Solvency II's coming challenges

The comprehensive Solvency II regime for Europe-domiciled insurers will finally and irrevocably go into effect on 1 January 2016. **Ms Alexandra Field** of **RGA International Reinsurance** provides a brief overview of the regime, portrays its main challenges for European life insurers, and outlines potential reinsurance-based capital optimisation solutions.

The Solvency II regulations, which will govern the amount of capital an insurer must hold to avoid insolvency, will come into effect on 1 January 2016 and will apply globally to companies and groups with headquarters in all 27 European Union countries plus Norway, Liechtenstein and Iceland that will be implementing the regulation.

The regime's requirements are segmented into three pillars: Pillar I, which contains the quantitative rules for calculating target capital; Pillar II, the detailed qualitative risk management and supervision requirements; and Pillar III, the technical reports needed to fulfil its disclosure and transparency requirements.

Companies are currently under substantial pressure to implement many changes to operations to ensure full compliance with the finalised standards and guidelines at the regime's launch. This is quite challenging, as many of the regulation's technical details and implementation elements are still being negotiated and finalised.

Challenges

The requirements of Solvency II's pillars are already putting new pressures on Europe-domiciled insurers – pressures to change operations and procedures to comply with the new disclosure and reporting requirements.

The main challenge so far is cost: implementation costs for many companies have already far exceeded what most had budgeted, in part due to the many changes in the regulation over the years.

Companies that have developed their own internal models as an alternative to using Solvency II's standard formula are also encountering challenges, as they must obtain the approval of the local supervisor – a comprehensive and lengthy process with massive documentation requirements.

The many new requirements are also challenging for mid-size and smaller insurers. This is ironic, as one of regime's aims was to make compliance less comprehensive and burdensome for smaller companies.

The many postponements of Solvency II's introduction have been a challenge for supervisors as well, as many essential aspects are only now being defined. Several are also still under discussion, which is further squeezing the implementation timelines for affected companies.

Another challenge has been how companies can best arrive at market-consistent valuations of best-estimate liabilities. Given the ongoing global low interest rate environment of the past seven years, these valuations are introducing new and significant volatility into insurer solvency.

New adjustments and measures

This ongoing environment has driven the development and recent incorporation into Solvency II of three new adjustments and measures:

- a volatility adjustment, which includes some of the credit spread in insurer assets;
- a matching adjustment for asset-liability-matched annuities that meet certain additional conditions (eg, no surrender options and no future premium payments) that will vary by company; and
- transitional measures, which will provide for a smooth, linear transition from statutory accounting to Solvency II's technical provision calculation framework over a 16-year period.

Insurers will need prior approval from their regulatory supervisor in order to use these adjustments and measures.

Reinsurance's new roles

Reinsurance bought to reduce risk volatility or to provide access to a reinsurer's value-added services will be unaffected by Solvency II, but as the regime will decrease solvency ratios for most insurers, innovative capital-efficient reinsurance and other risk mitigation solutions will be needed.

Several structures have already emerged that will support and optimise life insurer Solvency II capital positions:

Fungibility solutions

One focus of Solvency II is the fungibility of capital in a group's subsidiaries and solo entities (ie, whether capital in one solo entity can be available to meet risks and absorb losses in another). This resulted in fungibility requirements and conditions related to insurance groups. In addition to classic reinsurance solutions, "reinsurance options" or "just-in-time reinsurance capital", each of which enables the rapid execution of a financing agreement in the future, can be effective, especially for non-European non-equivalent subsidiaries.

Shock absorber solutions

These solutions cover defined ranges of selected Solvency II shock scenario stress tests, which are used to calculate the SCR (Solvency Capital Requirement) for sub-risks. Insurers can use reinsurance to reduce their capital requirements as needed, for a cost far less than that of the additional capital it would have had to hold.

Asset-intensive coinsurance solutions

Asset-intensive reinsurance lets insurance companies reduce market risk in annuity portfolios by the reinsurer taking ownership of a pre-agreed portfolio of these assets. The reinsurer then assumes all future payments to the surviving annuitants and pensioners. This strategy would shift the annuities' market and longevity risk to the reinsurer, and would significantly reduce the insurer's SCR.

Longevity swaps

In a longevity swap, all longevity risk is transferred to the reinsurer. Essentially, a reinsurer receives, on an ongoing basis, reinsurance premiums which were fixed at the reinsurance's inception. The reinsurer then pays all future annuity benefits until the reinsured annuity portfolio expires.

Value In Force (VIF) financing

The conclusion of one of the longer debates during the development of Solvency II is about the treatment of a company's Expected Profits in Future Premiums (EPIFP), sometimes also called VIF (Value In Force).

EPIFP, it has been determined, will count as Tier 1 Own Funds, which is defined that these funds are permanently available to absorb losses on a going-concern basis. (Tier 1 of a company's Own Funds is considered the highest quality capital.) Although EPIFP as a component of Own Funds will reduce the need for reinsurance financing, there may still be cases where a legitimate need for such financing might exist, and reinsurance is the best vehicle for delivery. With reinsurance financing, an insurer can lock in a portion of the VIF and eliminate further downside risk, particularly in situations where the EPIFP might be underestimated in Solvency II.

Beyond reinsurance: portfolio transfers and acquisitions

For insurers, Solvency II is both a new financial constraint and a new operational and management burden, causing them to give serious consideration to new solutions for capital and risk optimisation.

Some companies, faced with higher capital requirements for low-profitability units, might choose to close certain business units or even sell some portfolios. Such transactions would provide relief from Pillar I requirements, but the additional relief from Pillar II and Pillar III requirements could be of interest to companies or groups struggling with Solvency II.

After optimising their in-force business for this new regime, companies may be in a better position to manage their business lines sustainably and in capital-efficient ways that can more effectively reflect their individual business strategies and risk profiles.

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