Solvency II

The stringent capital requirements of Solvency II are causing concern for UK insurers and consumers alike. **Tim Evershed** reports

Two's company

The latest stage of Solvency II has prompted fears for the health of the UK life insurance market with claims that firms will need to raise between £30 - £70 billion in fresh capital to comply with new European rules. Aside from the substantial challenge of raising such large volumes of capital this would also entail sharp increases for in premiums for policyholders.

The disquiet over the proposals is so great that Association of British Insurers (ABI) has written to the UK's Chancellor of the Exchequer, Alistair Darling, stating that the proposals are so "extreme" that they could destabilise the industry across Europe. The ABI has warned Darling and the European Commission (EC) over a threat "to the industry, to its customers and even to financial stability".

Stephen Haddrill, ABI director general, believes that the initial impact of the proposals would be to increase capital and reserves requirements of British insurers by up to £70 billion and adds that similar effects would be seen across Europe.

"In the UK, the impact is close to requiring fresh equity capital equal to the industry's current market capitalisation. It is hard to see how such a massive recapitalisation could be achieved," he wrote. "This huge over-capitalisation will mean that investment returns in insurance will fall. Companies will exit the market, prices will rise, cover will reduce and innovation will lessen."

Some executives have warned that future pensioners could see their level of retirement income from an annuity cut by 10-20 per cent. Jon Pain, managing director, Retail Markets at the Financial Services Authority (FSA) comments: "The nub of the issue arises from the question whether the legislation will allow firms to continue to take into account a liquidity premium in capital provisions for annuity business. In simple, non-technical terms, if the implementing legislation does not allow for it, annuity providers are likely to have to significantly increase the capital they hold and as a result increase the cost to consumers."

The liquidity premium issue would weigh disproportionately on British life insurers, who sell far more annuities than their continental rivals because the UK's lower state pension makes consumers there more dependent on private retirement products. British insurers say the proposals are overzealous, arguing that since annuity holders are not allowed to cash out their policies, the prospect of life companies being forced to sell their corporate bonds at a loss is remote.

Pain explains: "Let me be clear about one thing: the FSA supports the existing concept of the liquidity premium. During the Directive negotiations we were careful in ensuring that the Directive would allow for the concept and the final text of the Directive indeed allows for this.

"You may (remember?) that the ABI said the amount of capital could be equivalent to the current market capital of the whole industry, probably an over estimation, but highlights the potential bombshell for the pensions market."

However, Jim Bichard, insurance partner, PricewaterhouseCoopers LLP (PwC) says: "If you look at the components of the range some of them are on the prudent side. We have done some work at a high level and we thought the numbers were conservative."

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The new rules, laid out in the Solvency II directive, are set to come into force in 2012 after the Commission has set implementation standards by the end of 2010. They were designed to improve capital management and transparency in the insurance industry and to create a single capital requirements standard across the European Union.

The directive was passed into law by the European Parliament in April this year and is now with the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), which is charged with making recommendations on implementation of the directive.

Haddrill explains: "Some of the proposals go further than those designed for the banking sector, which is bizarre given that the insurance industry has weathered the worst financial crisis in eighty years. Its reserving policies have been tested in reality, not in theory, and were found to be secure. Major additions to capital reserving, on top of the current requirements, are therefore unnecessary. Far from adding to the security of the industry, they will destabilise it."

The ABI is far from alone in its concerns, its counterparts in France, Germany and Italy are also lobbying their governments for action while the European Insurance and Reinsurance Federation (CEA) said earlier this month that the latest Solvency II proposals amounted to "a crude ratcheting up of financial requirements".

In a statement UK life insurer Scottish Widows says: "Scottish Widows supports the principle-based economic approach of the Solvency II Framework Directive. Like all other industry providers, Scottish Widows has reviewed the consultation papers on the more detailed Level 2 implementing measures.

"We are in alignment with the ABI's assessment of the draft implementing measures and share concerns about the impact of some of the proposals. We remain hopeful that these issues will be resolved through the consultation process."

The ABI does support the more sophisticated approach of Solvency II, saying it should ensure a more accurate allocation of capital to risk and deliver a more competitive single market, to the benefit of consumers. It also says it has the potential to deliver a world-class regulatory regime that will enable the insurance industry to better meet the needs of consumers across the European Union and reduce the likelihood of insurers failing.

Pain says the FSA agrees: "The Directive includes all the building blocks that we believe are central to a sound prudential regime for insurers, including placing strong risk management at the heart of the regime, supported by robust capital requirements and objective, economic basis for the valuation of assets and liabilities. This represents a positive development for the UK as it builds on our existing Individual Capital Adequacy Standards."

So with three years until Solvency II is implemented, there is clearly much lobbying and debating still to be done to ensure that the regime will strike the right balance for insurers and consumers alike.

Bichard explains: There are some assumptions in there that paint a deliberately bleak picture. These are just proposals from CEIOPS and do not have to be accepted by the EC. There is still a long way to go in both terms of consultation and directive. 2012 will be a firm deadline, but there may be a squeeze between Level 2 and that deadline the final form as a consequence of the debate that is going on at the moment."

Paul Barrett, Assistant Director of Financial Regulation at the ABI adds: "CEIOPS has a lot of different teams that have been working on this in isolation from each other and the current proposals are the cumulative effect of all their work. It needs some joined up thinking."

So what are the issues life insurers will be hoping to influence over the course of the next three years? Clearly, the liquidity premium and its affect on the annuity market is close to the top of their agenda. Although Bichard warns: "Annuity premium is a Level 1 issue, the industry has been a bit late in complaining about it." However, Mark Chaplin, global head of risk and value services for life insurers at Watson Wyatt disagrees, saying: "It is far from decided whether there will be a liquidity premium or not."

If the firms are not allowed to take the liquidity premium into account it would mean significant increases to capital reserves, and those increases would come at a cost. "They would be planning to pass that onto policyholders, which would not be very popular and would also be counter to the Government's attempts to get people to save more for their retirements," explains Bichard. "But, some may say that policies have been to cheap for too long as the market has been cut throat and a rise is overdue." Chaplin believes it might cause high demand for annuities now as the current proposed changes could see an increase of up to 20 percent in the price of annuities by 2012.

Another question is where life insurers would find the necessary capital. "It will all depend on the market conditions when Solvency II comes into force in 2012. If hybrid capital was not allowed and credit spreads were at their widest you would not see a lot of capital, but the spreads have closed recently easing that situation. You would hope that market conditions would have improved by 2012," says Chaplin. Although he also points out that a number of companies raise capital over the last year in the face of some tough economic factors from a range of investors including institutional and pension funds.

Bichard cites Resolution's proposed takeover of Friends Provident as an example of the ongoing attractiveness of the market, he notes: "If you pitch it as an opportunity to investors for growth rather than as a need brought on by regulatory pressures you will be more successful at raising capital from the markets."

As the Solvency II regime continues to evolve and make headlines in both the financial and mainstream press consumers will want to know what implications the regulation will have on them and their investments. "Financial advisers need to be talking to their carriers about what their strategy will be, distribution strategy, communication strategy, but many companies do not know they will be doing because the rules have not been finalised yet," explains Bichard. "The fact that the UK industry and the ABI are putting forward the case for the industry and making sure that the new regime will be right for consumers. It does not come into being for another three years so there is time to get the balance right." FS

The Solvency II Directive

Solvency II is the name of the Directive developed by the European Commission, which will provide a comprehensive new framework for insurance supervision and regulation. It is intended to introduce across the EU a more sophisticated, risk based approach to supervision and capital assessment, using modern techniques for market-based valuation of assets and liabilities.

By promoting more sophisticated approaches, including firms' internal capital models, Solvency II will ensure a more accurate allocation of capital to risk. This should:

1. reduce the probability of firm failure;
2. increase efficiency in the use of capital, improving returns; and
3. achieve a more efficiently priced market for insurance products.

Solvency II will consolidate many of the existing insurance Directives. A draft of the High-Level Framework Directive was published in July 2007 and its final adoption is expected for 2008-2009. More detailed EU legislation will follow after that in 2009. The entire framework Solvency II is expected to come into effect in 2012 and will need to be implemented into national legislation by that time.

Source: ABI

Cost of capital

'Cost-of-capital' is the name of a method used to establish the full economic value of insurers' liabilities where there is no 'market price' which can be used to establish their value.

Without a market to compare against, the cost of capital approach looks instead at the amount of risk-capital an insurer needs in order to manage and run-off their liability. This approach has been pioneered in Switzerland, (and is known there as the Swiss Solvency Test). The idea is that an insurer makes their 'best estimate' of the cost of claims that will arise from a given set of insurance liabilities. The insurer must also hold capital to provide a buffer against volatility and uncertainty in this 'best estimate'. Holding this capital has a cost, an interest cost. Once the amount of risk-capital needed for a given set of liabilities has been calculated, an interest cost can be derived, based on the length of time over which the liabilities will be run off (the period over which claims may be expected). This cost is discounted and then added on top of the basic 'best estimate', to give a more accurate assessment of the total cost of meeting the specified liabilities.

Source: ABI