

Building Momentum

After some initial scepticism, the French insurance market is warming to Solvency II and seeing the business advantages it can bring. But there is still a long way to go according to Stéphane Chappellier of EMB France.

France prides itself in the rich diversity of many aspects of its life and culture. Despite the trend towards consolidation, this remains true of its insurance industry, making it very difficult to generalise about the French market.

Although the top 5 groups account for more than 50% of non-life business, there is also a tremendous range of medium-sized and smaller insurers from niche players to mutuals to bank-owned insurers. All these entities are well established and have quite loyal customer bases, yet there is a big question mark over how Solvency II will affect them. Will they all survive as independent insurers?

As you would expect with such variety, there are many different attitudes among insurers. As a market, it is fair to say that there was some scepticism until quite recently, but that enthusiasm for Solvency II has increased markedly over the past year. There is a growing realisation that it is going to happen and, furthermore, that approaching it in the right way can create business advantage.

Some simple statistics help to illustrate the story:

- The French regulator, ACAM, recently announced that the number of firms taking part this year in QIS 3 (the process where insurers test Solvency II plans and give their feedback) had doubled compared to QIS 2;
- Attendees at regular EMB France seminars stated in June 2007 for the first time, that their firms have plans in place to meet the requirements of Solvency II. Two thirds of these acknowledged, however, that they still need extra work to achieve the goal.

These, admittedly anecdotal, facts underline the impression that France is finally mobilising. It is doing so against a background of increased competition in rates in the non-life market and a steady process of consolidation.

It is a challenging period for all concerned, and fair to say that the quality of response to Solvency II could make all the difference for individual insurers. Whilst some of the smaller entities will be well placed to expand in the new environment, it is hard to avoid the conclusion that, overall, Solvency II will encourage further market concentration as companies seek to achieve size and diversification.

French Revolution

The recent French mobilisation has quite a lot to do with the experience of the QIS exercises, which gave insurers the opportunity to see how the reform would affect them. There is now a widespread appreciation that the change is a lot more than just a substitution of a simplistic Solvency I formula by a more elaborate Solvency II one; it is a real revolution.

Unlike its predecessor, Solvency II tries to reflect the risk profiles of each insurer and the strategies to manage them. The industry is so diverse that a standardised, one-size-fits-all approach will not be able to capture the specifics of individual risk profiles and the strategies used by the regulated companies to mitigate these risks. That is the challenge we now face, and a large portion of the market is not yet fully prepared for it.

More and more insurers have got the message

The diverse impact of Solvency II

Inevitably, the larger the company the more likely it is to be comfortable with Solvency II. Bigger insurers have the resources and technical knowledge to embrace the reforms, and they see benefits. Bigger insurers, and specifically groups, will fully benefit from Solvency II because of the way it favours diversification.

The ability to pool their risks will provide them with capital relief at both group and subsidiary level. Paris remains an important centre for reinsurers, and they have particular reason to be watchful about Solvency II. For the first time, the probability of reinsurer default will be explicitly measured as a form of credit risk. Insurers will, therefore, have incentives to select highly rated reinsurers, making the rating agencies even more important.

French reinsurers welcome the fact that the new regulation provides a value for their diversification and mutualisation of risks. They remain concerned, however, that the new regulation may distort competition in a way that benefits competitors not subject to the requirements of Solvency II.

It is a different picture for the smaller and medium-sized non-life insurance companies and mutuals. They are unlikely to have the same ability to diversify as their larger competitors. They are also less likely to have the resources or in-house expertise to face the organisational challenge that Solvency II will generate. This challenge will be even more crucial for the specialist insurers as they face a potentially massive increase in capital requirements to judge by the experience of QIS3.

However, since almost all the companies in the French market have historically been regarded as over-capitalised, we believe that the main effect of Solvency II will be a reduction in the amount of free capital. SMEs already face pressure to diversify and consolidate, and this will continue, but it will come mainly from market forces rather than specifically Solvency II.

Standard Formula vs. Internal Model

Now that the market accepts that Solvency II is for real, the debate has turned to the best method of implementation. Specifically, Standard Formula or internal model.

Putting it simply, the Standard Formula may appear easier to implement, but it provides a one-size-fits-all formula. It cannot possibly reflect the risk profile and other characteristics of each company. Even less does it take into account the diversity in terms of risk mitigation techniques that companies have implemented. As a consequence, many French companies are giving a closer look to the alternative of an internal model.

Internal models are the complete opposite to the Standard Formula. Although more complex at the outset, requiring more sophisticated risk quantification and risk management techniques, they provide companies with the tools and means to better identify and manage their risk; and thus with a way to prove the efficiency of their risk mitigation techniques and the soundness of their business. More and more companies are willing to take advantage of internal modelling to exploit every centime of their capital.

The bank-insurers - insurance companies owned by banks which have a small market share but a rapidly increasing one - will mostly adopt internal models as their parent companies are already familiar with them, having been through the Basel II process. Specialist companies and mutuals predominantly underwriting long-tail business have also been quick to show an interest in developing an alternative to the Standard Formula. Amongst these companies are the General Liability and more specialised Liability risk underwriters such as Medical Malpractice or, specifically French 10-year construction defect Liability. They are particularly interested in alternative solutions to evaluate Risk Margin and Reserving Risks.

Some smaller and medium-sized French insurers, though, will find themselves in a double squeeze: at a disadvantage both because of their lack of diversity and their use of the Standard Formula. Some will buck the trend and thrive in this new environment, but perhaps not all.

Solvency II: a Business opportunity

To succeed in an insurance market as mature as the French one, with such limited scope for organic growth, requires technical excellence. Solvency II is promoting excellence by encouraging best practice in managerial and actuarial techniques. For this reason, Solvency II should be seen as a business opportunity rather than yet another regulatory burden.

There is now a consensus on the French market regarding the fact that internal modelling is a more appropriate way to:

- Describe and evaluate the real nature of risks
- Take into account the efficiency of risk mitigation techniques
- Understand business interactions.

More and more insurers have got the message. Our own experience at EMB, providing tools and consultancy for non-life insurers and reinsurers, indicates that there is a growing interest in the French market for internal modelling capabilities, and it comes first with the most obvious one the reinsurance optimisation.

Finally, Solvency II appears to be an accelerator of an already on-going transformation of the French insurance market where companies are exposed to new challenges. Success will go to those that treat them as business opportunities.

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Stéphane has over twenty years experience of general insurance, in which time he has worked in personal and commercial insurance as well as reinsurance.



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