Solvency II Goes Live – Optimisation Is the Next Step After Implementation

By **Alexandra Field**

Manager, Business Development
RGA Global Financial Solutions
Cologne, Germany

afield@rgare.com

Solvency II finally and irrevocably goes into effect on January 1, 2016 after more than a decade of extensive discussion and testing, and many insurers are feeling substantial pressure. The clock is ticking as they prepare to comply with new regulations affecting the way they model and calculate their balance sheet as well as their operations. The focus, however, cannot be on just being ready on January 1, but on having an effective plan for deploying capital long term.

Last-minute challenges

First of all new modelling and calculating procedures have been developed for setting up a market-consistent Solvency II balance sheet, and these need to be stressed according to Solvency II shock scenarios in order to achieve the company's solvency capital requirement (SCR). In addition to the quantitative requirements, many operational changes must be implemented to ensure full compliance with the finalized standards and guidelines at launch. This has been quite challenging, as many of the regulation's technical details and implementation elements have been negotiated and were only finalized at a very late date. For example, it was scarcely a year before Solvency II was to go into effect that long-term guarantee measures were included in the regulatory framework, affecting transitional measures on risk-free interest rates or on technical provisions, volatility adjustment and matching adjustment.

In these few months companies needed to assess which of these measures were most appropriate for each company's individual situation. Based on this decision, they then had to send application forms to their regulator for supervisory approval. Companies intending to use an internal model are having an intensive dialogue with their regulator to get this approved. In most cases approval for their internal model is not expected before the end of a six-month approval process — just in time to be used when required through the introduction of Solvency II.

RGA has produced a discussion paper, "Solvency II: Change Brings Opportunity," which contains 12 cases about reinsurance and SII. It is available in **RGA's Knowledge Center**, or please ask your RGA contact for a copy.

Optimising Solvency II for the future

After companies successfully perform the huge task of introducing Solvency II and become more familiar with the new calculation, reporting and documentation processes, the next step is identifying areas for optimisation and improvement and resolving these. In the past reinsurance has been important for its core function of reducing risk exposure and volatility, and to a lesser extent as a tool for capital management. Solvency II generates an intrinsic link between risk and capital management, meaning reinsurance will automatically be measured from a capital perspective. Solvency II decreases solvency ratios for most insurers, so the need for capital-efficient reinsurance and other risk mitigation solutions increases.

Capital-efficient reinsurance under Solvency II

The following structures 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 (i.e., 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, alternatives such as "reinsurance options" or "just-in-time reinsurance capital" enabling 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 stress tests used to calculate the SCR 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 they would otherwise have had to hold.
- **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.
- **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 shifts the annuities' market and longevity risk to the reinsurer, and significantly reduces the insurer's SCR.
- **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 Value In Force (VIF). It has been determined that EPIFP counts as Tier 1 Own Funds, defined as funds that 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 reduces the need for reinsurance financing, there may still be cases where a legitimate need for such financing exists, 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 to get relief from Pillar 1 requirements. The additional relief from Pillar II and Pillar III requirements, however, could be of interest to companies or groups struggling with Solvency II. After optimising their in-force business for this new standard, companies will be in a better position to manage their business lines sustainably and in capital-efficient ways that better reflect their individual business strategies and risk profiles.

As the clock ticks toward Solvency II's implementation, it is easy to focus on the work that still needs to be done. Our attention shouldn't just be on compliance, however, but on ways to grow and thrive in this new environment. ■