



THE BOSTON CONSULTING GROUP

The Solvency II Challenge

Anticipating the Far-Ranging Impact on Business Strategy

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Executive Summary

Insurance companies are making tremendous efforts to comply with Solvency II, but to date their responses have been more mechanical than strategic. To recast Solvency II as a source of value rather than simply a driver of compliance costs, insurers need to look beyond mere models and metrics. They must capitalize on the new rules by revisiting their business strategies, product portfolios, distribution approaches, and risk management practices. In some cases, insurers may need to chart an entirely new course for their businesses.

The deadline for compliance is still measured in years, not months, but insurers have no time to waste. By broadening their view of Solvency II now, insurers stand a chance of gaining a competitive advantage over less-forward-thinking rivals by the time the new rules come into effect.

Although the Solvency II rules have yet to be finalized, one thing is certain: they will introduce far more variability—and transparency—into the risk-adjusted profitability of different businesses and products.

- ◇ Their impact will vary widely among business lines, product types, and countries. Even among companies that appear to be similar and are competing in the same market, the new rules will lead to vastly different outcomes.
- ◇ Some insurers will find themselves in a stronger position. Others will struggle to survive in the face of higher capital requirements and lower profitability.

Despite the profound changes in store, many insurers have not yet explored the strategic implications of Solvency II. They are responding mechanically—doing what’s necessary at a technical level to make their businesses compliant—without questioning whether the business itself needs to change.

- ◇ This narrow view, which echoes banks’ initial responses to Basel II, will leave insurers unprepared to deal with the forces that will reshape the industry landscape in the coming years.
- ◇ The scope and rigor of each insurer’s Solvency II strategy will ultimately determine the extent to which the new rules create or destroy value for the business.

The impact of Solvency II on life and nonlife businesses will vary from country to country, but the broad implications are as clear as they are distinct.

- ◇ Solvency II will incentivize life insurers to shift more risks to policyholders and third-party asset managers, while more accurately accounting for the cost of guarantees, product flexibility, and investments in volatile assets. Some insurers will reduce or even abolish their offerings of guaranteed products. Others will lower their guarantees, introduce resets, or impose higher fees for certain services in order to reach an acceptable level of risk-adjusted profitability.
- ◇ Solvency II will diminish the profitability of many nonlife products, which will force insurers to either raise prices or set tighter boundaries around the risks they cover. Cross-subsidization between product lines will become more transparent than it has been in the past. Therefore, it will be sustainable only if it is based on a clear strategic rationale.

The new rules will reshape the industry landscape in some countries by creating a new balance of power or intensifying consolidation.

- ◇ The impact of Solvency II will vary within each market, based on each insurer's current leverage, hidden reserves, business mix, and investment and reserving policies. These differences will give some companies a competitive edge—and in some markets, such as France, Italy, the Netherlands, and the United Kingdom, they may force insurers to merge. Many in-force books will be put into runoff or sold.
- ◇ Many banks are reevaluating the economics of their insurance activities because of the increasing capital charges stemming not only from Solvency II but also from Basel III. In markets where bancassurers play a significant role, such as the French life market, the landscape could change dramatically.
- ◇ In general, smaller insurers will be at a relative disadvantage because of the sheer cost and complexity of internal capital models and compliance requirements such as the Own Risk and Solvency Assessment (ORSA), as well as their limited diversification. This may lead to defensive mergers or portfolio sales.
- ◇ On the whole, Solvency II will increase consolidation in the industry, but the degree of consolidation will vary among markets.

Insurers will need to be more rigorous when assessing the economics of their portfolios and business decisions. Insurers should use this newfound rigor to reshape their businesses. They will also have to explore structural changes to their capital-management and reinsurance strategies.

- ◇ Companies should question whether they are competing in the right places and with the right products. They should determine how their current businesses and product portfolios—as well as their competitors'—will fare under Solvency II. This relativity is crucial: it may well be that a company suffers under Solvency II, but if its competitors suffer more, it will still gain an edge.
- ◇ Each insurer needs to develop a clear, fact-based, and pragmatic business strategy that accounts for the risk and solvency implications of all products, both new and in-force. This strategy should reflect an insurer's aspiration for how it can best compete in the Solvency II world.
- ◇ Across virtually all strategic decisions, insurers will need to factor in the growing significance of diversification. Solvency II makes plain the benefits of spreading risks across lines of business, asset classes, counterparties, and—to a certain extent—regions.
- ◇ Solvency II will prompt many insurers to transform their capital-management and reinsurance programs, for three reasons. First, it will introduce a new definition of eligible capital. Second, reinsurance will become more complex, more attractive, and perhaps even essential as a substitute for available capital. Third, the need to lower capital consumption may prompt some insurers to seek new counterparties, such as hedge funds or institutional investors.

The changes to business strategy will force insurers to revisit four core elements of the value chain: product development, sales and distribution, IT and operations, and asset management.

- ◇ At an operational level, the new rules will have the greatest impact on product development. When developing products, insurers will have to think more explicitly about capital requirements and investment strategy. Products should also be developed with a view toward exploiting the benefits of diversification and the possibilities of creative reinsurance.
- ◇ The adjustments in sales and distribution could be critical to supporting more fundamental changes in product development and risk management. Insurers will need to reevaluate the suitability—or even viability—of their distribution systems. Some products will be profitable only if their customer-acquisition costs or associated sales incentives are below a certain threshold.
- ◇ Managing IT complexity will be an ongoing task. The changes to the IT environment should be driven by—and checked against—an insurer's Solvency II product and sales strategies.

Insurers have no time to waste. To help set their priorities, insurers should concentrate on two groups of activities.

- ◇ The first group is focused on immediate actions, such as understanding the risk-adjusted returns of all lines of business and investments, estimating the impact of Solvency II on key competitors, lobbying and preparing contingency plans for aspects of Solvency II that are still evolving, and defining a comprehensive road map for implementing Solvency II changes.
- ◇ The second group entails a number of more fundamental tasks. Essentially, insurers need to reshape their businesses around the capabilities and characteristics required to thrive in the Solvency II world. These include leveraging the benefits of diversification and enhancing risk management throughout the organization.

Sizing Up the Impact of Solvency II

Solvency II is set to come into force in 2013, and its impact will be profound. The new rules will harmonize capital requirements across the European insurance industry, highlight the real risks and capital absorption of all products, and introduce new standards for risk management. In short, Solvency II will transform the European insurance landscape and change how the business is managed. It is expected to touch off similar changes in markets around the world.

Resetting the Attractiveness of Products and Markets

Although Solvency II is not intended to dramatically reduce the overall solvency level of the insurance industry, its final impact has yet to be determined. The current specifications—as defined in the fifth Quantitative Impact Study (QIS5)—would reduce the industry’s solvency level, but they are almost certain to be revised.¹

For all the ambiguity that still surrounds the draft rules, however, the strategic implications of Solvency II are clear: relative to the status quo, the new rules will introduce far more variability—and transparency—into the calculation of return on risk-adjusted capital for different businesses and products. The onus is therefore on insurers to adjust their businesses in ways that maximize the upside of the new rules and minimize the downside. For this to happen, however, they need to look well beyond the technicalities of compliance and focus on both the strategic and operational implications of Solvency II.

Unfortunately, Solvency II does not lend itself to easy interpretation. Its impact will vary widely among business lines, product types, and countries. By changing the capital requirements, and thus the relative risk-adjusted profitability, of insurance products, the new rules will lead to vastly different outcomes even among companies that appear to be similar and are competing in the same market. Furthermore, Solvency II will be based on mark-to-market principles, which will lead to greater volatility in both capital requirements and risk-adjusted returns. Given this variability, it was perhaps not surprising that our interviews with executives uncovered widely divergent views—even within companies—about whether Solvency II will create or destroy value. (See Exhibit 1.) (For more on The Boston Consulting Group’s ongoing study of Solvency II, see the sidebar “BCG’s Methodology.”)

To be sure, Solvency II will have a disparate impact on insurers. Some will find themselves in a much stronger position. Others will struggle to survive in the face of higher capital requirements and diminished profitability. There are several steps that insurers can take now to ensure they end up in the former group, not the latter.

- ◇ Develop a granular, feature-by-feature, product-by-product view of how the new rules will affect the capital intensity and profitability of the portfolio. Insurers should also assess how the rules will affect key competitors, and then prepare accordingly.
- ◇ Develop clear product and investment strategies for each line of business, taking into account the new capital requirements. In particular, insurers need to reassess their business portfolios, define their aspi-

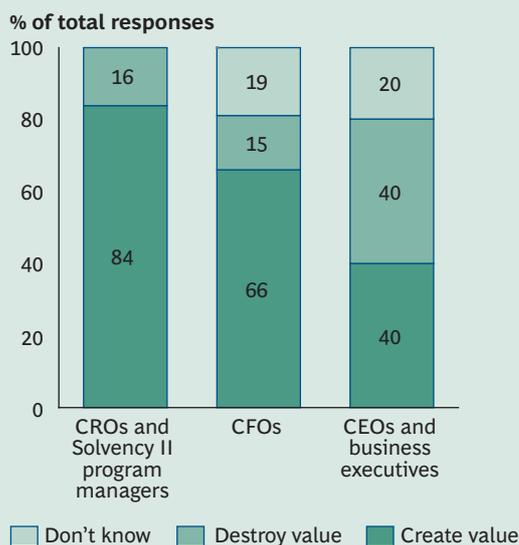
1. QIS5 is being run by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). It will conclude in November 2010. The official results are expected to be released in April 2011.

rational portfolios, and adjust each element of the value chain accordingly. Solvency II will punish any mismatches among products, systems, and investments.

- ◇ Manage the complexity of the regulatory transformation by defining a clear road map for implementing the necessary changes. Insurers should concentrate their Solvency II resources in the areas that truly matter to their businesses. In all other areas, the implementation should be kept as lean as possible.
- ◇ Begin changing the company’s risk culture now. The Own Risk and Solvency Assessment (ORSA) will require the risk function to be involved in all key business decisions. More broadly, all staff who can significantly influence risk positions will need to be much more conversant in risk management.

Exhibit 1. There Are Widely Divergent Views on the Business Impact of Solvency II

In the long run, will Solvency II create or destroy value in the industry?



Source: BCG Solvency II task force interviews.
Note: The results are based on 44 interviews conducted from May through August 2010.

Risk managers are more likely to see the upside of Solvency II than other executives

- “Solvency II will force all players to sell products based on risk-adjusted analysis. Therefore, it will improve the true solvency of the industry.”
—CRO of a multinational insurance group
- “The disclosure requirements cost a lot and are indigestible for the regulators—they will not be able to read all this stuff.”
—CFO of a mutual insurer
- “Solvency II is just a lifetime employment act for actuaries.”
—Head of group strategy for a major global insurer

BCG’s Methodology

BCG has been conducting an extensive study to clarify both the strategic and operational implications of Solvency II. From May through August 2010, BCG’s Solvency II task force conducted about 50 workshops and interviews with senior executives at large and midsize insurers in Europe, along with several interviews with North American insurance executives. The gross written premiums of the interviewees totaled more than €500 billion in 2009. The interviews were mainly with CEOs, CFOs, and CROs. In parallel to the interviews, the task force developed a detailed, quantitative picture of the market- and product-specific implications of Solvency II. It validated BCG’s assessment of the impact of the new rules by modeling the effects of Solvency II on some of our clients, based on QIS5 and company cash-flow data. In par-

ticular, the figures presented in this paper are based on the BCG internal model, which was tested and validated in BCG projects for multinational groups and midsize mutuals.

The task force also compared QIS5 results with the impact of QIS4. Although QIS5 is expected to trigger higher capital requirements than QIS4, the *relative* impact of the new solvency requirements—by line of business, product, and market—will largely remain the same, though there are exceptions, especially concerning the treatment of catastrophic and equity risk, the eligibility of value-in-force as available risk capital, and the scope of the so-called illiquidity premium.

Not Seeing the Forest for the Trees

Some insurers have begun to take a broad view of the changes that lie ahead—but only recently. “We have had a Solvency II program involving more than a hundred people,” remarked the head of strategy at one of Europe’s largest insurance groups, “but they have been focused on IT and models. This is the first time that we have actually looked at what it really means for the setup of our business lines and group structure.”

Most insurers are at risk of repeating the same errors many banks made in the run-up to Basel II. They are focusing solely on model-oriented activities, such as designing and documenting mathematical systems and changing the IT environment. These steps are critical to compliance, but they do little to illuminate the business implications of Solvency II, including its impact on capabilities and practices such as product development, sales and distribution, and asset-liability management. Moreover, insurers are neglecting the “soft” topics described in the second pillar of Solvency II, such as governance requirements and ORSA, and there is often little or no buy-in among the business managers.

In other words, most insurers are going through the motions: they are responding mechanically—doing what’s necessary at a technical level to make their businesses compliant—without questioning whether the business itself needs to change. Taking this narrow view will have two negative effects:

- ◇ *It will lead to significant waste.* Models are usually developed in isolation, and their relevance to the business is often recognized only by the specialists who build them. “Many firms are creating ivory towers,” said the CFO of one mutual insurer. “These are staffed with experts who are sitting on top, and the only thing they can see are other ivory towers.” As a result, the models can be underutilized or wasteful—they either duplicate efforts elsewhere in the company, or they could have been built more efficiently if they had been integrated into a more comprehensive approach. Some insurers are thinking about stopping the development of their internal models due to a combination of less-than-expected capital relief and high maintenance and documentation costs.
- ◇ *It will leave many insurers unprepared to deal with the forces that will reshape the landscape in the coming years.* Only a small number of insurers have begun to revamp their businesses in light of how the rules will change the dynamics of the industry.

To clarify the strategic implications of Solvency II, BCG modeled the impact of the new requirements (based on QIS5) across different lines of business—primarily life and nonlife—as well as on the overall industry and different countries. We then developed a set of strategic and operational imperatives based on these findings. To gain a competitive edge from the introduction of the new rules, insurers need to respond to these imperatives now.

The Implications for the Life and Nonlife Businesses

The impact of Solvency II will vary widely among countries, depending on the local accounting standards, regulatory regimes, and predominant business models. But the broad implications for the two main businesses are as clear as they are distinct.

- ◇ *Life Insurance.* Solvency II will incentivize life insurers to shift more risks to policyholders and third-party asset managers, while more accurately accounting for the cost of guarantees, product flexibility, and investments in volatile assets. Some insurers will reduce or even abolish their offerings of guaranteed products. Others will lower their guarantees, introduce resets, or impose higher fees for certain services in order to reach an acceptable level of risk-adjusted profitability.
- ◇ *Nonlife Insurance.* Solvency II will diminish the profitability of many nonlife products, which will force insurers to either raise prices or set tighter boundaries around the risks they cover. Cross-subsidization between product lines (most often seen between the retail and industrial product lines) will become more transparent than it has been in the past. Therefore, it will be sustainable only if it is based on a clear strategic rationale.

Life Insurance

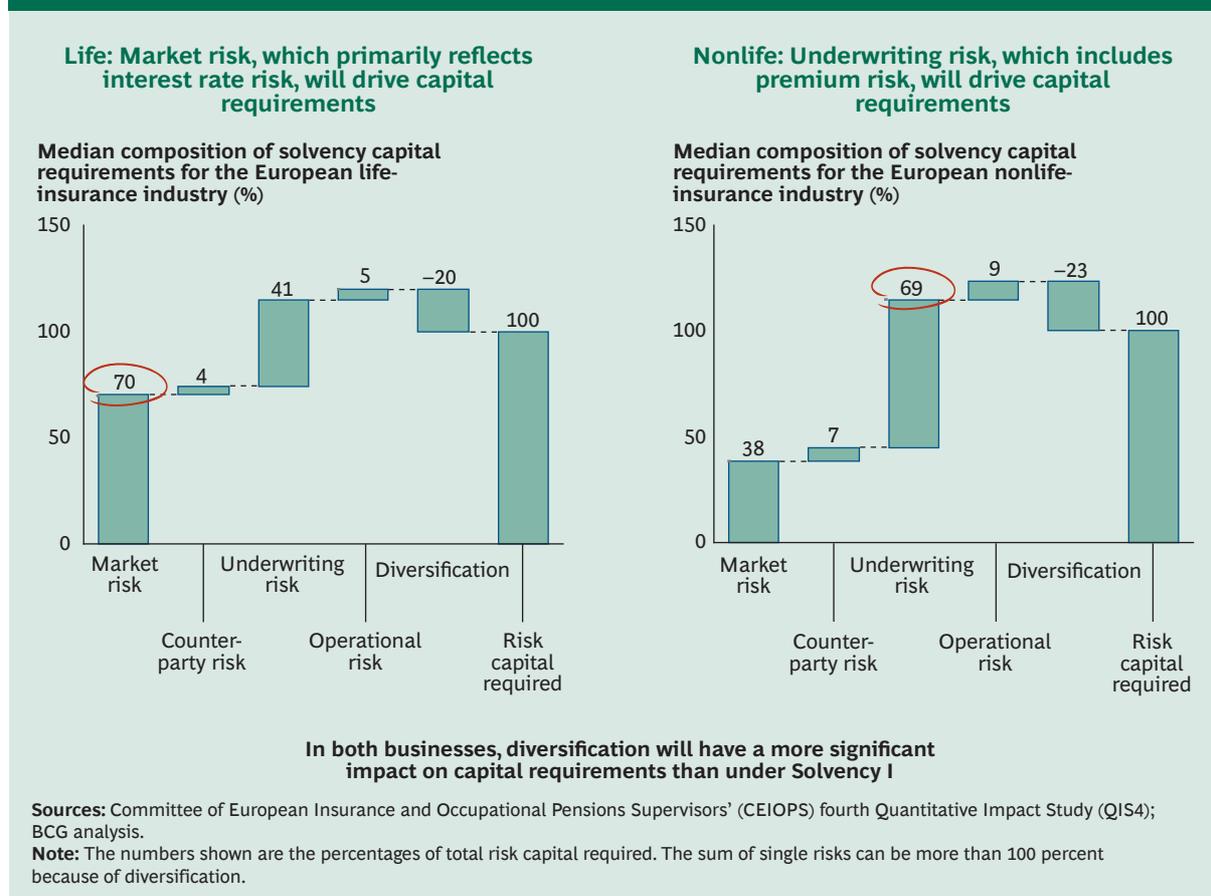
Under Solvency II, life insurance products that have unpredictable cash flows or long-term guarantees will require much more capital. But capital requirements will decline for products that have policyholders or other third parties bearing most of the risks.

For life products, in general, the impact of Solvency II will be determined largely by their exposure to interest rate risk, which typically accounts for approximately 50 to 60 percent of market risk and is driven by the mismatch between future asset and liability cash flows—also known as the duration mismatch. (See Exhibit 2.) Market risk, in turn, accounts for approximately 70 percent of the capital requirements for life insurance products in Europe. (Equity risk is also part of market risk, but it is expected to be less of a factor, since most insurers reduced their equity exposure during the financial crisis.) Exposure to interest rate risk varies among different types of life products.

Accumulation and Traditional Long-Tail Guaranteed Products. These products have the greatest exposure to interest rate risk. They will become very costly unless insurers can reduce the duration mismatch, which usually entails high hedging costs and higher fees for the customer. In some cases, insurers may also need to anticipate and control the erratic cash flows arising from flexible pay-in and pay-out schemes and lapse options.

Historically, life insurers have relied on the duration mismatch as the primary source of revenues and profitability. It has also been a key differentiator—they were virtually the only companies providing such long-term guarantees. By increasing the cost associated with long-tail guaranteed products, Solvency II could undermine the viability of the classical life-insurance business model. In fact, some insurance groups are actively considering shutting down their life insurance businesses owing to both Solvency II and current capital-market conditions.

Exhibit 2. The Main Drivers of Capital Requirements Vary by Line of Business



Two factors might help lessen the burden of Solvency II on accumulation products and traditional long-tail guaranteed products (for which the risk associated with the guarantee is borne by the insurance company). First, the rules proposed in QIS5 would allow in-force profits—the present value of future margins on all cash flows in the in-force book—to be counted as eligible risk capital. But this rule is still under intense debate. Moreover, its inclusion would likely lead to an even stronger focus on profitability (as margins would be a key driver of available risk capital) and, therefore, higher fees or lower guarantees.

Second, some markets have built-in buffers against higher capital requirements. In France and the Netherlands, for instance, many traditional life products have guarantees that are directly linked to the values of government bond indices, which reduces the interest rate risk. In countries such as Germany and Austria, future discretionary bonuses, or FDBs, could reduce the capital requirements of accumulation and long-tail guaranteed products by more than 80 percent. (FDBs are payments that may be granted to policyholders in excess of the statutory minimum bonus.) Another buffer can be found in products that enhance free reserves, which are pools of money that can be used to stabilize returns in times of crisis or volatility.

In addition, annuity products with fully illiquid liabilities (in other words, they carry no risk of an unexpected change in payment streams or guaranteed lapse payments) will benefit from the so-called illiquidity premium, which will lessen their capital requirements. The illiquidity premium, depending on its final definition, could give rise to a sharp divide between products that benefit from the premium and those that do not.² If so, some insurers are likely to reconfigure their product portfolios to take full advantage of the premium.

These factors will lead to different outcomes. In some markets, life insurers will face significant pressure. In others, we expect the new rules to bolster solvency ratios.

- ◇ In Sweden, solvency ratios could fall by well over a hundred percentage points, as the interest rate risk in “with-profit” products and the longevity risk in annuity products would lead to a sharp increase in capital requirements. Still, most insurers in Sweden have strong capital positions and would stay well above the solvency capital requirement under Solvency II.
- ◇ In the United Kingdom, life insurers tend to have long-tail annuity products that are backed by relatively risky asset allocations; many have significant exposure to corporate bonds and, to a lesser extent, equities. As a result, their capital requirements will be substantially higher compared with other life insurers. But the illiquidity premium will stave off the worst effects. (It remains unclear to what extent this premium will apply to partially illiquid insurance liabilities, such as most Dutch or German accumulation products.)
- ◇ In Italy, conversely, life companies could see their capital surpluses increase by as much as 300 percent, as their portfolios typically have limited market risk. These insurers tend to have a large share of unit-linked products along with certain products for which the guarantees are renewed every five years.

Unit-Linked Products. Unit-linked products will become less capital intensive, as they provide an almost perfect match between assets and liabilities from the insurer’s perspective—policyholders or third-party asset managers usually bear all of the investment risk. Moreover, the value of future profits from unit-linked products can be booked as available capital. In addition, life insurers that rely heavily on unit-linked products will see a significant increase in their solvency ratios, because (as for all life insurance products) their hidden reserves and future profits will be counted as eligible risk capital.

Luxembourg’s market, for instance, has a high proportion of unit-linked life-insurance products. As a result, many life insurers will see their capital surpluses more than double relative to Solvency I levels.

Hybrid Products and Variable Annuities. These products might benefit from the changes, depending on their cost and risk structures. Hedging for innovative products—including hybrid products that shift investments between secure and risky accounts—can reduce capital requirements, since the hedging

2. Roughly speaking, the illiquidity premium reduces the present value of insurance liabilities that are very predictable and will be paid out only at fixed points in time.

instruments are based on technical models that can be easily assimilated into the Solvency II framework. But hedging can be expensive and unreliable if it triggers new capital requirements based on counterparty risk and market volatility.

We expect only the most sophisticated and disciplined insurers to find success with variable annuities under Solvency II. And even these companies will need to limit their exposure to these products, based on the maximum losses and volatility they can endure. The poor performance of variable annuities during the financial crisis has left many insurers skeptical about these complex products.

Nonlife Insurance

Among nonlife products, capital requirements will be driven primarily by underwriting risk, which in turn will hinge on an insurer's underwriting discipline and its level of prudence in calculating reserves.³ As these practices typically vary by product type, we expect to see significant differences in capital requirements for various product lines. For example, according to our analysis of QIS5 specifications, the capital charges for premium risk—a subset of underwriting risk—would be about 30 percent of premiums for retail products, but they would be as high as 70 percent for most industrial products.

We expect several corporate product lines to come under pressure because of their exposure to catastrophic outcomes and long-tail liabilities. In some cases, their capital charges could be more than 600 percent higher than they were under Solvency I.⁴ The changes reflect the increased value of provisions (or technical reserves), higher underwriting-risk charges (for credit insurance, the charge for premium risk alone could be 180 percent higher than the *total* Solvency I capital requirements), and new asset-risk charges that penalize exposure to corporate default risk. In the most affected markets, Solvency II may lead to significant price increases, the discontinuation of product lines, or a surge of insurance-linked securities.

In addition to the high charges on underwriting risk, capital requirements will also be affected by the change in valuation of assets and liabilities, which will shift from book to market values. The impact will vary among countries. Germany and Italy are at opposite ends of the spectrum.

Traditionally, many German P&C insurers have had conservative provisioning policies along with stores of equalization reserves, which can act as a rainy day fund to offset spikes in claims. These hidden reserves would be classified as eligible risk capital under the new rules. As a result, the surplus capital of P&C insurers would increase by 100 to 150 percent, based on rough QIS5 estimates. On average, therefore, Solvency II's impact on capital requirements is not expected to lead to higher prices in Germany's nonlife market (though there may be exceptions in certain industrial lines).

In Italy, some P&C insurers have relatively limited hidden reserves to offset the increase in risk charges. As a result, Solvency II would trigger a sharp decrease in capital surpluses. Under QIS5 specifications, the solvency ratio of many Italian P&C insurers could fall below 130 percent, which might force them to raise additional capital—insurers generally prefer to stay well above a 150 percent solvency ratio—or else raise prices across the board.

The Changing Competitive Landscape

Solvency II is going to reshape the industry landscape. (See Exhibit 3.) Its impact will vary within each market, based on each insurer's current leverage, hidden reserves, business mix, and investment and reserving policies. In some markets, these differences will lead to a new balance of power. On the whole, Solvency II will increase consolidation in the industry, but the degree of consolidation will vary among markets.

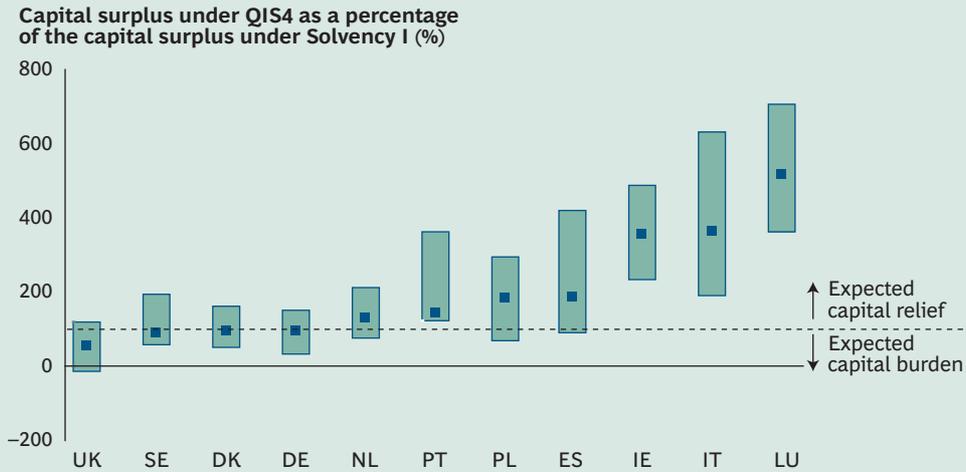
In the Dutch life-insurance market, for instance, the in-force books of major insurers vary widely. For some insurers, long-tail guaranteed products with profit sharing account for more than 40 percent of their portfolios. For others, their portfolios are dominated by unit-linked products. These different profiles will

3. Underwriting risk arises from the possibility that actuarial predictions do not match real claims and expenses—in other words, that an insurer's pricing or reserving levels are wrong.

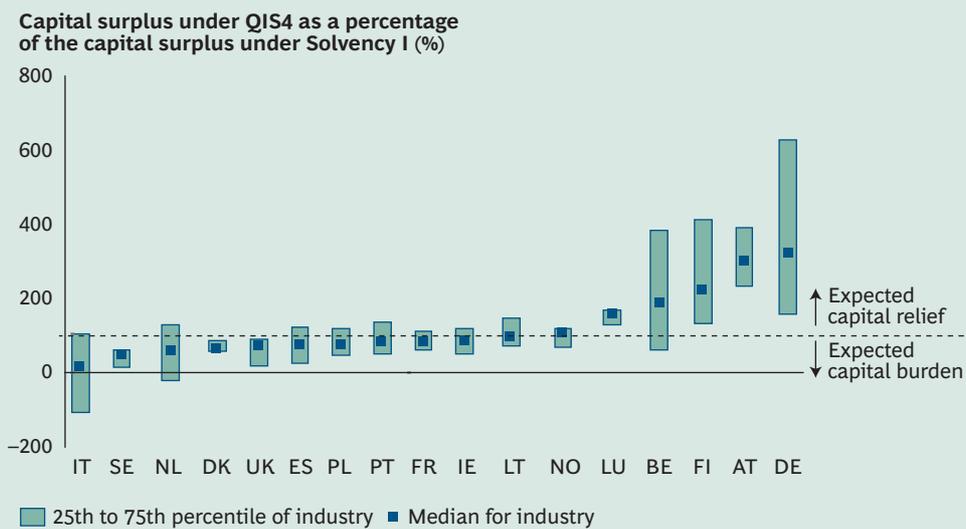
4. The actual increase will vary according to the associated asset allocation.

Exhibit 3. Solvency Levels Throughout Europe Will Change—With Radically Different Results

Life: In general, capital surpluses would increase under QIS4 specifications



Nonlife: In most countries, capital surpluses would decline under QIS4 specifications



Source: Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).
Note: Includes all countries that had a sufficient sample size in the respective line of business to be included in the CEIOPS analysis. QIS4 refers to the fourth Quantitative Impact Study. Data are from Austria (AT), Belgium (BE), Denmark (DK), Finland (FI), Germany (DE), France (FR), Ireland (IE), Italy (IT), Lithuania (LT), Luxembourg (LU), Netherlands (NL), Norway (NO), Poland (PL), Portugal (PT), Spain (ES), Sweden (SE), and the United Kingdom (UK). QIS4 numbers are based on precrisis balance sheets and technical specifications. The QIS5 results are expected to increase the capital burden significantly.

lead to vast changes in solvency ratios. According to our QIS5 analysis, the solvency ratio of some insurers in the Dutch market will decline by as much as 40 percent, while for others it will increase by as much as 20 percent. This disparity could accelerate the already-brisk pace of consolidation of the Dutch life-insurance market.

In Germany, too, Solvency II will lead to sharp differences among individual insurers. Among the top 15 nonlife companies (measured by their share of the P&C market), the increase in own funds—or available solvency capital—will vary from about 100 percent to more than 500 percent. In the mid to long term, the differential is likely to give rise to a new balance of power. In particular, some insurers that can sustain low prices, given their healthy capital reserves, will be able to cut their prices even more.

The new requirements will also trigger consolidation and runoffs, but the degree to which Solvency II reshapes the landscape will depend on market dynamics:

- ◇ In general, smaller insurers will be at a relative disadvantage because of the sheer cost and complexity of optimizing capital models and complying with requirements, such as ORSA, as well as their limited diversification. They might also incur unnecessarily high capital requirements, if they have to rely solely on the regulator's standard model. "Solvency II will be a great challenge for many of the smaller companies," said the chief risk officer (CRO) of one of the world's leading insurance companies. "Some interesting M&A opportunities might come up in light of the increasing complexity of the business."
- ◇ Many banks are reevaluating the economics of their insurance activities because of the increasing capital charges stemming not only from Solvency II but also from Basel III. The insurance business may simply become too expensive for some. In markets such as France, where bank subsidiaries account for 60 percent of the life insurance market, the landscape could change dramatically.
- ◇ In some countries, insurers are convinced that Solvency II will be a tipping point. "It's going to be a revolution," said the CRO of a French insurer. Capital allocation has been less of a factor in the French insurance industry—the market has been focused on growth, and more than half of all P&C and health insurers are mutuals. Companies clearly expect the new rules to set off a wave of consolidation or intensified cooperation, especially among the smaller mutual insurers.
- ◇ The new rules will also trigger consolidation in specific parts of the market. Many of the Italian P&C insurers we interviewed expect to see an increase in M&A deals or collaborative risk-sharing arrangements. In the Netherlands, many P&C insurers are starting to reconfigure their business portfolios, and some still expect to see forced M&A activity. In some life insurance markets, such as the United Kingdom, Solvency II may lead to a wave of consolidation as the business model itself becomes less attractive.
- ◇ In other countries, Solvency II is not expected to intensify M&A activity. "I am really not worried about Solvency II," said the CEO of a leading German P&C insurer. "There are other things that keep me awake at night." On the whole, Germany will be one of the least affected markets. The new rules will make mergers and acquisitions more attractive, but they will not put enough pressure on the German market to force a wave of consolidation within the next five years.

These changes are not expected to happen overnight—it could take years for some markets to find their new equilibrium. But there is little doubt that Solvency II will realign the competitive balance in certain markets.

The Strategic Imperatives

Solvency II will require insurers to use far more rigor when assessing the economics of their portfolios and validating their business decisions. It is critical that insurers use the newfound clarity to reassess their planning and strategy development processes as well as their capital-management and reinsurance strategies.

Planning and Strategy Development

In line with investors' expectations, many insurers currently conduct their planning and strategy development with an overwhelming focus on profit, growth, and dividends. Driven by this calculus, companies listen most intently to the sales and marketing units when setting the strategic agenda—and the emphasis is squarely on growth and market share. Embedded value (EV) is typically less relevant; and few insurers incorporate a true risk lens in their top-level decisions.

In the new regime, the P&L and EV lenses will have to be accompanied by new evaluations that clearly identify the tradeoff between risk and return. These risk models will allow insurers to develop an incisive, feature-by-feature and product-by-product view of risk-adjusted profitability. With this new frame of reference, insurance companies will question whether they are competing in the right places and with the

right products. How will the current business and product portfolios fare under Solvency II? Where do we need to grow the business? Where do we need to wind down our presence? How will Solvency II affect our competitors? Where are we relatively advantaged? How can we use the new transparency of risk to improve our standing with our customers and investors?

These questions should help each insurer define a unique aspiration for how and where it will compete in the Solvency II world, as well as identify a product strategy that accounts for the risk and solvency implications of all products—new and old. The product strategy should define the key dimensions of the product portfolio, including maturities, flexibility, and major risks. Undoubtedly, the revised strategy for life and nonlife products will lead to changes throughout the value chain.

- ◇ For their new business, life insurers need to decide whether they want to be a premium provider, with an array of sophisticated products that have expensive options and long guarantees (along with the corresponding fees), or a low-cost provider with simple products—perhaps with short-term guarantees or limited options to postpone or prolong payments—and simple processes and systems. Low-cost providers are already starting to emerge. In the Netherlands, for instance, Brand New Day provides simple pension products, primarily through direct channels.
- ◇ For their in-force books, life insurers need to consider a range of options for reducing the burden imposed by capital-intensive policies. They could make fundamental changes by securitizing groups of policies, running off books, or acquiring new books to increase diversification. They could also make operational changes, namely by revising their reserving policies. In Germany, for instance, a few large companies have been shifting from fixed reserves (which accrue to the policyholder on an annual basis) to free reserves and terminal bonuses (which are most often not assigned to the policyholder until the end of a policy's term). Smaller insurers have been following suit.
- ◇ Nonlife insurers will no longer be able to rely on investment returns to offset negative technical results because of the higher charges on risky investments. Underwriting skills and risk-adjusted pricing will become strategic, rather than operational factors—they will play a major role in determining how and where an insurer can compete. It will also become more critical for insurers to ride the economic cycle, keeping their powder dry for the downturns and refusing to join the thundering herd in the upturns.

Across virtually all of their strategic decisions, insurers—both life and nonlife—will need to account for the growing significance of diversification. Solvency II rewards companies for spreading risk across lines of business, investments, counterparties, and—to a certain extent—regions. As insurers reassess their portfolios, they should identify opportunities to reduce capital requirements through diversification. For example, the capital requirements of a composite insurer—one that has both life and nonlife businesses—would be 10 to 15 percent lower than the sum of the capital requirements for separate life and nonlife businesses (based on actual calculations for multinational groups).

It is important to note, however, that the current specifications limit diversification across legal entities. As a result, groups should consider changing their legal setups to maximize the benefits of diversification across lines of business and regions.⁵ Over the past several years, some large insurers have been doing just this. Zurich Financial Services, for example, recently began concentrating its European insurance business with one risk carrier based in Ireland.

Insurers should also recognize the diversification benefits of product and risk types *within* a line of business. Life insurers, for example, will be able to lower the capital requirements associated with underwriting risk by striking a better balance between mortality risk and longevity risk. And in contrast to Solvency I, insurers will be able to lessen the capital requirements associated with market risk by adopting a balanced asset allocation. Overall, a diversified approach can lower the capital requirements associated with each specific type of risk, such as market or underwriting risk, by more than 40 percent.

5. They could also use internal reinsurance, but this could lead to significant charges for counterparty risk if the internal reinsurer is not rated.

Under existing regulations, most large P&C insurers are already generating substantial benefits from diversification. As a result, there may be little opportunity for them to reap further rewards from diversification, but there will be greater pressure on insurers that are not yet well diversified. Insurers are currently lobbying for Solvency II to permit diversification across legal entities. If this happens, large multinational insurers will have a significant advantage.

Capital Management and Reinsurance

Solvency II will prompt many insurers to transform their capital-management and reinsurance programs, for three reasons.

First, it will introduce a new definition of eligible capital, which will be grouped into three levels of quality, from Tier 1 to Tier 3. This could affect the eligibility of certain hybrid capital instruments. Dated and subordinated debt, for example, might be admissible only under certain circumstances. Even though we expect grandfather clauses to ease the refinancing burden for the industry, the change in admissibility may still lead some insurers to rethink their financing strategies or perhaps raise new capital, even if their actual capital requirements do not change significantly. For instance, AXA recently issued fresh hybrid debt that satisfies Solvency II requirements, thereby strengthening its capital position under the proposed rules.⁶ Also, Austria's UNIQA Group has mentioned the possibility of raising additional equity capital, in part to be better prepared for Solvency II.⁷

Second, reinsurance will become more complex, more attractive, and perhaps even essential, for several reasons:

- ◇ The increased transparency of risk and volatility will enable primary insurers to use reinsurance products more effectively. Primary insurers could also use internal reinsurance to diversify or transfer risk capital across legal entities, though this would entail counterparty risks and capital costs (the costs would be higher if the internal reinsurer were unrated).
- ◇ The survival of some undercapitalized insurers or mutuals that have limited access to fresh capital could hinge on sophisticated reinsurance products. They should consider working jointly with reinsurers to develop customized solutions.
- ◇ Some insurers may transfer the risk attached to runoff portfolios to reinsurers.
- ◇ The Solvency I limits placed on reinsurance for the calculation of capital requirements—50 percent for P&C and 15 percent for life—will be lifted. As a result, even though counterparty risk will be factored into capital requirements, primary insurers will have more to gain, from a capital point of view, by utilizing reinsurance.

Third, the need to lower capital requirements may prompt some insurers to seek new counterparties. More specifically, insurers will be able to reduce their capital requirements by selling structured insurance liabilities to hedge funds or institutional investors.

The Operational Imperatives

By giving rise to new—and often dramatic—variations of attractive businesses and products, Solvency II will force many insurers to revise their business, risk, and product strategies. As a result, they will need to revisit the four core elements of the value chain: product development, sales and distribution, IT and operations, and asset management.

6. AXA, *Activity Report / Half Year 2010*.

7. "UNIQA im ersten Halbjahr 2 - Unwetterschäden bei 50 Mio. Euro" ("UNIQA in the first half of 2010 – storm damage at €50 million"), *DerBörsianer*, August 26, 2010, <http://www.derboersianer.com/maerkte/oesterreich/single/details/uniqa-im-ersten-halbjahr-2-unwetterschden-bei-50-mio-euro236083.html>.

Product Development

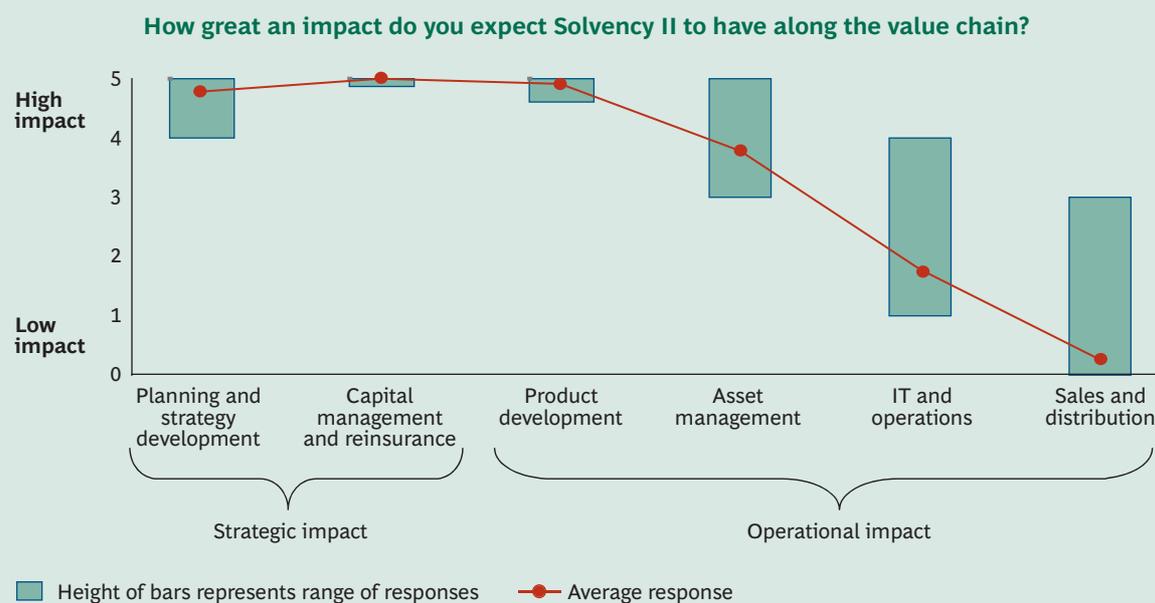
Product development is expected to be one of the most affected parts of the business. (See Exhibit 4.) The new rules will trigger several fundamental changes:

- ◇ When developing products, insurers will have to think more explicitly about capital requirements and the ramifications on the investment side of the business—Solvency II will make asset-liability mismatches and investments in volatile assets both transparent and costly. Asset managers will therefore need to be more active in product development as well as in all steps of the product life cycle.
- ◇ Diversification should influence product development. Products should not be developed in isolation; rather, they should be viewed against the backdrop of the broader portfolio.
- ◇ Through ORSA, risk managers will come to play an integral role in the development process and will need to review and document any decisions that would affect the company's risk profile.
- ◇ Prices will need to reflect a more accurate and transparent reading of risk. Instead of changing prices, some insurers might choose to alter the features of certain products, thus changing their risk profile.
- ◇ Innovative products, which lack historical data, will likely require extra capital at the beginning of the life cycle. But insurers will be able to dramatically reduce their capital requirements by developing models that can mimic the performance of new products even in the absence of historical data—for example, by replicating portfolios and analyzing analogous products.
- ◇ Insurers, in general, will need to strengthen risk awareness throughout the product development process, even among staff whose mandate has not traditionally included risk management. The process will also need to become more disciplined, with a stronger focus on capital absorption and return on capital.

Sales and Distribution

In the life business, changes in sales and distribution will be driven by the need to align sales-steering and compensation systems with the new portfolio strategies. In the long run, this may fundamentally change

Exhibit 4. Insurers Expect Solvency II to Have a Profound Strategic Impact



Source: BCG Solvency II task force interviews.

Note: The results are based on 44 interviews conducted from May through August 2010. The results were derived from the responses to two questions: In which parts of the value chain do you expect a great increase or reduction of complexity? And how will Solvency II affect different parts of the value chain?

the way life insurers lead their sales forces. The changes will take a different form in nonlife companies, where the importance of underwriting will force many insurers to develop more disciplined sales networks. This will be similar to how Basel II prompted many banks to retrain their sales personnel to focus not on individual products but rather on the capital-efficient generation of revenues.

Some insurers—particularly those facing significantly higher capital requirements—have already started to shift their sales force incentives to emphasize profitability and diversification, rather than only growth. This trend toward value-based sales is beginning to emerge in places such as Italy. We expect it to continue. We also expect to see greater discipline in the use of rebates, as insurers begin to concentrate more on generating sustainable profitability.

Most of the executives we interviewed consider sales and distribution to be the least affected part of the value chain. But the adjustments in sales and distribution could be critical to supporting more fundamental changes in product development and risk management—and they will likely require a significant change-management program.

- ◇ Insurers will need to reevaluate the suitability—or even viability—of their distribution systems. Some products will be profitable only if their customer-acquisition costs or associated sales incentives are below a certain threshold. They will also need to clarify to what extent they should adjust their target-setting and compensation systems.
- ◇ Insurers will need to craft sales approaches for newly developed or revised products.
- ◇ Direct insurers will have little opportunity to explain new products to their customers, given their arm's-length business model. As a result, they will need to focus on relatively simple products that can be sold without an involved explanation and are still attractive from a capital perspective.
- ◇ A strong intermediary network can be a great competitive advantage when adjusting the product portfolio. Well-trained intermediaries can help explain new terms and conditions—such as changes to a life insurer's reserving policy—and dissuade customers from canceling their policies or switching to competitors.

IT and Operations

Solvency II will lead to a wave of new requirements concerning the accuracy, timeliness, and groupwide consistency of data. For many insurers, meeting these requirements will be an existential challenge. Initial certification processes have already produced extensive lists of shortcomings, and some insurers have been instructed to adapt their IT systems and tools accordingly.

The demands on technology systems could tie up most of an insurer's IT resources for years. Reining in complexity will be an ongoing task. Companies that already have a plethora of systems and interfaces may need to overhaul the application landscape. More important, insurers must view IT as a means to end. In other words, the changes to the IT environment should be driven by—and checked against—an insurer's Solvency II product and sales strategies. Although tactical fixes and temporary solutions may be necessary to meet the deadline for compliance, they should not be allowed to ossify: insurers must create appropriate plans and budgets to mop up such unfinished business.

In addition, Solvency II will require insurers to quantify their operational risks and factor them into their capital requirements. For most insurers, operational risk will account for approximately 5 to 10 percent of their solvency capital requirements. As a result, the case for adopting lean practices will become even more compelling. These practices will not only improve the efficiency and reliability of operations but also directly impact capital requirements, provided that local regulators are willing to recognize insurers' internal modeling of operational risk.

Asset Management

Solvency II will have a direct impact on asset management by changing the return on capital of specific asset classes. The proposed risk charge of 39 percent on equity investments, for example, will prompt insurers to scale back their investments in stock markets. Capital requirements will also be much more

sensitive to corporate credit quality. At the same time, the current specifications of QIS5 do not include any significant charges on EU government bonds, so asset allocations may tilt toward these investments, despite their conspicuous risks.

The new rules will also indirectly impact asset management by changing its underlying principles. On the whole, the changes will lead to greater stability but lower returns.

- ◇ More than ever, asset managers will need to see themselves as a service provider for the actuarial practice. In other words, they will need to focus on actively managing (if not minimizing) the gap between assets and liabilities, rather than outperforming a given index.
- ◇ Many insurers will need to develop more sophisticated processes and systems for asset-liability management and hedging. In particular, the collaboration and mutual understanding between actuaries and risk managers will need to be strengthened.
- ◇ Insurers will need to align their investment strategies with their overall business and risk strategies by adhering to clearly defined principles. Will the investment strategy focus on total return or outperformance? Will it be plain and simple, or will it utilize complex instruments?
- ◇ Many insurers will aim to minimize volatility and stabilize their balance sheets, perhaps by shifting to illiquid assets or unlisted investments, such as complex infrastructure investments. Smaller insurers, however, may lack the skills to manage exotic investments. In addition, illiquid investments can become extremely costly when book values cannot be realized. This could have undesirable second-order effects in times of crisis.

Insurers, in general, will manage their assets with a view toward reducing their capital requirements. The preference for risk-free investments will limit the flexibility of product development and the returns promised to customers, but well-capitalized companies will be able to use their additional elbowroom to offer investment returns that others cannot match.

Moving Forward

The deadline for complying with Solvency II may be years away, but insurers have no time to waste in preparing for the structural changes that lie ahead. The scope of the strategic and operational transformation will make it hard for companies to develop a coherent, comprehensive plan for anticipating Solvency II. To help set their priorities, insurers should focus on two groups of activities. The first involves immediate actions, though some are also critical to enabling or informing more fundamental changes to the business.

- ◇ *Understand the risk-adjusted returns of all lines of business and investments.* Insurers will need to identify all key risk drivers and potential capital charges. They should complement their internal assessments with an outside-in analysis of the impact of Solvency II on all relevant market participants, since even close competitors can be affected differently. In addition, companies need to monitor and prepare contingency plans for critical elements of Solvency II that are still taking shape. (See the sidebar “The Key Variables of Solvency II.”)
- ◇ *Develop a new portfolio strategy based on risk, profit, and EV.* By understanding the risk-adjusted returns of different lines of business, insurers will have a clear view of the tradeoffs among three priorities: minimizing risk capital requirements to optimize the return on capital, generating net profit (under IFRS and local GAAP), and maximizing embedded value. These tradeoffs need to be factored into an insurer’s business and risk strategies.
- ◇ *Identify and address any capital issues early.* Insurers should clarify the different types of available risk capital they have (for example, hybrid, value-in-force, or pure equity), along with how this capital will be treated under Solvency II. Will it be classified as Tier 1, Tier 2, or Tier 3? This will allow an insurer to determine whether it needs to seek additional funding or perhaps restructure the business.

- ◇ *Create a road map for responding to Solvency II.* Simply complying with the technical aspects of Solvency II will require a substantial change-management program, but companies also need to respond to a range of strategic and operational imperatives. To avoid being overwhelmed by the complexity of these tasks, companies should spell out exactly what is needed for their specific business profile and strategy, who has to deliver it, and when it needs to be done. Companies will need to be just as clear about the things they do not need to do, given the specifics of their business. Parallel developments, such as the revision of IFRS or changes to local regulations, should be factored into all of these planning decisions.
- ◇ *Keep the implementation simple and focused.* Solvency II has been derided as a lifetime employment act for actuaries. The finer details are important, but insurers must make sure their Solvency II programs are guided by the right priorities—namely, their business needs and strategic imperatives. In addition, the choice between satisfying the minimum requirements and developing extremely sophisticated capabilities and models has to be carefully considered. As a rule, insurers should aim to keep their Solvency II

The Key Variables of Solvency II

The broad dimensions of Solvency II are fairly well defined, but several critical factors have yet to be finalized. Insurers should closely monitor these variables and determine what the potential outcomes might mean for their businesses.

- ◇ *What will be the absolute level of capital required for the industry?* The proposed capital requirements, as outlined in QIS5, are lower than what was proposed in 2009, but they remain significantly higher than they were in QIS4, which was issued in 2008. At the same time, QIS5 allows for the value of in-force business to be counted as eligible capital. This may lead to a significant easing for life insurers with large, profitable in-force books. It might also improve the attractiveness of life insurance relative to the nonlife business.
- ◇ *Will the illiquidity premium be extended to a broader range of products?* Currently, QIS5 includes an illiquidity premium for illiquid liabilities, such as U.K. annuities, along with a reduced premium for partially illiquid liabilities. It remains to be seen which kinds of products in continental Europe will benefit from the premium and how high the premium will be.
- ◇ *To what extent will hybrid capital and future profits be treated as Tier 1 capital?* QIS5 has a more relaxed definition of Tier 1 capital, which includes a grandfather clause for hybrid capital. But its exact implications remain unclear.
- ◇ *To what extent will there be a convergence among European regulators?* It remains unclear how Solvency II will be coordinated across Europe, whether the balance of power will tilt toward certain regulators, and how multinationals can best navigate the new regulatory landscape. At this point, we expect different regulators to emphasize different aspects of Solvency II, depending on the predominant business and product mix in the local market. We also expect them to interpret the rules in a way that favors the most important local insurers.
- ◇ *How will Solvency II treat non-EU regimes?* The issue of regulatory equivalence is critical to some insurers. Companies that have operations in markets outside the European Union could be hit with additional capital requirements, unless the regulatory regimes in those markets are deemed equivalent to Solvency II standards. Although the methodology for assessing equivalence remains unclear, EU regulators recently recommended that Bermuda, Switzerland, and Japan be the first regulatory regimes assessed for equivalence. The United States was a notable omission from the list.
- ◇ *Will the benefits of regional diversification be recognized?* Regional and product diversification benefits are now included in QIS5, but the extent to which these types of diversification will offset capital requirements is still a matter of debate.
- ◇ *How will the concept of proportionality for small insurers be interpreted?* The concept of proportionality is meant to ease the complexity burden for small companies, but it is open to interpretation by local regulators. Final specifications are still missing.
- ◇ *How will Solvency II evolve in the wake of Basel III?* The requirements for greater conservatism and higher-quality capital in QIS5 parallel those in Basel III. In contrast, the issue of procyclicality, which was the subject of a recent consultative paper by the Basel Committee on Banking Supervision, remains largely untouched by insurance regulators. Moreover, neither bank nor insurance regulators have fully addressed the dependence of their methodologies on credit-rating agencies.

programs as simple as possible and as complex as necessary. Resources should be concentrated in areas of the business that will have the greatest impact on capital requirements.

The second group of activities is focused on a number of midterm tasks. These initiatives, which are geared toward the business capabilities and characteristics that will matter more in the Solvency II world, will help position the business to thrive.

- ◇ *Leverage the benefits of diversification.* Insurers need to search for ways to increase diversification across all types of risks. Their options might include changing the company's legal setup or buying or selling in-force books of business. In markets where we expect a wave of consolidation, companies need to understand how these changes might affect the diversification benefits accruing to both their businesses and their competitors.
- ◇ *Improve efficiency to offset reduced profitability.* Solvency II will make profitability, rather than growth, the primary measure of performance. As a result, insurers will need to focus even more intently on efficiency.
- ◇ *Enhance underwriting accuracy.* Solvency II will reward companies that have less volatile, more accurate technical reserves and claims estimates. As a result, some diversified insurers could find themselves at a disadvantage compared with monoline insurers, which typically have specialized knowledge about a specific corner of the nonlife world. The disadvantage may be great enough to negate the "diversification edge" of large insurers, making it even more critical for them to enhance their underwriting skills.
- ◇ *Improve risk management throughout the organization.* Insurers need to have risk management functions that are not only sophisticated and extremely capable but also closely integrated with the business. Risk managers should not be walled off from strategic planning, nor should they be confined to simply measuring risk. They need to play an active and involved role in setting the company's direction.
- ◇ *Do not leave risk management solely to the risk managers.* The risk culture has to be embedded throughout the entire organization. All staff who can initiate significant risk positions need to be educated in risk and should develop a clear understanding of the dynamics and limitations of risk analysis. Insurers must not underestimate the change management challenges associated with developing a company-wide risk culture.
- ◇ *Focus on the people side of change.* Models and systems are essential to satisfying many of the technical requirements of Solvency II, but they are no substitute for the expertise and judgment of risk experts, particularly those who are as familiar with the business as they are with the complexities of risk management. Insurers need to develop clear strategies for attracting and retaining well-rounded risk experts.

Solvency II will dictate a raft of changes for the insurance industry, but its impact on individual companies is not a foregone conclusion. The scope and rigor of each insurer's Solvency II implementation program will ultimately determine whether the new rules create or destroy value for the business. Companies that have the strategic vision to capitalize on the changes—rather than merely comply with the new rules—will have a competitive edge in the Solvency II world.

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