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THE TGP NEWSLETTER: ISSUE 6 – SEPT/OCT 2007

Solvency II – Looking in the right areas?

TGP asks why capital is required at all and presents a fresh approach with application to all types of insurers, not simply highly-diversified multinationals.

Benefits

- *Fast improvement in ROC;*
- *Demonstrably superior Risk Management;*
- *Pricing advantages.*

The New Regime for Fixing Solvency

The generally favourable reception given to this initiative is understandable, although we do wonder if all of the focus is in the right place. Is an excessive interest in capital still taking precedence over proper concern for the control of operational risk?

A few years ago the European regulators looked at a wide selection of insurance company failures, searching for a common thread (Lessons about Risk: Analysing the Causal Chain of Insurance Company Failure – Ashby, Sharma and McDonnell 2003). What they concluded was that the one thing shared by all failed companies was bad management. Some members of the group thought that this conclusion was no more than a blinding glimpse of the obvious, but we believe that it was more then that. Insurance companies fail because they do not conduct their business correctly. They fail in risk selection, or in risk appreciation, or in pricing, or in loss reserving (particularly when legal or social circumstances change), or often a combination of all of these – that is to say in their core business of underwriting. Rare indeed are failures that are due to an ill-advised or mismatched investment programme, for example.

The classic route to avoiding insurance failure up to now, however, has not been to ensure that the business is being properly conducted but to require insurers to carry surplus funding, usually known as solvency margin or regulatory capital, and this often on the basis that more is better. The obvious downside of this attitude is that while a heavy concentration of capital might give regulators comfort, it drives down the insurer's rate of return, possibly leading to internationally uncompetitive pricing or the search for a more favourable regulatory regime.

How far does Solvency II take us from this? First let's look at the three pillars:

- Capital requirements and valuations;
- Supervisory review (operational risk);
- Disclosures.

The Capital Concern

Well capital still comes first, the prize now being how to justify less capital than would have been required under the old system. The prize is, of course, considerable. A reduction in capital produces an immediate improvement in ROC without any need to improve the Insurance Operating Return. Most of what has been seen reported to date, however, amounts to little more than the development of arguments that the total capital needed may be less than the sum of the parts. In other words, if one simply calculates the capital required for each line of business by territory (not that we are suggesting that this is a trifling task) it is then just a question of demonstrating to what extent there is a lack of correlation between these lines/segments in order to argue for some kind of overall capital discount. This may be fairly easy for a true multinational which could claim, quite justifiably, that Japanese earthquake risks are not correlated with German automobile, for example (although there could be a capital contagion issue, of course). But many insurers do not have this degree of diversification and, even for those that do, there is only so far that one can go down this road.

As we have already noted, insurers do not usually go under simply for lack of capital. They fail because of shortcomings in operations. The true key is managing operational risk: how this risk is identified, quantified and, above all controlled. There are plenty of areas where things can go wrong, consider just two: the rogue underwriter and the optimistic claims manager. We do not intend to delve into the root causes of these disorders (just think about 'going for growth' and 'claims leakage programmes') the real question is: why was management not aware of what was happening when it was happening? In all cases the answer is the same: failure to understand, and control operational risk.

The Zero Capital Approach

TGP's Zero Capital approach is radical. It argues that a well-founded and well run insurer needs no capital at all, and seeks to help clients demonstrate their understanding of the risks that they run and how these are controlled by a process of relentless mapping and rigorous rolling analysis, so that things will not go wrong. Mega capital is no solution if the fundamentals are adrift; an obsession with capital is starting in the wrong place.

This is the same argument that says that someone driving a flimsily constructed car with no occupant protection features will drive more carefully than someone in a Hummer. A system of management set up to run as though there is no capital cushion will make for more safety than knowing that there is a big chunk of money to burn. We would argue that an under-capitalised company, making underwriting profits on a consistent basis, is much further from failure than a company with a mountain of capital but losing money on many lines.

Of course we are not suggesting that we will persuade any regulator to accept zero capital but we do aim to show that no capital is actually needed. In this respect we start with pillars two and three and visit pillar one only when operational risk is fully locked down. This approach is appropriate even to a monoline insurer operating in a single territory and carries the same big reward that comes with any regulatory capital reduction initiative.

And The Consumer?

Here we have looked at the matter purely from the insurer's standpoint. Solvency II has generally been seen as good news for consumers, as less capital should mean lower premiums. But does it mean more likelihood of failure if operational aspects are not improved to compensate? We will address this issue in another bulletin.