

Waking Up To Solvency II

German companies have the capital for Solvency II, but this is no reason for them to be complacent, according to Knut Schaefer of EMB Deutschland.

It is both a strength and a weakness of the German insurance industry that it operates in a stable environment, at least in comparison with many other parts of Europe.

Strength of the German market

Companies are well capitalised - perhaps excessively so. It is by no means exceptional to find insurers with five times as much capital as they would expect to require under Solvency II.

Although it is a dynamic and competitive market, and some classes such as Motor are bordering on cutthroat, many areas of business bear the hallmarks of a tariff structure of underwriting.

They do not require the same level of technical expertise to be profitable. And, though the public are becoming more willing to shop around, customer loyalty and retention remain high.

For these and many other reasons the German non-life industry has yet to experience the headlong change witnessed in some other countries. That is not to say it stands still. AXA, for example, has jumped up the league table of insurers in Germany and is now one of the biggest players, partly thanks to organic growth and partly through acquisition. One or two old names have disappeared.

Despite these developments, there are still an amazing number of insurers - around 300. Some are tiny, like the mutual insurer for horticultural workers, which will not be overtaking Allianz any time soon. Yet, even if you remove these tiddlers from the equation, there are around 80 companies large enough to be taken seriously.

For years now, they have defied predictions of imminent market consolidation. A number of companies owned (at least in part) by the individual German states have merged. Several reinsurers have disappeared, either to merger or run-off. Overall, though, it has to be said that there is no sign of the tsunami that many thought would wash through the industry.

Although Solvency II will undoubtedly affect the landscape, there is no reason to assume that it will fundamentally change the market's structure, at least not in the short term. QIS3 (the latest exercise for insurers to test the Solvency II proposals to see how their companies might be affected) produced few alarms for the industry.

Data management is key

Such issues that have emerged, and they are not to be under-estimated, revolved mainly around getting the right data, being able to reconcile that data and having the actuarial techniques to exploit it effectively. Several shortcomings emerged, especially in the areas of calculating best estimate reserves and discounting them and calculating ultimate loss ratios. Many companies had to use back-up solutions given by authorities to populate the model to complete the exercise.

While these failings are serious, and they clearly need to be addressed well before implementation in 2012, the underlying message remains the same: risk capital really is not that much of an issue in Germany; we have plenty of it.

Compliance or Competence ?

False sense of security

But there is much more to Solvency II than having enough reserves. Management issues such as reporting, checks and balances, procedures, transparency and internal communication are arguably even more important. However, there is plenty of time to put these in place to the satisfaction of the authorities. This will undoubtedly be a challenge for many firms, but it will be a lot easier than having to compensate for a shortfall of capital.

In our opinion, a greater risk is that insurers may be lulled into a false sense of security. The point about Solvency II, as we have stressed time and time again, is that it is not just a piece of regulation. It is an opportunity for insurers to sharpen up their act, both managerially and technically: to become more capital-efficient and ultimately more profitable as a result.

The argument is a simple one, even if execution can be quite complex. Managers who have a precise and accurate understanding of the risks inherent in their business will allocate their resources more effectively. They will make better decisions across a wide range of fundamental areas, including the business they write and the prices they charge. Regardless of Solvency II or any other regulation, it is what insurers should be doing anyhow to protect and improve their own competitive position.

Better risk management

In fact, the signs are encouraging. The big international companies (Germany is, of course, home to some of the world's mega-insurers and reinsurers) got the idea years ago. Now the middle market - made up typically of entities with a mainly German footprint and annual premium income of around €500 million - is moving in the same direction.

This is, though, largely a parallel movement to Solvency II, and not directly connected to it. Many companies see no reason to build an internal model just for the sake of reducing regulatory capital requirements; as already explained, there is no particular incentive to do so. Indeed, many of those companies that have built internal models have no intention of showing them to the authorities even when Solvency II kicks in. Doing so would be time-consuming under the terms set out in the draft EU directive, and why reveal commercially sensitive information if they have no problem in passing the regulatory hurdle?

So for many German insurers the debate about whether to opt for the Standard Formula method of compliance with Solvency II or to choose internal modelling does not apply. Maybe, or so the thinking goes, it is better for them to opt for the less complicated Standard Formula, but to produce their own internal models anyhow, in the knowledge that they will benefit the business. The understanding they get as a result will help in many areas, including reinsurance optimisation, asset allocation and value-based management.

Skills Shortage

Moving further down the market in terms of size, things are different. On the positive side, participation in QIS 3 was much greater than for QIS 2 and that, in turn, exceeded the level for QIS 1. This trend shows, at least, that smaller companies have woken up to Solvency II, but their understanding of the issues and ability to use Enterprise Risk Management to their advantage is much more limited. These insurers are showing much less inclination to view the process positively. For most of them, admittedly with some exceptions, this is about compliance rather than business advantage.

Their position has been made more difficult by the loss of several reinsurers that were willing to give their smaller clients significant amounts of technical help. Goather Re and Gerling Global Re, for example, were notable for sharing their expertise in such areas as data management, large claims handling and rating. Their disappearance into run-off has left a gap in this kind of support.

Whatever rules may be in place, there is an imperative for firms to become more technically capable. It is in the interests of insurance companies, no matter how big or small, to make best use of their capital. To do this they must, among other things, maximise reinsurance retentions and the business they write. While under-reserving should be avoided, over-reserving can be a problem too.

Solvency II may or may not have much direct impact on the German insurance climate, but the questions it raises are of vital importance.

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Knut co-founded EMB Deutschland after working for 5 years at an actuarial consultancy based both in the UK and Germany. He was a research and teaching assistant at the University of Cologne, specialising in probability theory from 1992 until 1996. During that time he completed his PhD in applied mathematics. Knut is qualified casualty actuary and has been a member of the German Actuarial society since 1999. He has extensive experience with tariff rating both for primary and reinsurers, reserving issues, mergers & acquisitions and dynamic financial analysis, particularly with the design of optimal reinsurance programmes.

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