

June 2010 countdown



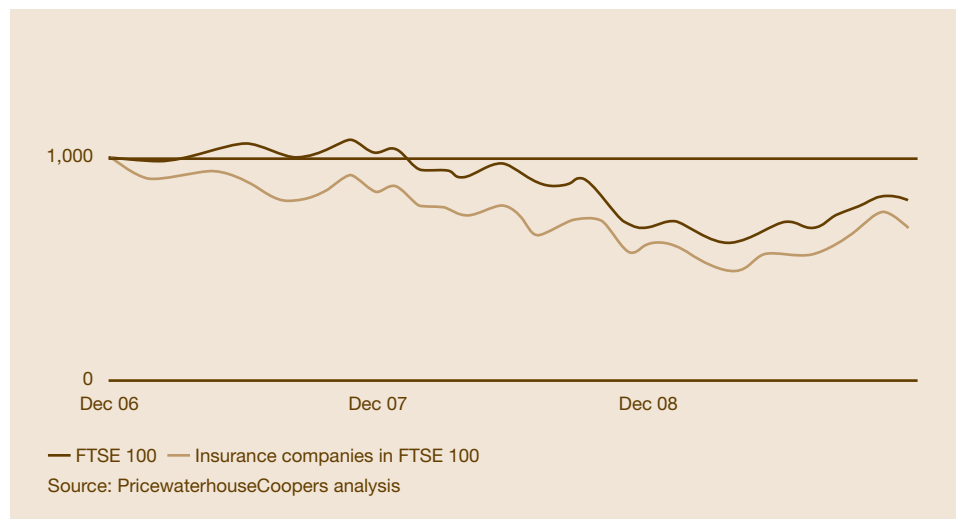
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Where's the benefit? Effective communication in a Solvency II world

Rather than strengthening risk and capital disclosure, Solvency II could lead to a reporting overload. How can insurers strike a balance between meeting regulatory expectations and providing information that would help them to convey the true strength and potential of the business?

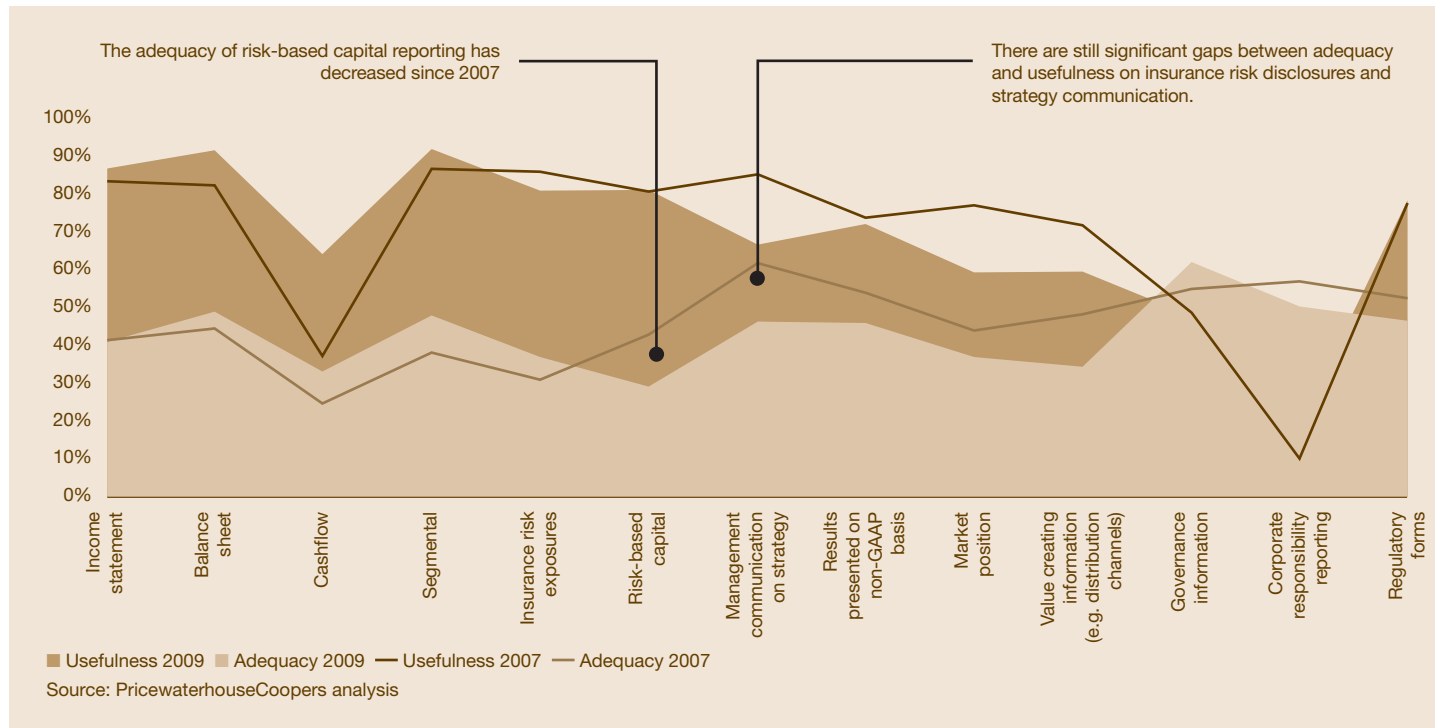
'There's huge room for improvement in reporting in the insurance industry,' said an analyst interviewed as part of a survey of market professionals carried out by PricewaterhouseCoopers in the autumn of 2009.¹ 'It's very difficult to gain a clear economic view of where profitability comes from,' said another participant. The deficiencies in insurance reporting are arguably one of the main reasons why shares in the sector continue to be undervalued and the cost of capital is generally higher than it should be (see Figure 1). PricewaterhouseCoopers' survey highlighted

Figure 1 | Underperforming the market



¹ 'Making sense of the numbers: Analysts' perspectives on current and future reporting in the insurance industry', published by PricewaterhouseCoopers on 25.11.09 (www.pwc.com/insurance).

Figure 2 | Analyst survey 2009: usefulness and adequacy of insurance reporting



particular dissatisfaction with the adequacy of disclosures relating to cash flow, business strategy and risk-based capital (see Figure 2), areas which are coming under heightened scrutiny in the wake of the financial crisis.

Insurers are keenly aware of the importance of effective communications in bolstering ratings and attracting investment. A poll of more than a hundred insurance professionals carried out by PricewaterhouseCoopers in November 2009 found that nearly 90% believe that the quality of reporting affects enterprise value and the amount of capital invested in the industry.² The problem is that insurers have always found it difficult to slice and dice the numbers and convey their profit potential in a way that makes sense to analysts and other stakeholders, especially those that do not specialise in the sector. It is telling that while banks have a range of comparable ratios to convey efficiency and profitability, and other service sectors such as retail have standard indicators such as like for like sales and revenue per square metre, insurance has no such readily comparable performance metric.

The growing stakeholder demands on risk and capital management disclosure can only increase these challenges.

More than 60% of participants in our poll of insurers identified future risk capital and the impact of key risks/stress factors as the areas of reporting in most need of improvement. While the potential impact of risk on performance is an increasingly critical area of market communications and internal management information, few have any more than a limited ability to analyse the risk factors affecting their profitability. Granularity is a particular challenge, with less than 20% of participants able to drill the analysis of their main risk factors down to business unit level.

Enhanced disclosure or more dead trees?

The publicly disclosed Solvency and Financial Condition Reports (SFCR) required under Solvency II Pillar 3 have been seen as an opportunity to enhance the quality and breadth of market communications. However, the implementation measures proposed by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in Consultation Paper 58 (CP58) has attracted criticism as being overly onerous and prescriptive (CP58 attracted more responses than all the other 23 papers issued in July 2009 put together).

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More than half of the participants in our poll of insurers felt that CP58 would put too much reporting in the public domain, and that this will not be used by the market. Only around 30% believe that the proposed disclosure would result in better ratings for those that get it right. The rest either disagreed or did not know, indicating that most are doubtful about the cost benefits of the SFCR. Other complicating factors include the extent to which Solvency II disclosure will be consistent with a future IFRS and how much they will conflict with one another.

The Pillar 3 reporting requirements present particular issues for smaller and unlisted firms. Public disclosure is meant to be proportionate to the nature, scale and complexity of the entity. In keeping with the terms of the framework legislation, it would seem reasonable that a relevant and applicable summary of the privately disclosed Report to Supervisors (RTS) would therefore be sufficient, especially as there is likely to be a limited shareholder base to report to, it is questionable whether policyholders pay attention to such reporting and other stakeholders such as brokers and IFAs have their own separate communication channels. Typical information might include the breakdown of an investment portfolio. If the summary proved to be inconsistent with the RTS or too brief to be of value, supervisors would have ample opportunity to insist on changes. However, under current proposals smaller firms are required to follow an extensive standard template for disclosure. The underlying concern is that proportionality is being treated as a selective concession within the implementation measures rather than a legal right.

While the responses to CP58 do not appear to have had significant impact on the recent guidance issued by CEIOPS to the European Commission, not everything is finalised. In particular, the Commission does not have to accept CEIOPS' advice.

Turning to your advantage

Whatever the Commission decides, there are enough requirements already contained in the framework legislation to ensure that the Pillar 3 reporting requirements will still be taxing. The overriding challenge is therefore how to ensure that implementation forms part of a coherent and cost-effective approach to disclosure. Among the key considerations will be discerning what information is of most value to particular stakeholders and what message and form of reporting would improve their understanding of the company. In seeking to reduce the burden of preparation and underlying risk and capital analysis, it will also be important

to look at how to make the most efficient use of the overlaps between the SFCR, RTS and Own Risk and Solvency Assessment and to avoid inconsistencies between them.

Market leaders are going further by developing new and improved ways (both quantitative and qualitative) to convey how management views particular risks, how they are managed

and how they influence strategy. As Figure 3 outlines, for non-life business this includes looking beyond relatively intangible 1 in 200-type measures to assess the impact of particular risk factors on expected profit. For life business this could include information on how potential variations in areas such as premium loadings and management charges might affect margins. Examples for both sectors

Figure 3 | Insightful analysis (non-life)

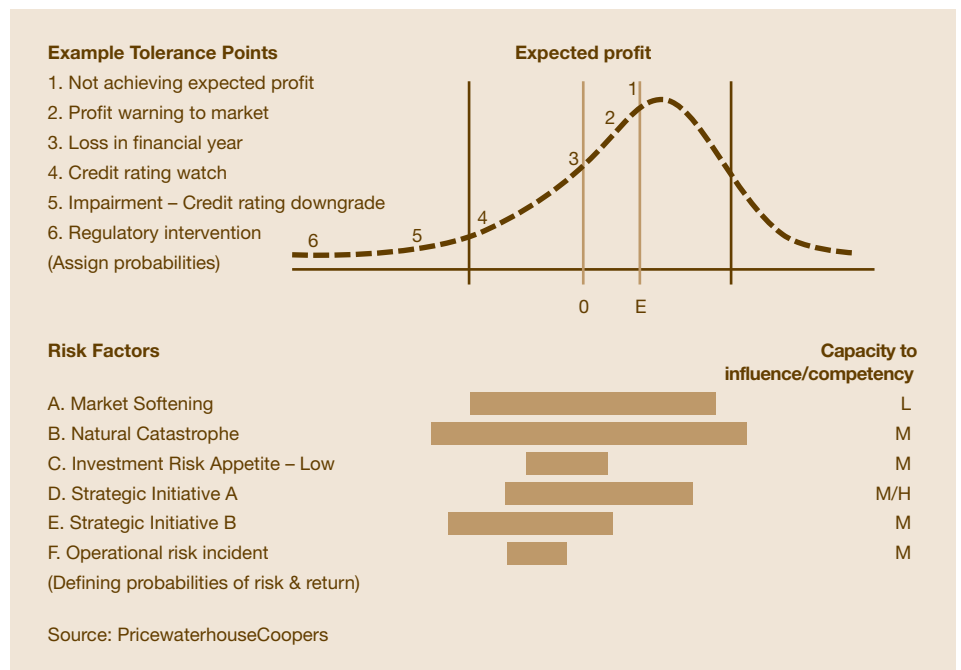
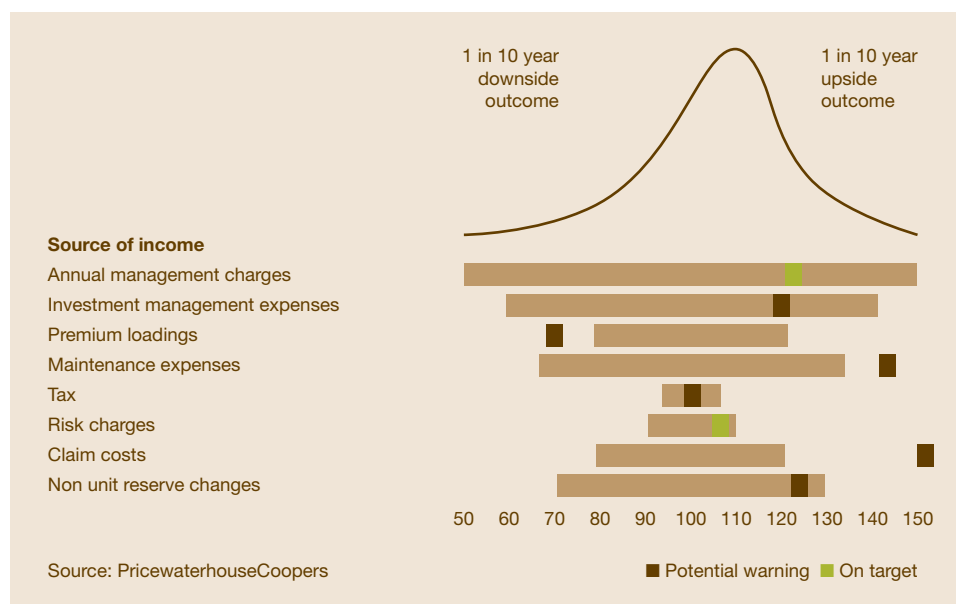


Figure 4 | Insightful analysis (life)



include the key drivers of capital requirements (both economic and regulatory), stress tests/sensitivities being applied by the company, their projected impact and how management would seek to mitigate these. Perhaps the greatest challenge is how to reconcile this analysis to other capital measures and performance metrics. The benefits are the ability to provide analysts and stakeholders with a clear view of how value is being created within the business and how various risks could affect this.

Less is more

Stakeholder communications under Solvency II are likely to be extensive and demanding, yet the benefits are uncertain. For all companies, the best way forward will be a pragmatic approach that addresses what would be of real value to different stakeholders and directs attention to genuinely relevant information about the firm's risk and capital management. Market-leading companies are likely to take this further by developing metrics that bridge risk and performance and seeking to provide a clear explanation of how this affects the management and strategy of the company.

Giving you the edge

PricewaterhouseCoopers is helping a range of insurers to get to grips with the practicalities of Solvency II implementation. If you would like to know more about how to develop effective communications in a Solvency II world, please contact:



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