

Driving capital efficiency

Countdown to Solvency II

Using Solvency II as a catalyst for more efficient capital, cost and tax structures.

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Solvency II will intensify the pressure on capital, cost and tax efficiency, making the potential benefits from corporate restructuring even greater.

If insurers could start with a blank sheet of paper, few would want the structure they have today.

For some insurers, a succession of acquisitions has created groups with a cluttered array of different underwriting platforms and separately regulated local subsidiaries. This results in the cost and inefficiency of dealing with multiple regulatory rules, relationships and returns. When the solvency requirements from all the various subsidiaries are added together, the cumulative sum tends to be much higher than that of a single consolidated entity.

Opportunities to simplify these convoluted structures have existed for some time with groups using the insurance business transfer rules and, more recently, the European company and cross-border merger directives. Figure 1 sets out a typical trend in restructuring in which separate subsidiaries are 'collapsed' into one main insurance company, which operates through a series of local branches. The EU single market 'passporting' regulations enable the company to underwrite all of its business through a single platform. The capital and regulatory burden is also much reduced as the consolidated entity takes care of all solvency requirements and associated returns,

leaving the local operations to deal solely with conduct of business. Once the legal structure has been streamlined, this can pave the way for further operational rationalisation such as the development of shared services.

Prominent examples of groups adopting this approach include Zurich Financial Services (ZFS), which now underwrites much of its general insurance in the EU through a single entity based in Dublin. ZFS believes that the 'simplification will further increase the group's flexibility and transparency and enable it to manage its capital and dividend more effectively'.¹ ZFS is reported to be considering a similar move for its life insurance business.² Another example is Swiss Re, which underwrites much of its general and reinsurance cover through centralised legal entities based in Luxembourg.³

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New model of efficiency

Solvency II will change the criteria for setting capital requirements, with many insurers facing higher charges, especially if they opt for the European Standard Formula. The directive will also increase the potential cost and complexity of compliance. Indeed, while insurers should in theory benefit from a harmonised EU-wide prudential framework, in practice each country will have its own 'referee', forcing groups to maintain multiple supervisory relationships and as a parent company to deal with different interpretations of the regulations.

Solvency II will therefore add further impetus to the moves towards legal and operational restructuring. A poll of more than 100 insurers carried out in May 2010 found that 24% are already pursuing plans to restructure part of their groups and 31% are actively considering such a move.⁴ As the full implications of the directive become clearer in the coming months, other companies are likely to follow suit.

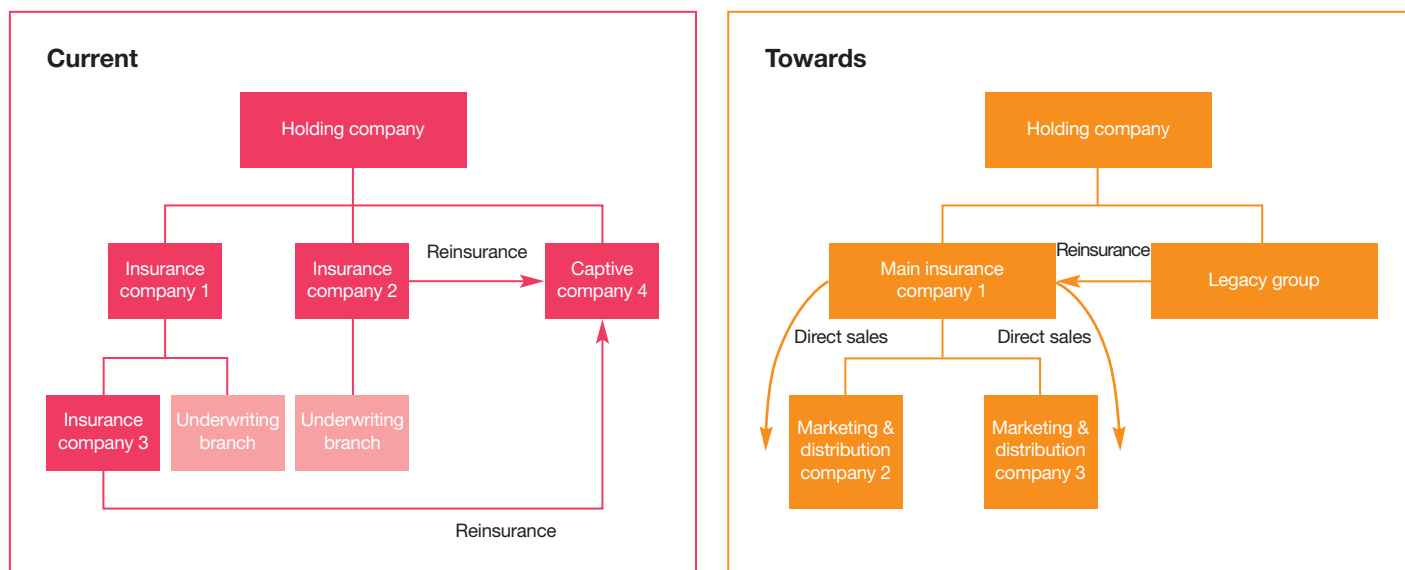
Bigger benefits for restructuring

The task of securing internal model approval will be easier for a single entity as it will only need to prepare one

application rather than a separate one for each of the group's companies. The amount of regulatory reporting and data gathering in a single entity is also likely to be much lower than a group with multiple subsidiaries. Solvency II will require each entity to prepare an Own Risk and Solvency Assessment (ORSA) and a Solvency and Financial Condition Report (SFCR), as well as the Report to Supervisors (RTS).

From a capital perspective, companies operating through a single underwriting platform will be able to take advantage of built-in diversification and a consolidated solvency

Figure 1: Trends in restructuring



Source: PwC

1 'Zurich streamlines its legal structure', ZFS media release, 04.12.2009.
 2 'Zurich in talks with FSA as it plans assurance base in Dublin', Independent, 14.06.2010.
 3 'Swiss Re optimises the structure of its legal entities in the EU', Swiss Re media release, 13.03.2007.
 4 114 insurers were polled by PwC at its London Insurance Club on 16.05.2010. The seminar brought together representatives from a broad range of UK-based and international groups.

Challenges for non-EU groups

A number of groups have moved their headquarters to offshore domiciles such as Bermuda. If these jurisdictions are seeking to bring their regulations into line with Solvency II ('equivalence'), companies will need to review the efficiency of their tax and reinsurance arrangements.

Groups based in countries where equivalent discussions continue, notably the US, may still find the group as a whole will have to meet Solvency II requirements and will therefore face higher compliance costs and capital charges than local peers with no EU operations. Such groups might therefore consider setting up an EU-based holding company. Equally, groups that are based in the EU but whose axis is shifting to Asia or the Americas may find that the EU is no longer the most efficient place of incorporation.

requirement. This could result in capital savings of 30% over a group of comparable size operating through around ten subsidiaries, and much greater flexibility of resources.

Tax within most EU jurisdictions is currently based on local regulatory returns. Once these are superseded by Solvency II, the basis for tax calculations will shift to the statutory financial return. With the assumption of risk through underwriting being the key consideration for tax liability, creating a single underwriting platform in a low-tax domicile could generate significant savings.

Weighing up the options

Given the potential benefits, why are so many insurance groups still reluctant to restructure? Moving to a single entity requires a considerable amount of consultation with policyholders and negotiation with regulators, a process that can take at least a year. Such is the weight of demands already imposed by Solvency II, it is understandable that some companies may want to avoid the further cost and demands on senior management of restructuring.

Others are concerned that if serious losses were to emerge in one branch they could bring the rest of the group down with them. In contrast, losses within an individually

incorporated subsidiary would be ring-fenced from the rest of the group. In the current climate, however, it is very unlikely that the EU or its member governments would let a subsidiary sink without the group being forced to step in and therefore the insulation is only nominal.

The other main concern is that policyholders may respond negatively to moving the underwriting platform or place of incorporation. In the restructurings carried out to date, however, brand issues have not materialised, and they are unlikely to be a problem in the future as long as the chosen jurisdiction is recognised as appropriately regulated.

Catalyst for change

There is no one-size-fits-all structure for such a diverse sector as insurance, and restructuring is never an easy option. However, all firms will have to evaluate whether their present capital, cost and tax structures are sufficiently efficient and how they are likely to be affected by Solvency II. If they don't, they could soon face questions about their relative efficiency from analysts or find themselves losing business to lower cost competitors operating with more effective structures.



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