

Germany needs its confidence in Solvency II restored

25 November 2011

German insurers are well capitalised but the German insurance association plans its own QIS next year because it says Eiopa's QIS5 destroyed confidence in Solvency II. Lorna Davies looks into Germany insurers' concerns over the directive.

The German insurance association (GDV) has devised an extra test of German insurers' readiness for Solvency II, based on firms' financial results at 31 December 2011. Dubbed QIS6 in the style of the five quantitative impact studies (QIS) carried out by Eiopa, the study will run between April and May 2012 and will test the revised level 2 requirements of Solvency II. As the test is optional, it isn't clear yet how many will take part, but according to Axel Wehling, a member of Berlin-based GDV's managerial board, "it would be in firms' best interests to do so."

However, Germany's last quantitative impact study (QIS5) found that firms were well capitalised - perhaps excessively so -- and this is something that's not expected to change in QIS6 or under Solvency II, according to Claus Brinkmann, head of Solvency II at Deloitte in Germany. "A couple of calculations that went into QIS5 are no longer relevant," he says. "The new volatility charges, for example, have not been tested yet and QIS6 -- currently only planned on a German national level -- will give firms the chance to see where their challenges will lie and give them enough time to organise themselves."

Wehling and Brinkmann agree that QIS6 is an opportunity for European regulators, national regulators and firms to understand the drivers for the changes in the QIS results.

EC needs to restore confidence

In January, Wehling said QIS5 had "destroyed confidence" in Solvency II, and even if QIS6 turns out to be helpful, it's now down to the European Commission, not the GDV, to undo the damage: "It is up to them, in the level two text, to restore confidence again."

At federal level (Germany is supervised at both federal and state level) the federal financial supervisory authority, BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht) supervises major private insurers and competing public-law insurers operating across the borders of a state. At state level, the authorities mainly supervise private insurers whose activities are limited to the territory of the particular state in question. There are around 480 insurers -- more heavily weighted towards non-life -- and the GDV covers over 95% of the German insurance market. At the moment a significant number of companies are considering applying for an internal model or a partial internal model, according to Wehling. One of the reasons might be that the standard formula -- once intended to ease risk calculation for small and medium-sized companies -- has become "far too complex", he says.

A dozen internal models

Around a dozen companies opted for an internal model, and around five are in serious dialogue with BaFin in the first application phase. "In the second application phase, more companies will try for internal model approval," says Deloitte's Brinkmann.

However, Julia Schüller, insurance risk management lead at PricewaterhouseCoopers (PwC) Germany and member of the PwC international Solvency II steering committee, says the next couple of years will show if a lot of insurers actually opt for an internal model. "It is a big difference between having an internal model in place for regulatory capital purposes and for risk steering (pillar 2)," she says.

Although it is dynamic and competitive, especially in classes such as motor, the German market has many small and medium-sized insurers, so the split deadline of Solvency II -- with supervisors' and Eiopa's deadline on 1 January 2013 and firms' a year later -- is somewhat more attractive than for markets with fewer yet larger players, such as the UK, "because the smaller firms are struggling with the technical regulations that Solvency II brings," according to Brinkmann. "A lot of small companies, especially those struggling with pillar 3, will welcome the extra time," he adds.

But most companies didn't change their project plans when they heard about the delay, according to Schüller, especially the larger, more prepared firms already in the pre-approval phase for an internal model. The world's largest reinsurer Munich Re, for example, has been using an internal model for its risk management for several years, according to Jürgen Dümont, head of Munich Re's solvency consulting unit. "The approval procedure for our internal model is in progress, and we are hoping for clearance from BaFin as soon as possible."

Pillars 1 & 3

German insurers are "quite advanced" in the pillar 2 part of the directive (i.e., risk management, governance, ORSA, capital add-ons and intervention), according to Brinkmann.

GDV's Wehling agrees: "The market is well placed for pillar 2. Most of the processes are ready and in place. Most of the discussion has been around pillars 1 and 3."

For pillar 1, special products on the life side are a continuing issue. The risk-free term structure tested in QIS5 revealed a strong volatility of results within a very short period of time (sometimes even within a few days) that would make it nearly impossible for German life insurers to keep offering long-term guarantees under Solvency II. "Implementing an appropriate yield curve is one of the main issues we are focusing on in the Solvency II process," said Wehling. "We particularly want to avoid artificial volatility by starting the extrapolation in year 20 (Euro Zone)."

But the main bone of contention is pillar 3. The excessive reporting requirements demand significant additional money and people power from the companies, while the supervisory benefit of the required information is "often not clear," according to Wehling. "We think that the scope, the level of detail and the frequency of the reporting requirements should be in line with the regulatory purpose. Furthermore the principle of proportionality should be applied."

What is it about pillar 3 that creates concern in Germany? PwC's Schüller says it's because at first glance it's costlier and takes a lot more effort than pillar 2 - mainly down to the technical

requirements and documentation improvements. "But nevertheless, pillar 2 is very challenging because it can only be implemented efficiently if the mindset changes," she says. "You could implement pillar 2 requirements just for compliance reasons, or you could use the opportunity to reflect the business risk profile and possible improvements to reduce or optimize the risk profile."

Main challenges

According to Wehling, the main challenges for the market at the moment are coping with the volatility of Solvency II, preparing for excessive reporting requirements and getting ready for Solvency II without knowing all the details. But although Solvency II is taking up a lot of time and effort, Brinkmann says the main challenge is the low interest-rate environment. German insurers are under pressure from reduced investment returns as the financial markets provide a big test for the industry, but these conditions have not yet led to an increased focus on underwriting performance and profits, according to a recent report from rating agency Standard & Poor's (S&P). Although the sector continues to show resilience and strong credit fundamentals, material exposure to unstable Italian and Spanish national debt could create rating pressure in the future. "Ultimately, insurers will have to see that they compensate for, or manage, the foreseeable lower return on investment through their pricing," Munich Re's Dümont comments.

Proportionality

In the past, many in the industry have predicted market consolidation in Germany. A number of companies owned in part by individual German states have merged, and several reinsurers have disappeared, either to merger or run-off, but a wave of consolidation yet to materialise. "The coming administrative challenges and the diversification advantages of the large multiline groups might affect the consolidation," Brinkmann observes. Solvency II's principle of proportionality should be applied to avoid smaller insurers being unduly affected by requirements aimed at larger firms that might weaken the smaller firms financially. "Unfortunately," says Wehling, "this principle has not been consistently applied so far. It is our firm position to make Solvency II applicable for all insurance companies - independent of size and legal structure."

Source: <http://www.insuranceerm.com/analysis/germany-needs-its-confidence-in-solvency-ii-restored.html>