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What we learnt from over 5000 pages of regulatory disclosure

SFCR

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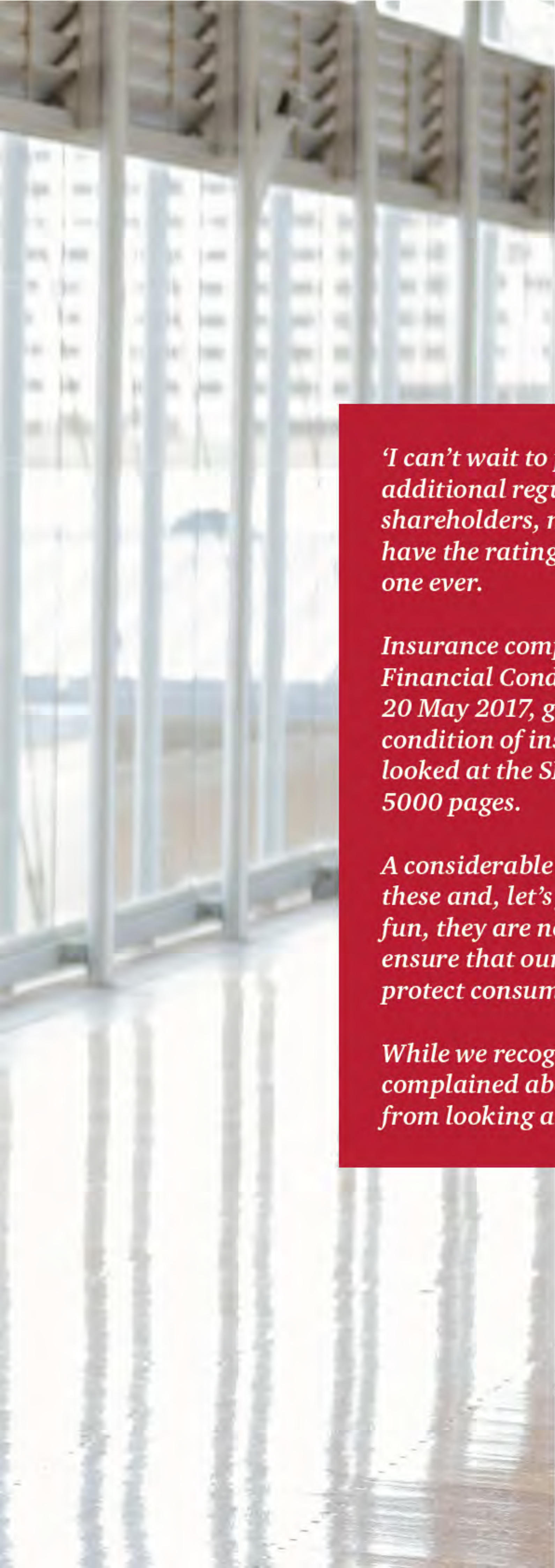


'I can't wait to prepare and file my 100 pages of additional regulatory disclosure that will confuse my shareholders, make my equity analysts', eyes roll, and have the rating agencies spamming my in-box!' – said no one ever.

Insurance companies published their Solvency and Financial Condition Reports ('SFCR') for the first time on 20 May 2017, giving us more insight into the financial condition of insurers in the UK than ever before. We have looked at the SFCRs of 69 UK companies, a total of over 5000 pages.

A considerable amount of work has gone into preparing these and, let's face it, – regulatory disclosures are not fun, they are not supposed to be fun – they are there to ensure that our financial systems remain healthy and protect consumers.

While we recognise the regulatory burden many have complained about, we learnt something very interesting from looking at the big picture data.

SFCR disclosures indicate opportunity for capital optimisation

Yes, that's right: there is an upside. And while some companies have taken a number of measures to optimise their capital position ahead of the mandatory disclosure to ensure compliance and to send a reassuring message out to stakeholders, the numbers show us that there still is significant potential for further capital optimisation under Solvency II.

Potential for capital diversification

There is significant headroom for increased use of both Tier 2 and 3 capital. For the firms covered in this analysis of SFCR data, on average, Tier 1 capital represented approximately 95% of both available and eligible own funds. This includes transitional measures which are considered Tier 1 capital by the regulator. While these high levels of Tier 1 can be explained by Tier 2 debt generally being issued at the holding company level and not by the solo entities, it highlights that there is ample opportunity for solo entities to make use of other forms of potentially cheaper capital, improving their expense base.

However, some firms' Solvency Capital Ratios ('SCR') do rely heavily on the use of transitional measures. Long-term guarantee measures, including the volatility adjustment ('VA') and matching adjustment ('MA') and transitional measure on technical provisions ('TMTP') have had a significant impact on the solvency ratios of firms included in our analysis. Indeed for many firms, removing the MA or TMTP would bring the firm close to, or even beyond, breaching the SCR. This is particularly true for UK annuity writers. However, these transitionals are recognised as Tier 1 capital and dividends can be paid from it. So transitionals or not, it's the same quality of capital.

What is important to note, however, is that the amortisation of TMTP over the coming years will have a significant impact on some insurers and special care will need to be taken that TMTP amortisation profiles are reflected and accounted for in any future capital optimisation plans.

Fig 1: Average composition of available own funds

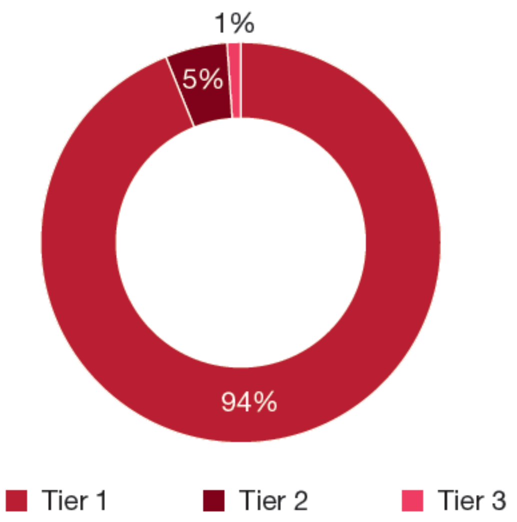


Fig 2: Impact of LTG and transitionals on solvency – Internal model firms

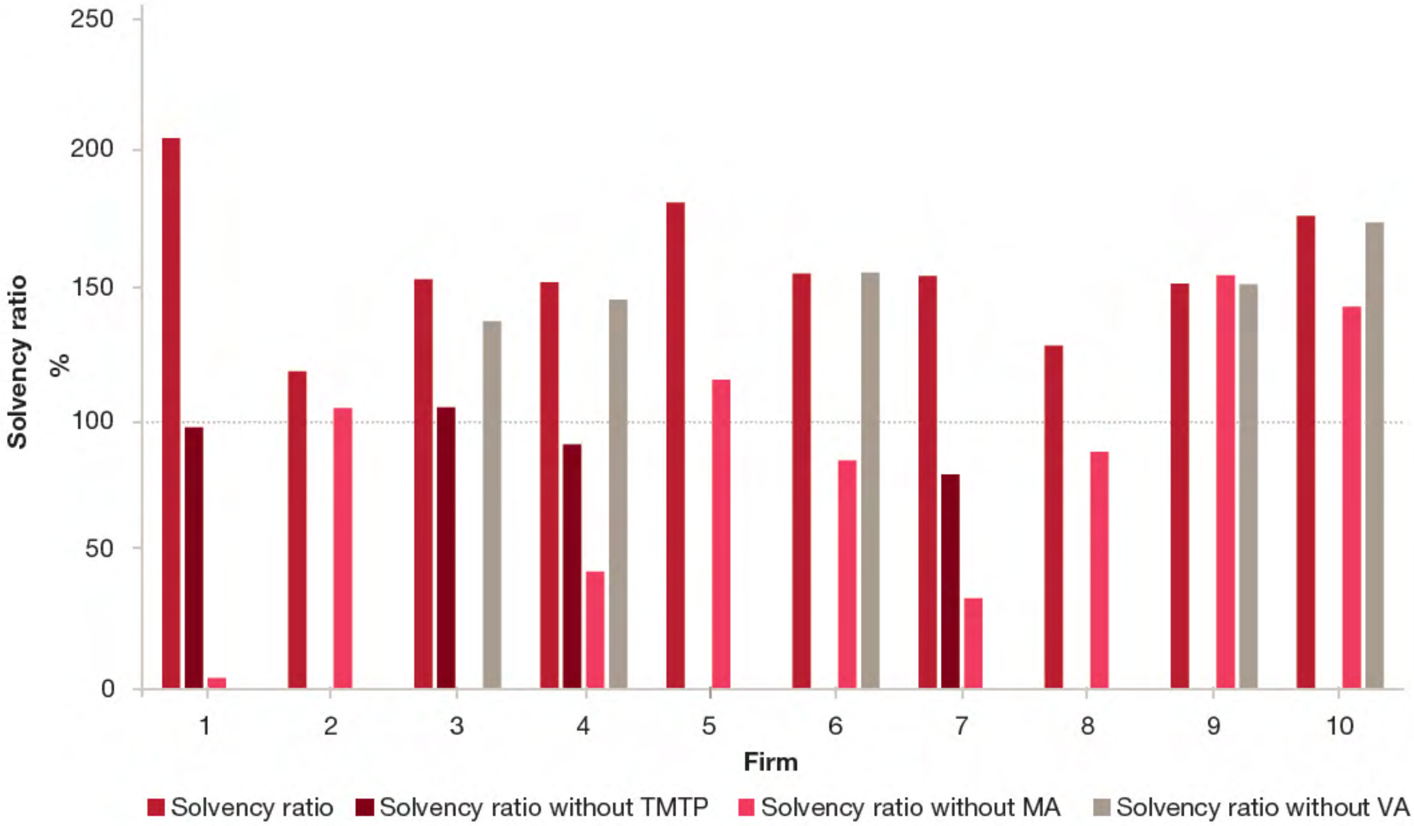
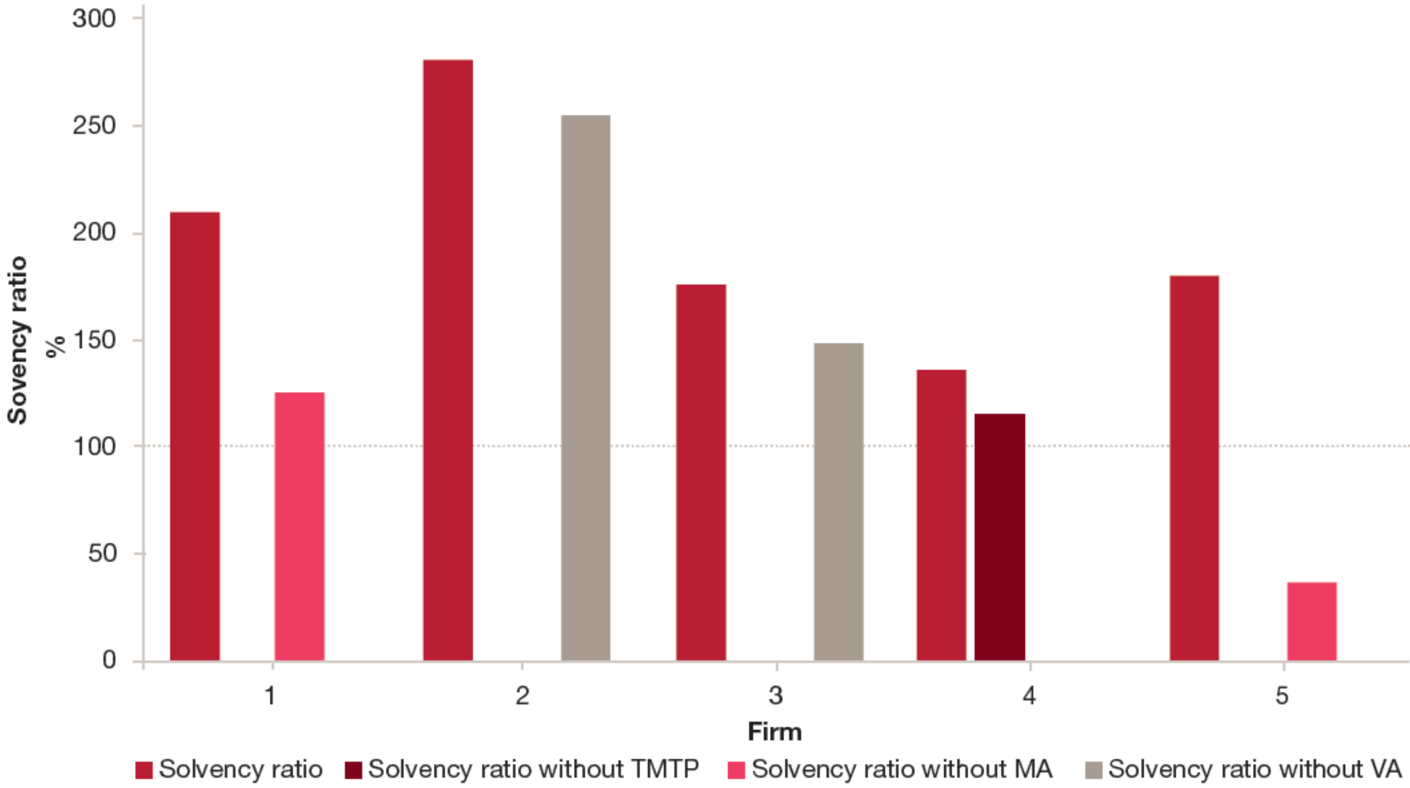


Fig 3: Impact of LTG and transitionals on solvency ratio – Standard formula firms



Ability to improve group capital efficiencies and financial flexibility

Insurance entities have the ability to distribute excess capital to their parent companies and thus increase group capital efficiencies and fungibility at the holding company level. Holding capital at the holding company or group level ensures better control and oversight of group resources, more efficient management of group capital and enhanced financial flexibility, with the potential to reduce risk and costs.

It is expected that SCRs will, however, be more volatile than the equivalent Solvency I metric. The increased volatility in SCRs might therefore warrant a higher capital buffer than previous solvency requirements to ensure solvency capital requirements are met at all times. However, volatility can be better understood and managed through increased and more sophisticated sensitivity testing which will ultimately lead to solo entities finding their optimal level of capital and optimal buffer level.

Opportunity for increased shareholder returns

There is significant potential for increased shareholder returns such as special dividends and further share buybacks for some. Solvency ratios are reportedly very strong, ranging from 150% to 250%. This would indicate that there is substantial headroom for capital returns, depending on firms' respective rating agency capital constraints. While rating agency capital requirements are generally assessed at group level for most, some solo entities are also subject to stand-alone capital evaluations, especially when carrying an AM Best rating.

However, with both S&P and Fitch's capital models being publicly available and AM Best striving to become more transparent, reflected in the recent overhaul of both its insurance methodology and capital model, it has become easier for insurers to look into the 'black box' of ratings and better understand and thus better control and manage their ratings, including required capital.

It is also interesting to note that there is a clear difference between the average solvency ratios for internal model firms and Standard Formula firms, with Standard Formula firms holding considerably more capital on average. We believe that this is partly because of internal model firms having had pre-existing economic capital models in most cases and therefore have better optimised their capital requirements.

Also, there is also a much greater range of solvency ratios among the Standard Formula firms compared to the internal model firms. Whilst this reflects the larger number of Standard Formula firms, it also reflects the more generic nature of the Standard Formula and the fact that it tends to be prone to increased volatility which leads to insurers wanting to maintain higher buffers.

Fig 4: Average solvency ratio by sector

And finally, what about the size of this reporting burden? Well, the most efficient report out of the 69 companies we have looked at came in at only 35 pages, whilst at the other end of the scale the longest was 137 pages.

Most reports fell into a range between 60 and 80 pages. The largest section was section B (System of Governance) with an average of 20 pages while the shortest one was section A (Business and Performance) with an average length of 7 pages.

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