



Strategic implications arising from Solvency II

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Introduction

It's an interesting time to be running an insurance company. If the challenges created by the continuing low interest rate environment, increasing competition and pressure on pricing combined with disruption from innovation and new entrants were not enough, Solvency II will go live on 1 January 2016.

The sector has responded to these underlying market dynamics with a wave of mergers and acquisitions (M&A), cost cutting and strategic rationalisation over the last 12 months. KPMG member firms across Europe believe that Solvency II will act as a further accelerator of activity.

As insurers react to Internal Model Approval Process (IMAP) notification, received on 5 December, we consider the possible implications for the sector in 2016 and beyond.

→ Strategic implications for insurers

The following trends are expected to develop across the life and non-life sectors:

Portfolio rationalisation

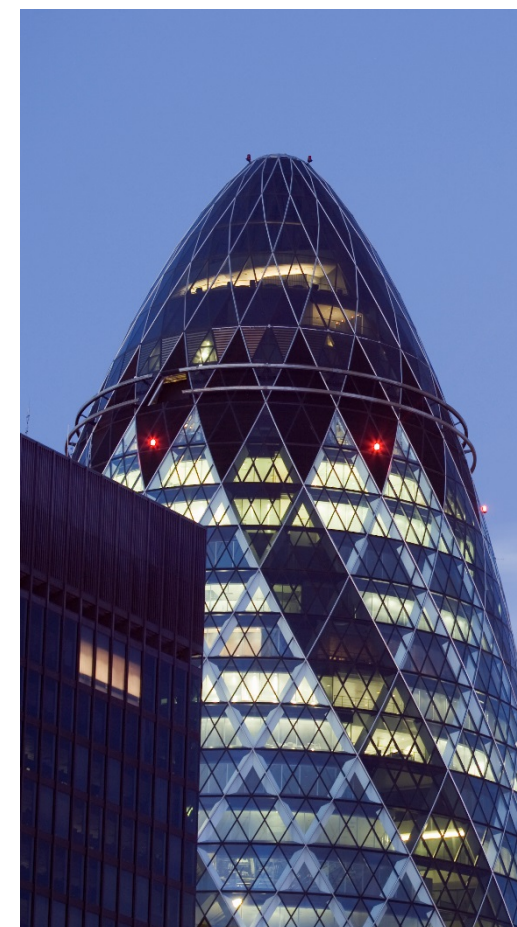
Increased M&A activity across the sector

- Solvency II, in conjunction with the broader market dynamics, is likely to force owners of insurance businesses to critically assess their strategy and geographic coverage, product development and distribution reach.
- Non-core, underperforming or sub-scale businesses are likely to be sold.
- Expectations of increasing attention on the management of back books and legacy portfolios as Solvency II sharpens the focus on optimising capital and emergence of profits.

Simplification

A move to less complex business models and greater use of alliances

- One of the more interesting implications relates to the extent to which Solvency II forces simplification of business models.
- There are two competing factors at play:
 - reducing complexity, breaking up composites, outsourcing administration and moving to a model that leverages alliances and partnerships to meet customer needs; balanced with
 - maximising benefits from diversification and scale to drive efficiency (which could increase complexity if companies look to share/swap risk through reinsurance type arrangements to manage the capital implications and maximise diversification benefits).
- The eventual outcome will vary across the sector but [greater use of alliances and partnerships](#) to create more efficient operating models (both from a capital and capability perspective) is likely.
- In addition, Solvency II may force further structural reform in the sector, by driving up costs for insurance based solutions thereby exacerbating the trend of unit linked savings and pensions products moving towards platform solutions.
- The platform model requires scale to drive profitability and accordingly, further consolidation should be expected.



Disruption

Disrupt or be disrupted

- Insurers face the challenge of either disrupting the sector or being disrupted by new entrants or more innovative players.
- Will Solvency II act as a catalyst for insurers to seize the initiative, linked to the need to drive simplification, develop new products and new ways to interact with customers? There may never be a better time.

Diversification and risk mitigation

Explore innovative ways to enhance risk profile

- Diversification and risk mitigation is an area of significant focus, for example reinsurers are particularly active in offering longevity solutions.
- The need for diversification may in itself drive further M&A activity as companies look for deals that provide increased diversification (e.g. adding protection portfolios).
- Popular solutions within the industry include optimising the use of external reinsurance, loss portfolio transfer, use of longevity instruments and restructuring liabilities (for example converting with-profit business to unitised or non-profit business).

Capital market solutions

Leverage capital market solutions over the medium term

- Capital markets may take some time to get comfortable with the new regime and therefore it may not be possible to implement some of these structures with significant scale immediately. However, we believe they may become increasingly important over the medium term.
- Potential options include:
 - securitisation to gain liquidity benefits or to access margins on expected future premiums
 - use of Special Purpose Vehicles (SPV) structures to release capital and risk margins
 - use of equity release mortgages and securitisation structures to support the matching adjustment and/or restructure the risk profile of the assets to better match liabilities
 - hedge Value of In-Force (VIF) using liquid market instruments to dynamically manage market risk
- In the short term we also expect to see insurers continue with rights issues or Tier 2 capital to raise additional funding.
- There is an interesting question around the capital buffer that the market feels comfortable with; the bar is being set high. This could put pressure on insurers that fall below the perceived market-accepted norm.

Balance sheet optimisation

Enhance capital structure, capital policy and fungibility of capital

- Insurers have a number of levers they can pull, including their capital structure (with increased use of guarantees and letters of credit), adopting an appropriate capital management policy and approach to regulatory buffers in light of market expectations as well as managing availability of group own funds in view of local fungibility and transferability constraints.

Legal entity restructuring

Optimise diversification benefit

- Many entities have already implemented significant restructuring to create a more optimal structure under Solvency II but KPMG member firms believe there is room for further improvement.
- Specifically, pooling of risks to maximise diversification, including use of branch versus subsidiary structures, internal reinsurance and use of reinsurance mixers.
- There is also the possibility of insurers placing business in different regimes (for example, annuities through a Bermuda based carrier).

Infrastructure

Invest in operational infrastructure to meet challenge of increasing requirements

- Finally, modelling requirements associated with Solvency II may increase over time as regulators seek to understand more complex scenarios. This will increase costs of compliance and will require further investment in infrastructure.



→ Triggers that insurers should consider

There are a number of underlying triggers that KPMG member firms believe insurers should be actively considering in assessing their strategy.

Clearly there are the fundamental KPI's underpinning the Solvency II regime, including SCR (Solvency Capital Requirement), internal model versus standard formula and the level of buffer to be applied. However, in such a diverse and evolving environment we believe a much broader assessment should be applied.

Indeed, there is an interesting question as to whether a high buffer is a positive over the longer term. Whilst a company with a high ratio may be seen as a more secure, by creating a precedent for itself it may need to charge more for products or reduce dividend capacity to maintain this ratio. Over the longer term, high capital multiples could be a drag on performance.

Managing and communicating the implications associated with increased capital volatility and demonstrating the ability to recycle capital to pay dividends will become increasingly important in creating confidence in your underlying business model.

A new lens may also be applied by the rating agencies, with an increased focus on 1:5 and 1:10 events and how insurers are set up to manage and

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respond to these more likely events. This may force a change in strategy and approach.

Fungibility of capital, particularly for insurance groups with operations outside of the EU will also be a key area of focus, particularly avoiding inefficiency and trapped capital.

The market will need time to understand the new regime so whilst we believe that ultimately the enhanced disclosure and move to an economic capital basis will enhance transparency and be helpful for investors, in the short term there are some fundamental changes that need to be digested.

Examples for the industry include

- The transition of value from VIF to adjusted new worth under Solvency II and explaining/justifying that future earning streams do still exist and no value has been lost; and
- The impact of transitionals and the implications associated with a drag on earnings.



➔ Impact on the market

So given all of the above, where, when and how will the impact of the new regime be felt most keenly? Particularly when considered in light of the other industry trends and drivers.

KPMG member firm's view is that portfolio rationalisation for certain businesses is likely to start straight away (and indeed, in some cases may already be progress).

In particular non-insurance owners of insurance businesses (private equity, family owned businesses and banks) have an increased incentive to sell to avoid either additional capital or the added complexity created by Solvency II.

Some of the large insurance groups may be expected to continue to divest non-core, sub-scale or underperforming businesses.

Concentrated underwriters may be affected hardest and accordingly are likely to be at the forefront of any activity.

Transformational deal activity may take slightly longer to develop, particularly in the life sector, given the level of uncertainty and accordingly the need for a period of time to elapse before management teams are comfortable committing to a large transaction. The general insurance market however is already experiencing large mega deals and we expect this to continue.

Insurers will also look at reinsurance solutions due to the complexity of splitting asset pools across the retained and sale business. However, in certain markets (e.g. Italy) where reinsurance structures are still traditional in nature, educating the regulator on financial reinsurance will take time potentially forcing insurers back to an outright sale.

It is also interesting to note that the approach to Solvency II is playing out differently across the markets in Europe as regulators apply a different interpretation of the rules. This can be illustrated by the treatment of transitionals in the UK (where they are considered 'real' capital) versus

➔ Where, when and how will the impact of the new regime be felt most keenly?

Germany (where they are not). It is possible that this differentiated approach will distort the level playing field. However, as underwriters tend to be concentrated in specific markets, KPMG member firms don't expect this to have an overly significant impact. Perhaps more relevant is the adverse impact on certain markets as a result of the underlying product mix, for example the implications of guarantees in markets like the Netherlands has resulted in a particularly adverse outcome under Solvency II compared to other markets with a more balanced portfolio.

As a result KPMG member firms expect deal activity to vary across the continent. Certain markets like the UK and Germany are likely to see further consolidation, particularly amongst smaller insurers, as well as an acceleration of activity around closed books/legacy. Conversely other markets may see a more gradual progression, for example in Belgium where a proactive approach has been adopted to commute guaranteed policies thereby reducing the need for immediate divestments.

➔ Agility and speed of execution will be key attributes of the insurers that are leading the sector in two years' time.

➔ Summary

In conclusion, KPMG member firms expect to see an increase in the level of M&A and corporate activity with Solvency II acting as an accelerator to existing market dynamics that are driving consolidation and rationalisation.

It's difficult to make specific predictions given the level of uncertainty but one thing is certain, there will be surprises.

Agility and speed of execution will be key attributes of the insurers that are leading the sector in two years' time.

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