The European Union's new regulatory framework will present compliance and strategic challenges for insurance companies worldwide

# Solvency II rewrites the rules for insurers

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Is your organization ready for Solvency II? The European Union will phase in its regulatory overhaul of the insurance industry beginning in January 2013. But the new rules have already changed the competitive landscape for insurers who face unprecedented management challenges. Solvency II will significantly tighten requirements for how much capital insurance companies will need to hold, impose tough new rules governing how they identify and monitor risk, and set strict disclosure guidelines to increase transparency.

Solvency II rules will have an impact far beyond the borders of the EU. Any life, property and casualty, or private health insurer that is headquartered in Europe, has subsidiaries that operate there, or competes in non-EU markets where European insurers are a significant presence will need to conform to its provisions or adapt to them. Insurers that are not directly touched by Solvency II may be able to seize competitive advantages from rivals subject to the new rules. (See sidebar, "Solvency II's global reach," on page 3.)

Although many crucial details remain unresolved, insurers cannot afford to delay preparing to meet Solvency II requirements. At the same time, to approach Solvency II solely as a matter of regulatory compliance would be shortsighted. Beyond reinforcing its capital base and strengthening risk governance and communications processes, every insurer subject to the new rules will need to rethink where and how to compete, and undertake deep organizational and cultural change. (To assess your organization's readiness to meet SII's mandates, take our interactive diagnostic quiz at *www.bain.com/solvency2*.)

The full dimensions of the implementation and strategic challenges emerge from a major analysis conducted by Bain & Company in partnership with Towers Watson, a global risk-management advisory firm. Using publicly available company and industry data, our evaluation focused on the 20 largest insurance groups in Europe's four largest markets—Germany, France, Italy and the UK. We applied the specifications used by the regulators in their most recent Quantitative Impact Study (QIS5) to examine two key metrics for each of the insurers' major lines of business: First, we looked at the company's solvency ratio, which measures how close the insurer is to meeting SII's benchmark risk-adjusted capital reserve requirement. We also calculated its risk-adjusted profitability to find out whether earnings met or exceeded its cost of capital, an all-important gauge of an insurer's ability to raise new equity. Our reliance on external data did not enable us to capture individual insurers' specific risk-mitigation strategies, but our analysis did conform to the official QIS5 results for each market and line of business.

The findings are striking. The insurers in our sample that currently fall short of the mandated new solvency requirements would need to reduce the risk profile of their current business portfolio in order to bring it into alignment with their current reserves or boost their capital by at least €10 billion—and potentially far more. Indeed, companies that aim to have 99.5 percent probability that they will remain above the Solvency II level would need a solvency ratio of 200 percent—a target very few companies currently hit. To attain that level, insurance companies we examined would cumulatively need to raise €37 billion.

Our country-by-country analysis reveals how exposed the different insurance subsectors, and even individual companies, are to the new solvency requirements (see Figure 1). Among life insurers, 25 percent of the German companies and 21 percent of the UK underwriters currently fail to meet the new Solvency II capital requirements. In both countries, annuities with fixed-return guarantees

Figure 1: Solvency II is expected to hit hardest with life insurers in Germany and the UK and with property & casualty insurers in Italy

**Percentage of companies with Solvency II ratio below 100%**

| Line of business | Germany | France | Italy | UK |
|---|---|---|---|---|
| Life | 25% | 8% | 0% | 21% |
| Property & casualty | 0% | 15% | 50% | 8% |

<10% | 10%–20% | >20%

Note: Solvency II ratio calculated for Top 20 groups per market per LOB
Source: Proprietary Bain & Company and Towers Watson QIS5 tool

make up a much larger proportion of life policies sold than in other EU markets, exposing German and UK insurers to potentially severe capital shortfalls under Solvency II. For example, many German insurers have relied heavily on investments in intermediate-term government bonds, taking a calculated risk that interest rates will rise from currently low levels and generate the revenue streams they will need to meet their long-term annuity payout obligations. Under new Solvency II rules, they will be required either to increase capital reserves significantly or close that duration mismatch. In the UK, annuity writers generate higher returns by investing in corporate bonds. Solvency II will require them to increase capital to adjust for the corporates' higher credit risk.

In the property and casualty segment, our analysis showed that half of the Italian insurers lack sufficient capital to clear the higher Solvency II hurdle, largely because motor-vehicle insurance makes up a far larger share of the P&C segment. The imbalance between the costs Italian auto insurers face and the premiums they collect in this fiercely competitive market will require them to strengthen their solvency ratios.

When we added the companies' profit profiles to our analysis, the future scenario for insurers becomes even starker. On average, insurers we profiled earned a risk-adjusted rate of return on risk-adjusted capital of just 2 percent. Across the four big EU markets, about half of the insurers we examined failed to earn their cost of capital. The variations in returns—and the implications for companies that will need to boost them—are especially profound when viewed product-by-product and market-by-market. For product lines that do not return their cost of capital, insurers have two choices: Find a way to make them more profitable, or exit the business. That challenge is further complicated for life insurers who are locked into long-term commitments to existing policyholders. The job of boosting their risk-

## Solvency II's global reach

*By Andrew Schwedel and Gary Turner*

Solvency II may have been made in Europe, but its impact will reverberate in other parts of the world.

For big multinational insurance groups, like Allianz, Aviva, ING and Mapfre, that have their home office in the EU, Solvency II's long reach can extend to their subsidiaries in the Americas or Asia-Pacific. Each of their offshore business units will need to comply with the national regulations in the country where they do business. But they may also need to conform to tougher Solvency II standards, potentially requiring that they significantly increase their capital reserves.

European subsidiaries of insurers domiciled outside the EU, including big North American groups like MetLife, Canada Life and Travelers, Australia's QBE, and Japan's Tokio Marine, will need to satisfy Solvency II capital requirements as any EU insurer would. Non-EU groups with a presence in several European markets may reap administrative efficiencies and diversification benefits by consolidating their European units into a single holding company.

Insurers that do not do business in the EU but compete against EU rivals in their home markets could enjoy some competitive advantages as Solvency II's new rules phase in. In Latin America, for instance, EU life and property and casualty insurers have made significant inroads in recent years. However, the potential requirement that the Europeans increase their solvency capital could result in their scaling back their participation in some lower-return product categories after 2013, giving local incumbents a home turf advantage.

Ultimately, no insurer can safely assume it will be able to circumvent the tougher capital and risk-management standards imposed under a Solvency II-like regulatory regime. The International Association of Insurance Supervisors, a supra-national regulators' group, has chosen Solvency II as a baseline for development of a global safety-and-soundness standard. This would suggest that if Solvency II compliance is not a near-term obligation, something very much like it could well affect all insurers in the future.

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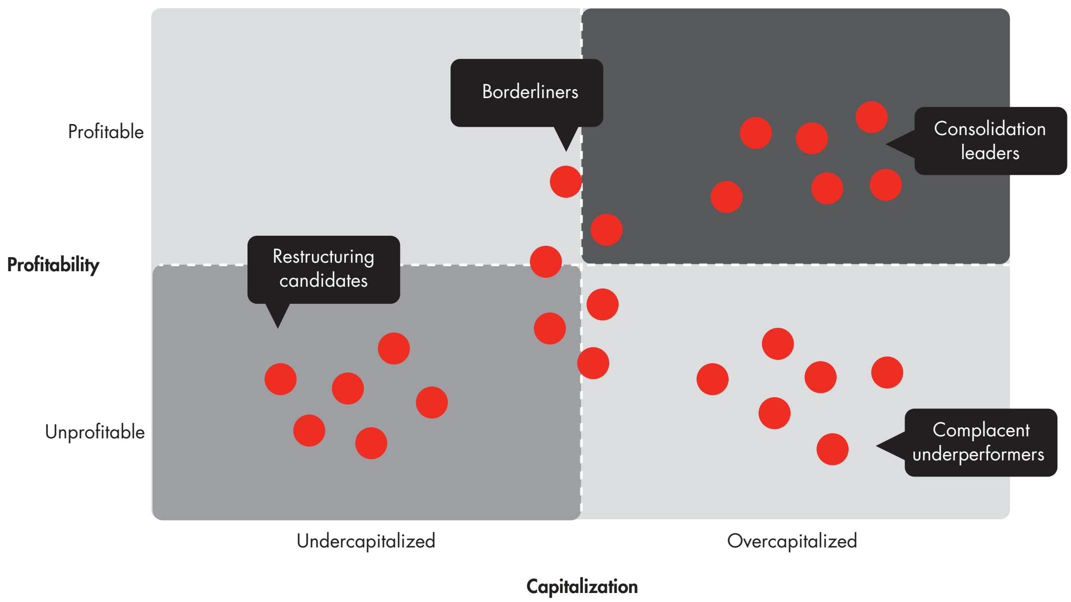
adjusted profitability above their cost of capital will take years.

Solving the multidimensional problem to optimize capital while improving risk-adjusted profitability will be a daunting task for many organizations and a major opportunity for others. To draw competitive starting positions for the post-Solvency II world, we grouped the insurers by their relative position in terms of capital adequacy and profitability (see Figure 2).

Best positioned are a group of companies that are poised to be potential *Consolidation leaders*. Already profitable and fully capitalized, these insurers will set the industry's competitive tempo. They will be able to make acquisitions of attractive assets that their weaker rivals may need to divest to raise capital. They also will be able to invest in product innovation and use pricing tactically to target the most attractive customer segments. Their relative strengths will enable them to accelerate their competitive lead.

Figure 2: Leaders and laggards under Solvency II




Source: Bain & Company and Towers Watson analysis

At the opposite end of the spectrum, a cluster of undercapitalized and unprofitable insurers will be *Restructuring candidates* whose options under Solvency II will be neither easy nor attractive. Their first priority will be to take measures that elevate them above Solvency II's capital threshold requirement, but finding that new capital will tax their capabilities. Because they are unprofitable, they cannot close their capital gap with retained earnings. Nor will they be able to raise new equity capital without diluting current stockholders.

A third group, *Complacent underperformers,* meet Solvency II capital ratios, alleviating the pressure to strengthen their balance sheets. Many of these companies are policyholder-owned mutuals, content to operate close to breakeven. But this group also includes publicly listed firms that will find their future growth constrained unless they improve their profitability to bring returns in line with capital market expectations. As the jockeying for competitive advantage becomes more intense, these companies may fall farther behind the more aggressive consolidation leaders.

A final group of insurers, the *Borderliners,* are perched on a precipice between insufficient capital and inadequate returns. As a result, they face delicate tradeoffs. If they stretch the risks they are willing to take to boost profits, they will likely need to add even more capital to remain Solvency II compliant. However, if they tackle their capital shortfall by withdrawing from higher-risk/higher-return lines of business, they could end up weakening their bottom line.

The key take-away from the Bain and Towers Watson study: Act now. Insurers that move early and take concrete measures to balance risk and capital sufficiency will be best able to strengthen their competitive position. The starting point for every insurer will be to define its risk appetite to determine how much volatility the organization is prepared—or can afford—to accept in order to achieve a targeted rate of return in each line of business.

The most fundamental strategic decision a company makes—the trade-off between risk and reward—is particularly complex for insurers facing Solvency II mandates. Solvency II requires that the market value of the capital insurers hold in reserve must be sufficient to meet all future claims to a 99.5 percent probability. This has major strategic implications. For example, well-capitalized insurers can live with a higher degree of volatility and fall back on their capital reserves to stretch for bigger potential gains. Meanwhile, undercapitalized companies can curb their risk appetite and satisfy Solvency II standards by raising a smaller capital backstop.

What this means, in effect, is that the central role of an insurer's risk appetite must be determined and reinforced by the highest levels of management. To safeguard scarce capital and prevent misallocations, the organization needs to impose risk limits on each line of business it underwrites and put risk analysis at the heart of its decision-making processes from front-line actuaries all the way up to the board of directors.

Calibrating an insurer's appetite for risk determines how much capital it will need to satisfy Solvency II risk requirements. But whether the insurer currently faces a capital shortfall or is already in compliance, the organization can act in four critical areas to strengthen its capital position while improving its risk-adjusted returns. The concrete results will vary according to the insurer's unique situation, but to illustrate we calculated what each initiative might be expected to produce for a typical large insurance group (see Figure 3).

Figure 3: How insurers can optimize their capital and risk structure

Solvency capital requirement point of departure and full potential (for an illustrative insurance group)

| | | Representative actions | Timeframe |
|---|---|---|---|
| **Initial solvency capital ratio** | 161% | | |
| **Strengthen products, pricing, and customer relationships*** | 7% | • Fill life-insurance product gaps<br>• Re-price products to adjust for risks<br>• Design products to discourage policy lapses<br>• Develop processes that boost customer loyalty | Midterm to long term |
| **Lower administrative and claims costs** | 7% | • Reduce costs and cost-of-loss ratios | Midterm |
| **Close investment gaps and increase use of reinsurance** | 17% | • For annuity products, increase average duration of fixed-income investments<br>• For P&C products, increase use of external and internal reinsurance<br>• Issue risk-linked CAT bonds | Short term to midterm |
| **Rebalance the business portfolio†** | | • In P&C lines, increase diversification based on consolidating books to one balance sheet or portfolio swaps<br>• Close or divest portfolio companies with negative risk-adjusted returns | Midterm to long term |
| **Interaction effects** | 2% | | |
| **Solvency capital ratio optimized** | 194% | | |

Note: Example simulates hypothetical actions taken by a German insurance group with a business mix consisting of 30% Life, 40% P&C, 30% Health.
*A 10% reduction in volatility of lapse ratios can result in a potential additional 1% reduction of solvency capital required. † An additional significant potential increase in solvency ratio can be achieved by consolidating balance sheets in groups with more than one P&C legal entity.
Sources: Proprietary Bain and Towers Watson QIS5 tool; Bain analysis

**Strengthen product offerings, pricing and customer relationships.** Solvency II will require insurers to sharpen how they approach the most fundamental business basics of deciding which products to sell, determining what premiums they need to charge to ensure they cover their risks, and attracting and retaining attractive policyholder segments they are best able to serve. The impact on capital adequacy and profitability from getting this right can be profound. In product design, for example, life insurers that predominately offer traditional annuities can prudently deploy capital when structuring guarantees by reducing the value of options like cash-surrender terms or protection against death risk.

Insurers can also relieve the amount of solvency capital they need to carry by increasing their reliance on unit-linked versions of life insurance that shift the provision of guarantees to the third parties whose investment products back up their policies.

Likewise, implementing risk-appropriate pricing that ties the premiums the insurer receives to its capital position will take on heightened importance under Solvency II. This does not necessarily mean engaging in less-risky business. If the price is right, an insurer can stretch to feed its risk appetite. Solvency II rules demand that insurers take such decisions systematically to ensure that they determine and put in place across the organization average prices that provide sufficient latitude to absorb the risks they face. To do that well, many insurers will need to tune up their risk-based pricing models.

As they adapt their product line-up and pricing policies to the new realities of Solvency II, insurers will also need to focus on strengthening the customer experience. Especially during periods of far-reaching organizational and business-process change, customer relationships can fray, attrition rates spike and distribution costs soar. Our experience has found that companies consistently outperform their competitors when they continuously monitor the health of their customer relationships using a metric like the Net Promoter® score and develop a closed-loop process to use customer feedback to improve processes that build customer loyalty. Loyal customers cost less to serve, they buy more products from companies that treat them well, and they are likelier to recommend those products and services to their friends and colleagues. Among insurers, we have found that the policy lapse rate of loyal customers is, on average, half that of their peers.

**Tighten cost management and lower the loss ratio.** Outstanding execution of everyday disciplines of cost control, efficient claims management and low administrative expenses help stretch disposable capital and lower an insurer's overall capital needs. Under Solvency II, cost savings help raise disposable capital and reduce capital requirements. Strengthening the firm's IT capabilities to better contain fraud and enhancing training of frontline employees in fast, error-free claims settlement can help compound those benefits, while improving profitability.

**Synchronize the investment structure and use reinsurance to rebalance risks.** One big burden on solvency to emerge from the Bain and Towers Watson analysis is a mismatch in the duration between assets insurers hold as investments and the liabilities the assets are meant to offset. The gaps we found were biggest among a subset of German life insurers who invested heavily in medium-term government bonds in today's low interest rate environment. The low yields they earn do not come close to covering the longer-term payout promises they made to annuity buyers. They will need to extend the duration of their assets over the next two years to close this gap.

More broadly, insurers can relieve the pressure on capital and benefit from a more stable profit stream through the judicious use of reinsurance to shift risks off their balance sheets. Regulators have yet to specify details on how Solvency II will deal with non-proportional reinsurance, but it is not too early for insurers to identify reinsurance programs that best suit their capital needs.

**Re-evaluate business fit and diversify risks.** Over the medium to longer term, an insurer can shape the capital and risk profile that best suits its broad strategy by reevaluating the entire spectrum of business lines and services. Which business does it make sense to run independently? Which divisions might be swapped with other insurers? Which legal entities can be combined to produce complementary benefits?

One big competitive change resulting from Solvency II is that companies with business in several product lines will enjoy major diversification advantages at the holding-company level. The leaders will look for ways to set up an internal reinsurance mechanism to push the benefits of diversification downstream to their product divisions. Diversified P&C groups will look for opportunities to consolidate their holdings by merging businesses or combining divisions over the coming two years. This will require an enormous effort organizationally and legally, but insurers that become merger masters can reap outsized gains.

As important as it will be for an insurer to marry its strategic assessment to the mandates of Solvency II, it is critical that the company implement the insights that emerge from the process in a speedy, seamless way. (See "10 steps to Solvency II implementation" on the back inside cover.)

Moving from compliance to industry leadership requires an insurer to implant three must-have capabilities deep in the organization. First, make risk-based value creation the organization's top job. Only a few insurers already use a risk-adjusted profitability ratio to inform their decision making, and the models they rely on are seldom applied rigorously and consistently throughout the company. They now need to make the everyday management of each line of business consistent with the organization's risk appetite and profitability targets. Responsibility for elevating value-maximizing risk-based management to its appropriate role starts with the management board. Its agenda should be set by the dozen decisions that most influence the company's value, and they should be the focus of each management meeting. This is not a capability that can be built overnight. It takes years, and companies will need to get an early start or risk falling behind their more nimble competitors.

To ensure that the goals of risk-based value creation and the actions it requires permeate all levels of the organization, insurers need to sharpen and quicken their decision-making effectiveness. Companies that excel at this core competency accelerate the time it takes to get from data-gathering, consultation and consensus to resolution and action by clearly assigning decision roles and responsibilities.

Decision tools like Bain's Risk and Capital-Adjusted Decision-making (RaCAD™) approach help avoid overlap, defuse sources of friction and bring issues to quick, actionable closure. The RaCAD framework aligns strategy and governance in the day-to-day decisions made by the insurer's operating units. It gives line managers clear, consistent procedures for allocating and budgeting capital consistent with the levels of risk set for their business. RaCAD provides tools for continuously monitoring and reporting the unit's capital and risk-return performance. It ensures that line managers adhere to clear procedures for allocating and budgeting capital and risk, consistent with the appetite and constraints set for their business units. Flexible and adaptable, RaCAD is a holistic approach for containing risk across the organization, while leaving division managers room to run their businesses.

A second critical asset needed for success in the more complex Solvency II environment will be industrial-strength risk-assessment processes. The analytical work EU regulators required insurers to do in the run-up to Solvency II rule-writing exposed major weaknesses in the abilities of actuaries and risk managers to measure changes in their solvency ratios. Satisfying the regulators' final quantitative impact study (QIS5) and crunching the data the exercise demanded, for example, took company actuaries between five and 13 months. Clearly, insurers will not have the luxury to hand-craft these critical calculations once Solvency II comes into full force.

Insurers will need to upgrade information technology systems and replace their improvised risk-measurement tools with robust automated solutions that can accommodate both their audit and risk-reporting demands.

The third key quality insurers will need is a disciplined, change-oriented culture. Merely to meet Solvency II's formal requirements without embracing the organizational transformation that will enable the company to thrive in the dynamic new competitive environment Solvency II will create is to leave the job less than half done. Led from the top of the organization, an effective change management process should train employees from the front lines to the executive suite in the skills of prudent risk taking. To help employees develop a keen awareness of risk and how it affects their business specifically, managers need to clearly communicate the organization's goals and provide employees with simple metrics that enable them to accurately monitor that they are on track to hit them consistently within the business' risk appetite. Finally, employee behavior needs to be guided by appropriate compensation that rewards performance. The CEO's bonus would be linked to boosting risk-adjusted profits; a marketing executive's incentive pay would recognize his or her success expanding business lines that do not put a strain on capital. All communication, measures and rewards should foster a culture that embraces change and anchors risk orientation deep in the organization.

The months remaining before Solvency II rules take effect will be an important time of testing for every company they touch. Unless they use this time to align their strategies, risk readiness and operating processes with Solvency II's mandates, insurers will find themselves on a rough journey, indeed. Those that are well prepared both technically and strategically will find new opportunities to pull away from the competition.



## Glossary of key terms

**Solvency ratio:** Measures the extent to which an insurer's capital requirements are covered by its current assets and future profits.

**Quantitative Impact Study 5 (QIS5):** The European Commission's fifth official investigation to determine what solvency capital requirements insurers will be required to carry under Solvency II before the new regulations are introduced.

**Profitability:** Calculated as the risk-adjusted return on risk-adjusted capital (RARoRAC), a performance yardstick that establishes a consistent relationship between the risks and returns of various business activities.

## 10 steps to Solvency II implementation

Each insurer faces its own unique challenges of optimizing its risk and capital structure, but all insurers have one task in common: to implement Solvency II swiftly and flawlessly. For this they must focus on the three pillars of Solvency II: the quantitative parameters of solvency ratio and risk-adjusted profitability; the qualitative considerations of risk management, governance and internal controls; and the reporting and disclosure requirements. The following 10-point checklist highlights the main tasks:

1. **Manage the technical implementation:** By no means a job simply to be delegated to IT specialists, model developers and other technical experts, it is the responsibility of senior management to determine which of the organization's legal entities and subsidiaries are able to work with standard models and where internal models are indispensable. A fully functioning system must be in operation by the beginning of 2013.

2. **Prepare for the "use test":** Before the new regulations become effective, companies will be required to demonstrate to their regulatory supervisor that their internal processes are running faultlessly and that Solvency II metrics are actually used for decision making and execution.

3. **Formulate the risk strategy:** Under Solvency II, the Own Risk and Solvency Assessment (ORSA) process requires insurers to make risks and their implications a central feature of their decision making. Establishing the risk appetite and risk-tolerance limits for critical international units is an important first step. But only a few insurers are prepared to answer four important questions throughout the group on an on-going basis: Which risks are we willing to take and how can we use them to achieve competitive advantage? How great is our risk appetite? Do we know our ten greatest risks? Do all decisions take account of the associated risk-return profile?

4. **Assign risk governance roles:** Design and install new decision-making roles for all key risk and capital management decisions, including the "use test." Insurers must determine how the tasks are to be divided among the chief financial officer, the chief risk officer and other involved parties and define the procedures of the risk reporting system.

5. **Clarify the distribution of risk-management responsibilities:** Insurance companies must clearly articulate how tasks will be divided among subsidiaries and the parent company and stipulate in writing how risk management is to be incorporated into the decision process.

6. **Optimize risk processes, policies and limits:** The introduction of Solvency II offers a welcome opportunity to design and establish risk-management processes for all major insurance risk categories—from underwriting risk to operational risk.

7. **Create a standard reporting system:** The demands of Solvency II on the risk and capital structure increase complexity. To ensure the right information reaches the right people and that there is sufficient coordination among the individual divisions, it is vital that information flows throughout the company in a synchronized way.

8. **Train Solvency II experts:** A system is only as good as the people who operate it. In the run-up to Solvency II it is imperative that each insurer prepare its specialist staff and management to excel in their new tasks. This includes sensitizing staff members to the need for open communication to ensure that potential weaknesses are exposed at an early stage.

9. **Ensure unimpeded communication with the supervisory authorities:** While insurers are accustomed to dealing with regulators, Solvency II will increase their interactions. Companies need experts to prepare and support the communication with the regulator and rating agencies on the theme of optimizing risk and capital.

10. **Establish a project team for Solvency II:** As with any complex undertaking, it pays to establish a central program management office to oversee the introduction of Solvency II. This is the best way to guarantee the many parallel tasks are completed on time and to quickly surface and address any issues that could result in delays.

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