

## On the look-out

**Solvency II poses some tough questions across the highly diverse Scandinavian market. Some people are even questioning the relevance of the reform, says Ørjan Ådland of EMB in the Nordics.**

When it comes to insurance, Scandinavia is a market within a market. Although part of a much bigger European picture, it has its own special characteristics and an impressive degree of diversity.

### **Smorgasbord**

Each of the four main countries - Sweden, Denmark, Finland and Norway - has a small number of dominant insurers. Typically, the top three to four have a combined market share of around 70% - 90%. Several of them are mutuals, though their operations resemble those of listed companies. The biggest insurer of all is If, owned by Finland-based Sampo; it is the only one to have a large share of all four markets.

Beneath these 'big beasts' is a patchwork of much smaller entities including specialist insurers, mutuals with strong geographical or sector bases, captives and mono-line insurers. Furthermore there is a range of new entrants, many of them subsidiaries of overseas companies or owned and operated by banks. Finally, and by no means least, there is a thriving marine sector which is especially strong in Norway and Sweden, covering both P&I and Hull insurance.

Whilst no market is static, Scandinavia has been relatively stable in recent years. With relatively little consolidation and only a modest degree of penetration by overseas companies, the pace has been that of evolution rather than revolution. Is all this threatened as Solvency II gathers momentum? The article will examine, first, the response of the largest insurers and then how the rest of the market has reacted, paying some attention to the special and sometimes overlooked needs of the marine and captive sectors.

### **Large companies - in the comfort zone?**

The larger Scandinavian players have long been aware of Solvency II. They are technically quite advanced and have the know-how to meet the requirements without too much difficulty. This sets them apart from some east and central European countries where even the largest home insurers are struggling to cope with the reform.

In fact, there has been a debate going on, with some Scandinavian commentators questioning the relevance of Solvency II. The ratings agencies are the main game in town, or so the argument goes. If you can get a good rating, then the regulation will fall into place.

That is, of course, an oversimplification. At the very least, Solvency II will demand more rigorous and time-consuming reporting systems. But the underlying point is a good one. The largest and most sophisticated insurers have already started to do what the new regime requires, not for regulatory purposes but because it is commercially advantageous. Enterprise Risk Management helps them to meet the agencies' criteria and the expectations of their corporate clients; above all, it is consistent with best practice.

# The winners will be those that (regardless of size) embrace the reforms

This point was well illustrated by the results of QIS2 and QIS3 (the exercises where insurers test Solvency II proposals to assess how they affect their companies) in Norway and Sweden. One key conclusion was that, although capital requirements will rise, they will remain within the levels that our larger companies have already achieved.

For these reasons, with one or two exceptions, the market leaders have welcomed the new Solvency II framework as being consistent with, and arguably less challenging than the demands already being made on them by stakeholders. They already either use or have started to implement the internal capital models that lie at the heart of Enterprise Risk Management. They understand the wider managerial imperatives, the need to embed risk management in the culture of the organization, and they are able to embrace them.

A key question (even if it does leave non-actuaries unmoved) is whether or not the large companies will apply to meet solvency requirements through their internal models or whether they will use the alternative Standard Formula. The reason it is such an important decision is that models represent a far more capital-efficient method, but firms may be tempted towards the Standard Formula because of its relative simplicity. At present, the large Scandinavian firms are waiting to see the detail of the proposed implementation, but the signs are that many favour internal models, because they will encourage lower capital requirements. It is, however, too early to say with any certainty.

## **SMEs - looking both ways**

It will come as no surprise that small and medium-sized companies are somewhat more reluctant and cautious about implementing Solvency II; it is the same all over Europe. It would be wrong, however, to portray a stereotype of insurers burying their heads in the sand and hoping the problem will go away.

It varies greatly from firm to firm. Most can appreciate the advantages of Solvency II, but have so far adopted a wait-and-see mentality to the new framework (as have some larger companies). The extra resources required to report to the national regulators will stretch many of the smaller players, internal modelling will be even more challenging for them. They see serious challenges regarding data quality and traceability.

On the other hand they also have advantages over their larger competitors. Although they may lose out on the diversification credits given to group structures, they will find the "use test" easier to satisfy because they are less complex organizations. This will facilitate the use of internal models and therefore make possible potential savings in terms of capital requirements.

The best way forward is normally to come up with a less ambitious solution that follows the principles of ERM, but makes allowances for the limitations of individual companies and their specific circumstances. Many of the smaller and medium-sized insurers are growing in enthusiasm for the project, and starting to appreciate that the initial costs of developing a proper internal model are really quite low compared with the prudent capital requirements that may come out of the standard formula.

## **Choppy waters for marine?**

Scandinavian marine insurers, who are mainly but by no means exclusively based in Norway, have been buoyant in recent years. The Nordic marine insurance market includes the Gard (the world's second largest P&I Club), the Skuld, the Norwegian Hull and Swedish Clubs.

The improvements in risk management in the P&I sector have already been pronounced, partly because the majority of clubs are based in the UK, where the FSA got in first. The difficulty they face under Solvency II is that, although there has been some diversification, they are essentially mono-line insurers; and that will mean extra capital requirements. A number of clubs have said that this will place upward pressure on premiums.

Similar influences apply to most Scandinavian marine insurers outside the mutual sector, which generally do not have the same opportunities to diversify risk as their larger more broadly based overseas competitors. Fortunately, they are generally well managed and should be able to meet the challenge.

## **Captives - facing a squeeze?**

It is not generally appreciated outside Scandinavia that the region is home to a significant captive community, which faces some interesting challenges as a result of Solvency II. Their needs seem to have been largely overlooked in the recent directive and, as things stand, captives may face the same regulations as mainstream insurers. Yet they are, of course, very different. A failed captive does not leave behind discontented policyholders; nor does it threaten the financial system. They should, therefore, not be required to meet the same criteria. Yet that is what the regulation, as currently drafted, appears to imply. Scandinavian captive managers are following developments with considerable concern.

## **Winners and losers**

In many ways the Nordic market provides a microcosm of the wider European industry, providing an eco-system that supports an impressive range of insurance operation. The big question is not whether the market as a whole can thrive in the new environment (it can), but whether this diversity will survive. The answer depends, in turn, on the enthusiasm with which insurers, especially medium-sized and smaller companies, take advantage of the opportunities that Solvency II offers.

We have always known that Solvency II would throw up winners and losers; and the winners will be those that (regardless of size) embrace the reforms, embedding risk management into the cultures of their organizations. It is a reasonable bet that there will be some casualties, but we live in a dynamic world where companies come and others disappear. Scandinavia will remain a distinctive insurance market for the foreseeable future.



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