Casualty Actuarial Society

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Solvency II
and
Run-off

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Summary

- Introduction to Solvency II
- The insurance industry’s response to Solvency II
- Impact of Solvency II on:
  - Companies, and their
  - Insureds
  - Reinsurers
- Managing the risk issues

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Introduction to Solvency II

- Just as with Risk Based Capital in the United States, Solvency II will require European Union (EU) risk carriers to make an assessment of their true financial position.

- The introduction of Solvency II (by October 1, 2012?) will require EU risk carriers to allocate their capital against specific underlying risks, which may well lead to increased capital requirements.

- Solvency II will require an objective appraisal by risk carriers of not just the liability side of their balance sheets but also the asset side.

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Introduction to Solvency II

- This will almost certainly lead to an increased focus on optimising the use of capital, and capital tied up in duplicated business activities or non-productive discontinued operations will become progressively more unattractive.

- Companies will therefore become increasingly encouraged to manage their businesses in the most capital effective way.

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Introduction to Solvency II

- Solvency II is based upon three "pillars":
  - Risk quantification
    - Technical provisions
  - Risk management and governance
    - Assessment of risk and solvency capital adequacy
    - Assessment of internal systems and controls
  - Risk reporting disclosure
    - Public disclosure (transparency)
- Under pillar 1 risk carriers will need to calculate:
  - Minimum Capital Requirement (MCR), and
  - Solvency Capital Requirement (SCR)

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Introduction to Solvency II

- MCR will act as a buffer over and above SCR.
- SCR covers all the risks that a risk carrier faces:
  - Insurance risk
  - Market risk
  - Credit risk
  - Operational risk
- SCR to be measured at the 99.5% confidence level.

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Introduction to Solvency II

- Breach of SCR will lead to supervisory intervention:
  - Progressive intervention designed to stabilise an ailing risk carrier before it threatens policyholders’ interests
- Breach of MCR will lead to “ultimate supervisory action”:
  - Liabilities transferred to another risk carrier, and/or
  - Licence withdrawn, and/or
  - Closed to new business, and/or
  - Liquidation of business

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The insurance industry's response to Solvency II

- Standard % Poor's "believe that Solvency II [will] result in more than 25% of Europe's 5,000 insurers being faced with major strategic decisions".*
- Such decisions will in many cases have a knock-on effect upon the market.
- Decisions on their response to Solvency II will be informed by:
  - Single European Passport
    - Ability to sell into another EU member state either directly or through a branch or subsidiary
  - EU Reinsurance Directive
    - Ability to transfer business across companies and across borders
- Package of legislation designed to give EU one of the most (if not the most) competitive markets in the world.

* Source – Standard & Poor's – RatingsDirect – March 12, 2008

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Example - Swiss Re - Group restructuring

By way of example:

- In March 2007 Swiss Re announced that it will restructure its European operations and create three Luxembourg domiciled entities to serve as risk carriers for its many European operations, with a view to improving "the alignment of regulatory and economic capital requirement".*

- Swiss Re's aims include:
  - the "elimination of multiple use of legal entity regulatory capital within group companies for group solvency calculation"*, and
  - "transferability of capital within the group"*

* Source – Swiss Re – Investor briefing – March 13, 2007

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Example - Swiss Re - Group restructuring

- Utilising the EU Reinsurance Directive, it is Swiss Re's intention to transfer the business of 12 EU non-life reinsurance entities into one Luxembourg domiciled entity "Swiss Re Europe".
- Similarly they will be amalgamating their life operations into Luxembourg based "Swiss International".
- This approach is made possible by the single passport and the Reinsurance Directive whilst being driven by Solvency II.
- To the extent possible, steps to achieve a similar reorganisation will be taken in the US where the existing Risk Based Capital regime has much the same impact and provides drivers that are similar to Solvency II.

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Impact of Solvency II

- Solvency II will make all companies reappraise their use of, and redistribute, regulatory capital.
- Where within an organisation there is duplication of operations, (both companies and/or business), these will be rationalised, leaving discontinued operations.
- What should be done with those discontinued operations?
- Each discontinued operation, be it a company, a branch, or a book of business will, in effect be in run-off.

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Run-off

- Run-off requires allocation of capital to non-productive business.
- Run-off will become progressively more unattractive.
- Run-off is no longer a dirty word.
- Run-off is recognised as part of the business cycle.
- Run-off is a means to achieving an end.
- Run-off is seen as a non-core activity that can be transferred (either sold or managed) into specialist hands.
- Run-off creates opportunity to crystallise a profit or release capital.

…………but there are risks

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Run-off

- Run-off is neither simple nor straightforward and the insurance industry has come to appreciate what a drag on their operations it can be:
  - Deteriorating experience
  - Increased costs
  - Earnings drag
  - Ratings drag
  - Management distraction
  - Allocation of capital to non-productive operations

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Run–off – Deteriorating Experience

- Remember – with a run-off:
  - You're not dealing with fine wine
    - Run-offs do not improve with age
- Murphy was right:
  - What can go wrong will go wrong
    - The greater the length of time
    - The greater the number of opportunities
    - The more that will go wrong
- All of which will cost more, not less, and will increase risk not reduce it.
- All of which are an encouragement to get run-offs off the balance sheet.

…………...all insolvent run-offs began as solvent run-offs

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Run-off - Ratings Drag

- Swiss Re is already fully aware to the impact of rating agencies' capital models on Swiss Re's rating:
  - "Attention is paid at all times to the impact on rating agency and regulatory capital adequacy" *
- At best rating agencies will treat well managed run-off operations neutrally, they will never give any credit for a well-managed run-off.
- With increased attention being focussed on the effective use of regulatory capital, companies should be aiming to remove the burden of discontinued operations from their balance sheets.
- This reduction in exposure to discontinued operations will allow companies to focus on their core activities, without the distraction and capital cost of managing their run-off portfolios.

*Source – Swiss Re – Investors Briefing – March 13, 2007

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Run-off – Why discontinue operations?

- Even without the driver of Solvency II companies already discontinue operations, and for a variety of reasons:
  - Unprofitable lines of business
  - Inadequate return on shareholders' funds
  - Pressure from regulators and rating agencies
  - Change in corporate strategy
  - Competition
  - Capital adequacy issues
  - More effective use of capital
  - To release capital
  - To crystallise a profit

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Run-off – Why discontinue operations?

- Solvency II brings all these considerations into sharper focus, and adds
  - Insufficient diversification
    - The capital allocation regime of Solvency II currently aims to reward diversification and punish lack of diversification
  - Increasing capital requirements

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Run-off risks

- The likely response of many EU risk carriers will be to de-risk their balance sheets by disposing of their discontinued operations:
  - Sale
  - Transfer of business
  - Packaging and sale of mature books of business
    - Utilise Reinsurance Directive to transfer business into sale vehicle
- Disposal will permit them to:
  - De-risk balance sheet
  - Crystallise profits
  - Manage their regulatory capital more efficiently
  - Release capital
  - Focus on core activities

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Run-off risks for cedants

- What will be the impact on cedants when their reinsurer become a discontinued operation?
- On the asset side there are already numerous risks where the reinsurance asset is concerned including:
  - Default risk – The risk that an cedant may not receive the proceeds to which it is entitled due to counterparty default.
  - Downgrade risk – The risk that a potential default by a counterparty will adversely affect the present value of the recoverable.
  - Settlement risk – The risk arising from the lag between value and settlement date.
  - Counterparty risk – The risk of changes in the value of receivables e.g. adverse judicial decisions.
- All these risks are magnified when a company places some or all of its business into run-off.
- Cedants will be required to allocate capital to manage these risks

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Run-off risks for cedants

- With an increased volume of run-offs likely to be managed by specialist owners/managers, what are the risks for cedants?
  - Downgrade risk
  - Default risk
- Introduction by owners/managers of stricter disciplines in management of operations
  - Settlement risk
  - Counterparty risk.
    - More thorough scrutiny of claims and contract terms
    - Increased willingness to dispute liability
    - Increased litigation
    - Consequential delays
- What will be the additional capital requirements?

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Run-off risks for cedants

- Typical rule of thumb is a minimum 25% provision for any company in solvent run-off and 100% for any company in insolvent run-off; or adjusted in line with ratings, but companies in run-off rarely have ratings.
- What provisions are made or ought to be made where a reinsurer only discontinues part of its operations?
- The counter to the prospect of additional capital requirements to cover the additional perceived risk to the reinsurance asset, when it becomes part of a run-off portfolio, could be:
  - Commutation of the debt
  - Sale of the debt
  - Purchase more reinsurance

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European competitive advantage?

- By having:
  - Access to the single passport and a level playing field across Europe .
  - The ability to transfer business portfolios, through the Reinsurance Directive, both internally, externally and across borders.
  - Opportunities for the more efficient use of capital driven by Solvency II.
  - Access to exit mechanisms that provide finality.
- European risk carriers appear to have a clear competitive advantage over other markets

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