interest rates widen, bond values will fall but discounted technical provisions may not vary much unless the risk-free rate also changes. The value of the company's assets will therefore fall at a greater rate than its liabilities, everything else remaining equal, so its solvency capital ratio will deteriorate.

This is in contrast to the current position under Solvency I, which typically values assets on an historic basis and values liabilities according to a prudent assessment of technical provisions. As a result, the Solvency I balance sheet has elements of valuation that are less sensitive to the existing market conditions and the underlying volatility is reported to a lower extent. It should be noted that a few jurisdictions, such as the UK, have already been using some form of market-consistent balance sheet for solvency purposes for a few years: they will benefit from an easier transition to the volatile world that comes with Solvency II.

Solvency II is likely to include some in-built dampeners to reduce the impact of market volatility on long-term life insurance products, through mechanisms such as the so-called equity dampener for equity risks and the matching premium for interest rate risks. However, the parameters of these have yet to be finalised by EIOPA. Moreover, they are not designed to eliminate all of the additional volatility, nor will they be appropriate for all insurers.

The challenge for senior management is to decide how much volatility they are prepared to accept and how they will manage it. This is connected to the organisation's risk strategy and risk appetite. Here the chief risk officer (CRO) and chief financial officer (CFO) have different roles. The CRO's remit is to challenge and influence decisions that are being made and ensure they are taken within the approved risk appetite. The CRO will have a role to play in deciding the company's volatility limit, in conjunction with others including the CFO. However, the day-to-day management of balance sheet volatility should usually fall within the remit of the CFO.

Full elimination of volatility is unlikely to be an objective for any insurer and most insurers senior management teams will likely focus on understanding both where the volatility is coming from and the tools that are available to control it within the agreed appetite.

For example, senior management may decide to maintain a higher solvency capital ratio as a buffer to protect against the risk that market volatility brings their capital below regulatory requirements. This may require additional capital to be raised or for the business to be restructured in order to free up capital. However, the level of any additional capital will need to be carefully considered given that an excessive capital buffer will affect the company's returns and may deter investors.

There are a number of key aspects which must be considered when developing a strategy for managing volatility:

Asset allocations

Insurers hold a range of assets to provide investment returns and meet their future liabilities to policyholders. Certain assets, such as equities and medium-rated corporate bonds, are more volatile and have a greater risk-weighting than other asset classes – government bonds for example – thus attracting a higher capital charge under Solvency II. This will particularly penalise life insurers which tend to use equities and longer-dated instruments to match their liabilities.

Insurers can reduce the volatility of their asset portfolio by reducing their exposure to these higher-risk, volatile assets. The move has already started with some companies increasing their allocation to government bonds and highly-rated corporate debt, while cutting back on equities and hedge funds.

Yet, there is a tension here: insurers must maintain a balanced portfolio that will provide sufficient returns to fund their liabilities in the long run. The challenge is to find assets with a low volatility, long-duration and good returns.

Insurers may look to less traditional investments classes, such as infrastructure, which can meet this criterion. This significant asset reallocation exercise may put companies without internal asset management skills at a disadvantage compared to those insurers with greater investment expertise that can fully assess the risks and opportunities associated with the whole spectrum of available assets.

In addition, insurers can increase their use of hedging techniques, including purchasing options, swaps and other derivatives, to manage asset volatility.

Among all the factors affecting this delicate activity, insurers must pay particular attention to matching the duration of assets and liabilities. Under Solvency II, additional capital must be held if there is a duration mismatch.

Product portfolios

Solvency II valuations affect some lines of business more than others. For example, annuities with embedded guarantees can lead to volatile solvency ratios, given the long-term nature of the liabilities and the interaction between assets and liabilities. Whereas for other lines, such as home insurance, volatility is mostly concentrated on the asset side and is relatively easier to deal with through asset allocation, hedging strategies and reinsurance.

Insurers should analyse their product portfolio and consider the volatility and capital implications of each of their product lines. This may lead to the conclusion that certain lines are capital-inefficient and should be run-off or sold, or it may lead to expansion into new and less capital-intensive business lines to generate diversification benefits.

Companies may also explore changes to the terms and conditions of their products in order to make them more Solvency II-efficient and thereby reduce the associated capital requirements, as well as the volatility of these products. This might involve changing the benefits structure, such as by transferring more financial risk to the policyholder, for example, by reducing the strike prices of embedded guarantees, or by requiring customers to pay a higher premium for any right to future bonuses.

Insurers can look to improve the sensitivity of their capital requirements to volatility factors by laying off the associated risks to reinsurance companies or directly to the capital markets via securitisations.

The costs and broader benefits of these alternative strategies and their impact on the company's returns will need to be considered and weighed against the potential capital benefits.

Data and modelling

If senior management is to devise and implement an effective strategy for managing future additional capital volatility then it is vital they have access to good quality data. It is therefore crucial that they have effective data management systems and processes in place in order to do this.

There are also benefits to be gained from investing in modelling technology. Sophisticated modelling techniques, coupled with high quality data will help senior management fine-tune their decision-making in terms of both asset allocation and product design.

It is in these areas where competitive advantage can be enhanced or gained. Less sophisticated insurers might be at a disadvantage compared to those with advanced modelling frameworks, which could be used to design a more tailored asset allocation and hedging strategy matching the risks from the insurance liabilities.

As some firms will be looking to de-risk, some may be able to keep more of the higher yielding, riskier assets if they have the infrastructure and the capability to manage within their 'volatility' appetite.

Internal innovations such as these, which are more difficult for competitors to imitate, will potentially provide a longer-lived competitive advantage than that achieved through external innovations such as new products, which are easier for rivals to replicate.

Governance and internal engagement

Having a well designed organisational structure is critical to maintaining an acceptable level of volatility. Clearly defined roles and responsibilities that provide a clear understanding of risks and exposure positions relative to risk appetite, coupled with effective management and oversight are examples of characteristics that would deliver such structure. Combining the new organisational design with a performance framework that encourages and rewards behaviours that limit volatility within the defined risk appetite should help management foster a culture that will make the business model sustainable and adaptable.

Beyond insurers

Many different players have a role in assisting insurers manage the additional volatility under Solvency II.

Investment banks, for example, will help insurers manage their capital more efficiently, designing new hedging techniques and strategies.

Asset managers will be able to develop new asset classes that are more closely aligned with insurers' needs – funds or financial instruments that are capital efficient and optimise the trade-off between volatility and yield.

Additionally, asset managers, brokers and IFAs, should be looking at insurers' data requirements given that the more data that can be provided the better insurers will be able to fine-tune their strategies for managing volatility.

Against all these opportunities to manage the new added volatility, insurers will have the challenge of understanding the more exotic and complex solutions offered to them and must be prepared to explain them to their regulator and the public.

Accounting volatility

We noted earlier that the additional capital volatility arising from Solvency II is likely to be followed soon by profit volatility from the new financial reporting standard for insurance contracts (IFRS 4 Phase II).

The standard, currently under development, aims to bring a consistent approach to insurance financial reporting across all IFRS reporting jurisdictions and introduce an increased level of transparency. IFRS 4 Phase II is expected to be implemented in 2015 at the earliest, although it is possible that a delay to 2016 may be considered if the completion of the final text of the standard goes beyond next year.

It is not certain that profit volatility will be the outcome of the new standard because the International Accounting Standards Board, which is developing the standard, is keen to avoid this and ensure that the accounts are based, as much as possible, on economic reality. Also, for reported profit under the new IFRS, one issue that has yet to be resolved which could introduce additional volatility into insurers' results, is the impact of interest rates movements.

Under the standard's current calibrations, short term fluctuations in interest rates could have a significant effect on the profits of an insurer. A mechanism has been proposed by the insurance industry to reduce the impact of these market movements, by removing them from the profit and loss account, which the IASB is considering but has yet to make a decision on.

The communication challenge

Solvency II and IFRS 4 Phase II will open a new phase of increased transparency in insurers' financial and regulatory reports. This will have benefits in terms of helping all stakeholders better understand a company's performance.

The side effect of these benefits is the challenge for companies to explain the volatility that may be introduced as a result of a more direct reflection of market price movements that are, to a great extent, unconnected with managements' actions to optimise capital and profit over the insurance business cycle.

Clear, consistent communication with external stakeholders, such as analysts and rating agencies, supervisor and clients, will be crucial so that they understand the new metrics, the reasons behind any volatility and the impact this may have on a firm's capital position.

Senior management must plan a market communications strategy to ensure the business is seen in its best light when the new metrics are published and that the corporate 'story' is reflected in the reports.

The additional volatility from Solvency II's market-consistent approach presents some difficult issues for insurers. However, there are tools available to manage it and there are opportunities to obtain competitive advantage. Effective volatility management will enable companies to reduce the capital they need to hold as a buffer above their regulatory capital requirement, allowing them to write more business and potentially increase their appeal to investors.

Insurers are already grappling with the effects of market volatility that emerged from the current economic turmoil. Once implemented, Solvency II will amplify the impact of market fluctuations, feeding these through to insurers' capital levels and making it a clear priority for senior management to consider how best to manage volatility and to obtain competitive advantage from addressing the issues it will create.

Authors

Michel de la Bellière

EMEA Solvency II
Lead Partner
Deloitte S.A.
+33 1 4088 2995
mdelabelliere@deloitte.fr

Rick Lester

UK Solvency II
Lead Partner
Deloitte LLP
+44 20 7303 2927
rlester@deloitte.co.uk

Claus Brinkmann

Partner
B&W Deloitte GmbH
+49 892 9036 8540
cbrinkmann@bw-deloitte.de

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