Taking Solvency II to the Next Level

Solvency II for Insurance Groups
Introduction

What are the most pressing issues? And why act now?

The spotlight on Solvency II is now focused more on requirements for risk-based capital adequacy for insurance groups and conglomerates, as opposed to legal entities or single insurers.

Insurance groups must look at their group corporate structure and intra-group risk transfer arrangements. Capital markets are placing further pressure on groups to increase capital efficiency, and Solvency II is also likely to increase group reporting requirements.

Despite this backdrop of pressure, companies should look for ways to derive additional business value. Groups can take advantage of group level diversification through optimized capital management and risk transfer strategies. The supervisory aspects of Solvency II may also help groups in the long run, providing standardization of reporting requirements across jurisdictions via one lead supervisor.

Only three years remain to prepare for the impact of Solvency II on capital requirements at group level, and the key implications of the Framework Directive (expected to be issued in draft in July) are already clear. Groups that start now to manage this change can realize considerable business benefits.

While there is no standard approach to tackling group issues, in this document we share our thoughts on the implications and requirements for groups, benefits versus risks, and possible conceptual frameworks.
Implications for groups – what do groups need to do?

Group supervision may call for an investigation of a group’s overall legal structure and business model with a view towards pooling capital and sharing services. But the ability to pool capital can require time-consuming modifications to legal structures – a further reason for groups to prepare now for change.

To prepare for and benefit from the impact of Solvency II on group capital requirements, groups need to identify and manage the following:

- Inefficient capital management
- Management information issues
- Multiple monitoring, financial, regulatory, legal and reporting demands: IFRS, EEV, external ratings agencies
- Group internal risk transfer structures that are geared to local compliance rather than group capital management
- Legacy problems associated with group corporate structures – often the result of historical mergers and acquisitions activities

Those who are responsible for capital requirements and risk management should start the process by asking a few key questions. The answers will provide insight into specific challenges and determine an approach to generating an action plan. Here are some examples:

**Diversification:**
- Do we understand the nature and source of diversification effects within the group?
- What impact do intra-group risk transfer arrangements have on diversification and capital requirements at the legal entity and group level?

**Capital efficiency:**
- Is it practical to pool capital more within the group, and are we able to estimate how much group diversification effects could reduce overall regulatory capital requirements?
- Are there further opportunities to increase capital efficiency through intra-group risk transfer?

**Legal entity structure and internal models:**
- How does our internal model currently address the risk embedded in subsidiaries and across the branch structure and make allowance for the risk transfer mechanisms between the entities?
- How do management and legal entity structures differ and what benefit is there in keeping separate legal entities?
- What are the most pressing legacy issues in terms of complex corporate structures stretching across multiple jurisdictions?

**Regulatory considerations:**
- Is the ‘standardized’ approach to the group SCR the best option for the group, and if not, how can the group best prepare for the process of obtaining regulatory approval of the group’s internal model?
- How can the group best develop and perform calibration tests, the ‘use’ test and statistical quality tests, to achieve a standard that will be acceptable to the lead regulator?
Components of a group issues action plan:

1. **QIS 3 analysis and leverage:**
   The third phase of quantitative impact studies (QIS 3) provides an early opportunity for a company to assess the effects of group diversification on regulatory capital requirements. How can this opportunity be best addressed?

2. **Review of risk management and internal control at group level:**
   Groups should look at how risk management processes, systems and internal controls can be developed to operate at a level that will allow management to understand group-wide risk exposure and make informed decisions at group level.

3. **Assessment of business benefits from restructuring:**
   Can internal models be used to derive additional business benefits across the group, for example, by optimizing allocation of capital and diversification? Can key risk management processes be moved from the legal entity level to the group level and does that raise broader corporate structure issues?

4. **Assessment of tax and legal implications:**
   What are the potential legal and tax consequences of any group restructuring, and is there a need for education of in-house legal and tax departments which may have had little involvement in the past with questions of regulatory capital adequacy?

5. **Optimizing the approach to group issues:**
   Can intra-group reinsurance and other forms of risk transfer help the group to improve risk management and realize greater benefits in a group-wide context? What needs to be considered beyond the limited QIS 3 guidance on internal risk transfer in order to achieve maximum flexibility?
Group benefits and group risks

Size matters in the insurance industry. In general, the larger the portfolio, the greater the potential diversification benefits.

Management often agrees that being part of a group can bring overall economic benefits, part of which can be gained from simple scaling and the leveraging of synergies. Group diversification effects and the possibility of group capital support offer the potential for lower local capital requirements.

Being part of a group also involves risks, as often recognized by regulators. Group risks, whereby one group entity is additionally exposed to actions by other group entities or by the group as a whole, include:

- Over-reliance on group capital to support local operations – capital may not be available when needed because other subsidiaries and/or the parent cannot release it.
- The potential for risk contagion and financial distress across the group as a result of the ownership structure and group internal transfer of risk.
- Damage to reputation from adverse events elsewhere in the group or that might affect the entire group.

For groups to obtain the benefit of diversification effects, and to allay concerns about group risk, they need to demonstrate capital mobility. In conditions of stress, group capital support and internal risk transfer are only effective if capital is transferable. Groups that include operations outside the EEA, where other capital constraints may operate, need to pay special attention to this aspect of group capital management.

1 The European Economic Area, being the European Union members plus Norway, Iceland and Liechtenstein.

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Figure 2 Recognition of group diversification effects may have decisive impact on capital adequacy at group level, but may be limited by capital fungibility and the SCR floor. This example is based on QIS 3 specifications.
Group requirements: demanding and still evolving

The technical requirements of QIS

While the specifications for QIS 3 do not necessarily reflect the final rules of Solvency II, nonetheless they represent a starting point for testing company readiness and obtaining insight into group diversification.

For those companies that already have an internal model in place, QIS 3 provides an opportunity to benchmark that model against QIS 3 standard model requirements.

QIS 3 will take account of group diversification by calculating a group SCR based on consolidated accounts. Consolidated accounts also will be the starting point for calculating available capital. Restrictions on capital fungibility are then reflected by limiting the available capital at group level to the aggregate of solo surplus capital that is freely transferable. Special attention is paid to non-EEA group entities as capital transferability may be restricted by local jurisdictions.

QIS 3 also probes the potential size and sources of group diversification effects by comparing:

a) the group level SCR (calculated on the basis of consolidated accounts)
b) the sum of solo SCRs
c) the sum of solo MCRs as specified by QIS 3.

As the group level SCR at a) allows full credit for diversification effects and the sum of solo SCRs at b) allows none at all, these two extremes define the possible range of a group’s SCR. The aggregate of individual MCRs at c) sets a limit to the recognition of group diversification effects, under the QIS 3 specifications.

Beyond quantitative assessments, QIS 3 also asks for the disclosure of qualitative group-specific risks including reputation, contagion, concentration and legal risks.

Companies using an internal model are requested to report on material differences between internal models and the standard approach. Intra-group reinsurance should be looked at closely in this respect as it is only tentatively covered by QIS 3. If intra-group reinsurance is disallowed at solo level, this may prevent some group entities from benefiting from group diversification effects.

The qualitative questionnaire also asks for information on participants’ use of special purpose vehicles, a risk management mechanism that was recognized in the Reinsurance Directive but whose status under Solvency II is currently unclear.
Group requirements – views from the UK Financial Services Authority, from the Swiss Federal Office of Private Insurance and from the Chief Risk Officer Forum

Papers on group supervision from the UK Financial Services Authority (FSA)\(^2\) and the Swiss Federal Office of Private Insurance (FOPI)\(^3\) provide some guidance on how to prepare for group supervision beyond QIS 3. The Chief Risk Officer Forum has also published a paper on diversification.\(^4\) The three papers take a similar approach to internal risk and capital transfer instruments as enablers for capital transferability and sharing of diversification effects across the group corporate structure. Legally enforceable internal risk and capital transfer instruments are seen as guarantees for capital mobility, including in financially stressed scenarios. Quantitatively, this approach requires a consistent modeling of solo balance sheets, as well as the ownership structure and support agreements (see Figure 3).

**Figure 3** Full diversification realized upwards through ownership, diversification streamed downwards via support agreements (in this example internal reinsurance).

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\(^2\) Joint paper on group supervision issued by the UK FSA and Treasury, ‘Supervising Insurance Groups under Solvency II – A discussion paper’, November 2006. HM Treasury is the UK Government Department responsible for Finance.

\(^3\) See e.g. FOPI presentation ‘Group Level SST’, 2006, and related documents, available at http://www.bpv.admin.ch

\(^4\) ‘A framework for incorporating diversification in the solvency assessment of insurers’, The Chief Risk Officer Forum, June 2005
Once the regulatory requirements are finalized, selecting and applying the right conceptual framework will be a complex decision for insurers. Companies need to implement a flexible framework which addresses the requirements at both group level (group capital requirements) and the legal entity level (recognizing group risks and benefits).

Companies that would like to adopt a comprehensive approach could opt for full modeling of the legal entity and ownership structure, which includes formalized group support (intra-group reinsurance and capital transfer instruments). This option assists those who prefer to be supervised as a group and, at the same time, enables the group to respond to group level inquiries regarding the provision of entity-level data.

The comprehensive approach will be challenging, with respect to the required data, modeling capabilities and consistency of the framework. In particular, the group will need to address the difficulty of aggregating risk across the legal entity structure, as opposed to the management structure. It also needs to be concerned with identifying sources of diversification, consistent modeling and the quantification of intra-group risk transfer arrangements.

Some companies may wish to pursue an intermediate approach that identifies material sub-sections of the group and formalizes support for each.

At the other extreme, and with a view towards QIS 3, groups may prefer to start their modeling efforts on a consolidated basis. While this approach is less challenging from a modeling complexity perspective, data requirements (i.e. consolidated accounts) may be a critical issue. In any case, consolidated accounts will be necessary to determine available capital, since the QIS 3 calculation of available capital begins with consolidated accounts.
Ernst & Young Services

How can we help you navigate through group issues?
There is no standard approach to tackling group issues, but we are working with our clients to help them ask the right questions of their organizations, to benefit from group restructuring and realize shareholder value beyond pure compliance.

- With Solvency II group requirements becoming clearer, there is an opportunity to raise awareness of those requirements both within head office and across the business units and also determine the state of preparedness. We can work with you to facilitate this education process.

- Early understanding of the proposals for group diversification and their potential implications for the future group structure can help improve management information and lead to more informed decision-making. We can work with you to prepare for strategic decisions, taking into account capital, regulatory, legal and tax issues.

- Introducing a consistent approach across the group through training and establishing group guidelines and common interpretation is an important foundation for success. We can help you to establish clear and consistent governance structures and provide training for all levels within your organization.

- Readiness may vary across the group. We can help you analyze where your hotspots are in terms of impact from the Solvency II proposals or ability to meet the Solvency II requirements.

- Resources may be scarce. We can provide input into the development plans or help to fill gaps in skills or systems, including capital modeling, understanding the impact of complex internal risk transfer, and preparing impact studies.

Why select Ernst & Young to help with preparation for group supervision?

- We draw on the experience of a team of actuaries, risk managers, regulatory transaction professionals, technologists, quantitative analysts, accounting, tax and transaction specialists, working together to provide integrated assurance and advisory services.

- We have deep industry knowledge of each aspect of risk that insurance and reinsurance companies need to manage.

- Our professionals have extensive experience implementing risk-based regulatory requirements, and we maintain a strong dialogue with national industry regulators and international bodies such as CEIOPS and the IAIS.

- We are able to draw on extensive knowledge of Basel II implementation programs for the banking industry and risk-based regulatory requirements for insurance.

- We have made a strong commitment to industry research and thought leadership, and produce regular reports highlighting hot issues within the insurance industry.
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