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A European tidal wave washes onto American shores: Solvency II and its implications for the U.S. life insurance industry

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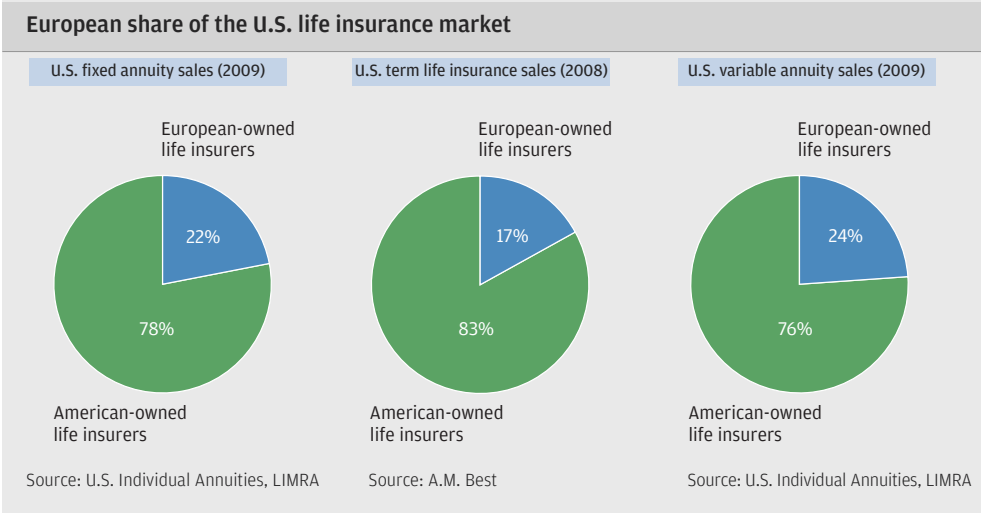
1. A European tidal wave washes onto American shores

On October 31, 2012, Solvency II will come into effect, the outcome of an ambitious nine-year project to comprehensively reform and harmonize insurance regulation across Europe. While its impact has been firmly in the center of European insurers’ radar for the past two years, so far it has not attracted much attention in America. Given the importance of European life insurers to the U.S. market, though, **this is likely to be an important strategic consideration for U.S. life insurers in the coming years.**

It is still unclear how Solvency II will treat U.S. subsidiaries. Most European insurers hope the current treatment will be maintained, and that Solvency II will use U.S. statutory figures in group solvency calculations. Under some proposals, however, Solvency II could dramatically increase the capital requirements of European insurers’ U.S. subsidiaries relative to their domestic competitors. Our estimates indicate that **for some products, the total capital requirement could be up to 12 times higher.**¹ This could effectively price Europeans out of the U.S. market entirely, in particular for some asset-intensive products such as fixed and equity-indexed annuities.

This would have a substantial impact on Europeans’ pricing, product design, investment and hedging strategies going forward. With a ~20% market share in almost every major U.S. life insurance product category, Europeans’ capital woes would probably reverberate widely across the industry.

Figure 1

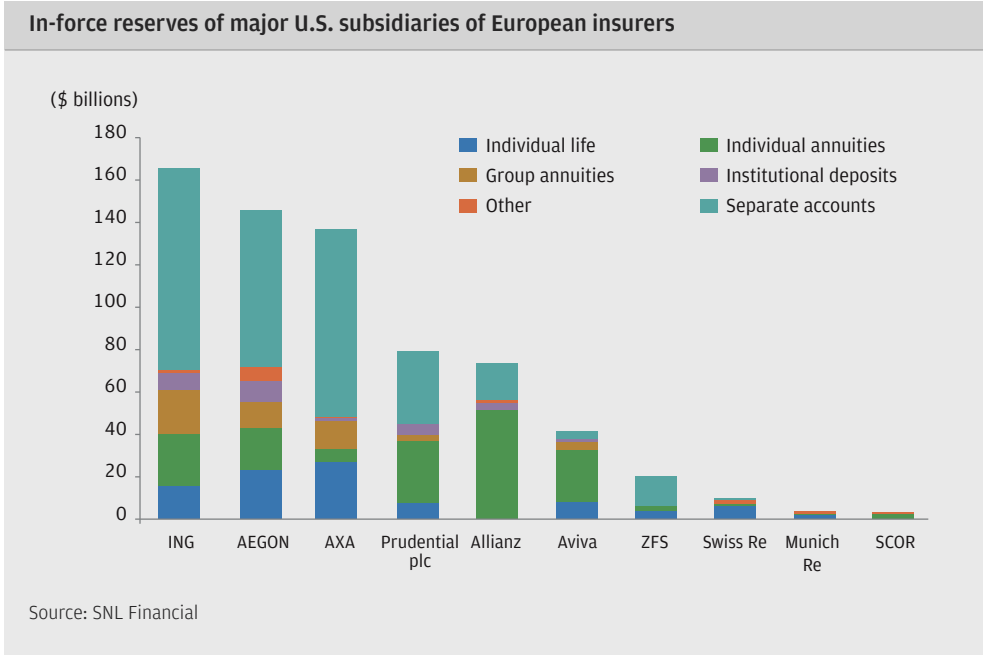


If these proposals were to pass, Solvency II would likely also trigger a wave of corporate activity. At year-end 2009, European insurers’ U.S. subsidiaries had total statutory reserves of ~\$670 billion, including individual annuity general account reserves of ~\$160 billion, individual life reserves of ~\$95 billion, and separate account reserves (including variable annuities) of ~\$320 billion. **This is likely to create significant opportunities for life reinsurers;** however, the size of the inforce blocks in question is likely to overwhelm current reinsurance capacity—in particular, for products such as annuities, where the reinsurance market is not significantly developed at present. As a consequence, **many European insurers may be forced to pursue all possible alternatives, including sales, carve-outs and spin-offs of subsidiaries, or redomiciling.**

¹ Total capital requirement is defined here as total asset requirement over economic reserves.

While many European insurance companies may feel it is worthwhile waiting until there is more clarity on the treatment of U.S. subsidiaries, given the number of potential sellers, there is likely to be a first mover advantage. **Solvency II should be a top priority consideration for anyone considering strategic acquisitions in the coming years.**

Figure 2



EXECUTIVE TAKEAWAY

Pending the European Commission’s final determination on the treatment of U.S. subsidiaries, Solvency II is likely to have a transformational impact on European insurers’ U.S. life subsidiaries. With Europeans holding ~20% of U.S. market share and ~\$670 billion in U.S. life reserves, this could have a powerful impact this side of the Atlantic. If Europeans are required to apply Solvency II capital requirements to their U.S. subsidiaries, it is likely to be one of the key drivers of product pricing and design, as well as increased strategic corporate activity in the U.S., in the coming years.

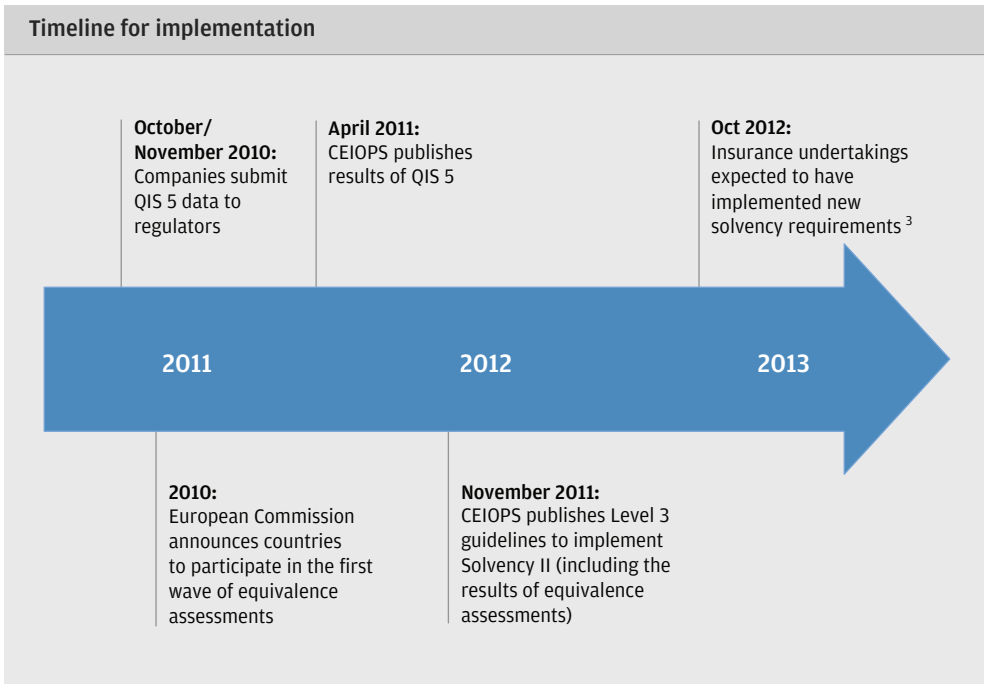
2. Solvency II overview

In many ways, the adoption of Solvency II is analogous to the migration from Basel I to Basel II for banks—indeed, regulators have conceptualized Solvency II as bringing insurance regulation to parity with Basel II. Like Basel II, Solvency II will rest on three pillars: quantitative requirements (Pillar I), supervisory overview (Pillar II) and disclosure (Pillar III). While Solvency I uses a factors-based approach to measuring capital, **Solvency II will use a fully risk-based economic capital model** (Pillar I), and will allow the use of internal models, subject to regulatory review (Pillar II). In addition, for the first time, **Solvency II will prescribe a consistent valuation basis for technical provisions (i.e., insurance liabilities) across the European Union.**

Unlike the regulatory framework of the National Association of Insurance Commissioners (NAIC), Solvency II looks, among other things, to a company’s ability to raise capital to meet any shortfalls. Therefore, unlike U.S. statutory accounting principles (SAP), which attempt to evaluate a legal entity’s solvency position on a stand-alone basis using a conservative rules-based approach, **Solvency II looks at a company’s overall financial position on a market-value basis.** In this respect, Solvency II harmonizes the new European regulatory approach with that employed by both capital markets and IFRS.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is currently conducting its fifth and final Quantitative Impact Study (QIS 5) to assess the impact of the current Solvency II proposals on the European insurance market.² Based on the outcome of this study, it will be providing more detailed guidance for implementation in November 2011.

Figure 3



² Although QIS 5 is officially still the final QIS, there is discussion of a QIS 6.

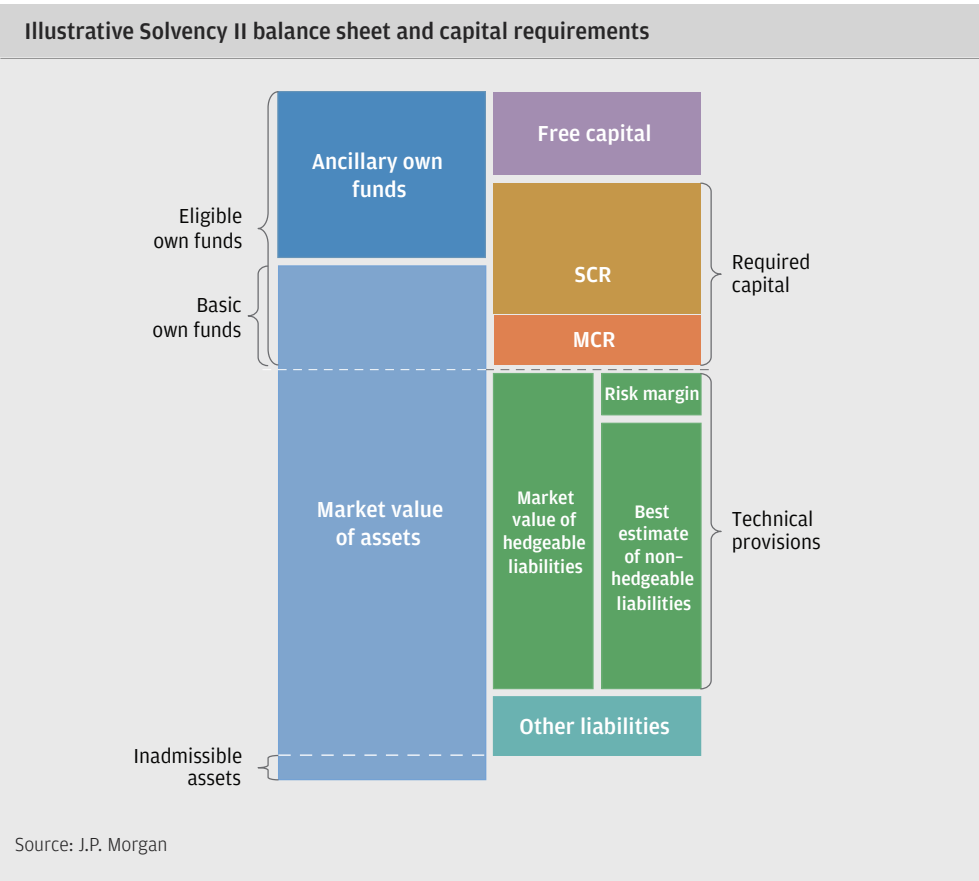
³ Although October 2012 is officially still the implementation date, there is discussion of pushing back the timetable to January 2013.

3. Overview of quantitative requirements

To meet its quantitative requirements under Solvency II, an entity must have enough eligible own funds to meet its Minimum Capital Requirement (MCR), below which threshold the entity would be seized by regulators, and Solvency Capital Requirement (SCR), below which the entity must present a plan to regulators for its recapitalization. **The MCR is set to meet a group or entity’s 85% VaR over one year, while the SCR is set to meet a 99.5% VaR over one year.**

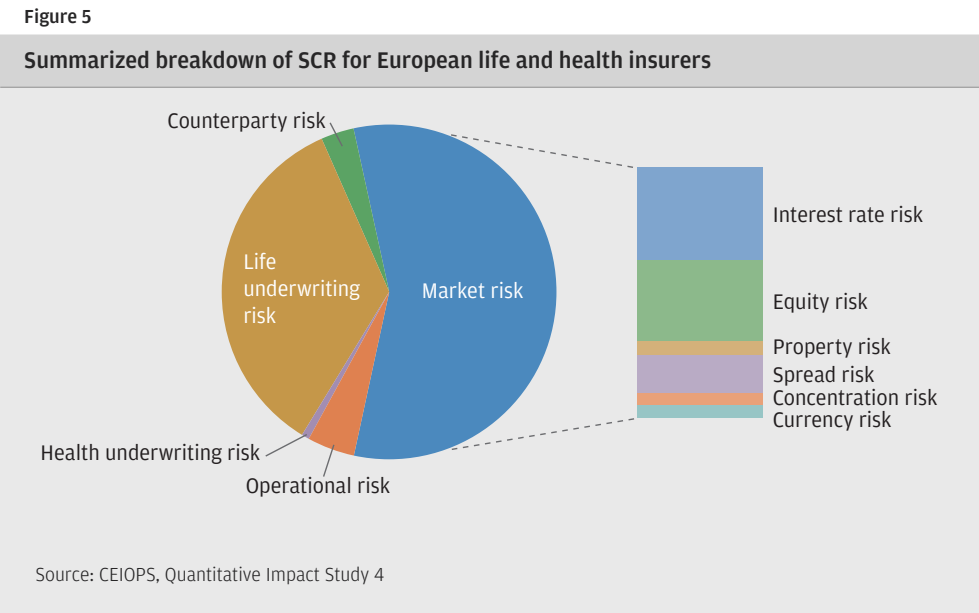
Eligible own funds are the sum of basic own funds (the excess of assets over liabilities on a market value basis, *plus* subordinated liabilities) *plus* ancillary own funds (other sources of contingent or hybrid capital e.g., letters of credit and guarantees). The use of market values to calculate basic own funds is expected to substantially increase the volatility of companies’ solvency positions compared to cost accounting-based regimes, such as U.S. statutory accounting and NAIC RBC.

Figure 4



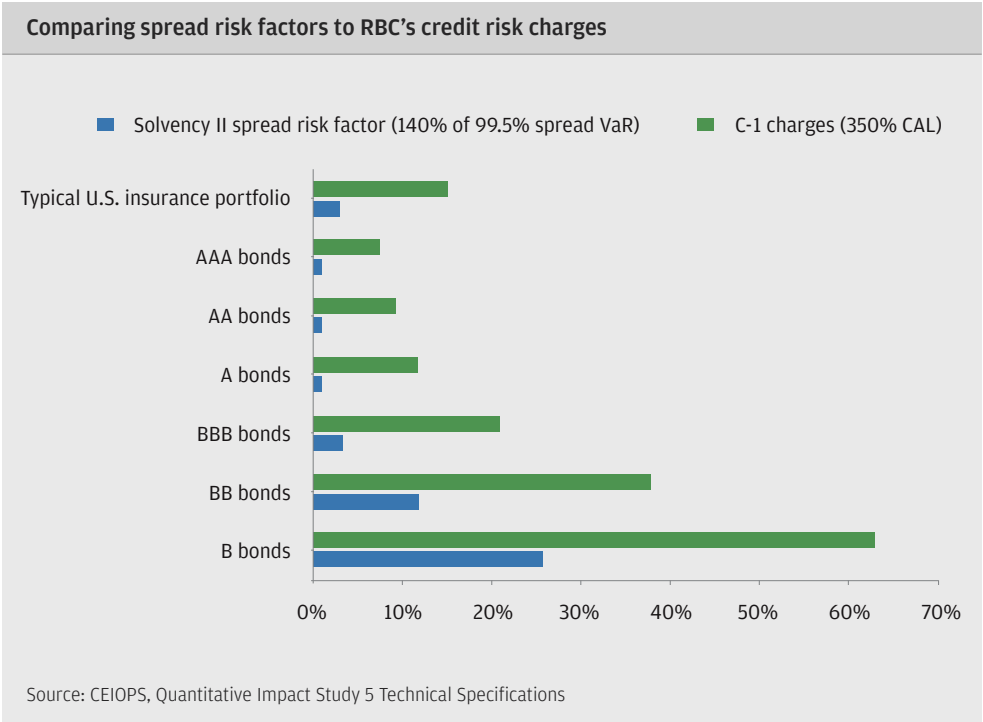
The calculation of MCR and SCR includes all material risks, and takes into account risk mitigation techniques and risk diversification across product lines, asset classes and risk categories. **Either a standard formula or an internal model can be used for this calculation.**

The SCR is calculated on a “delta NAV” approach: in each scenario (whether stochastic in an internal model or prescribed when using the standard formula), an insurer must determine the change in net asset value (i.e., assets minus liabilities). For life and health insurers, the scenarios are calibrated based on five risk modules: life underwriting risk, health underwriting risk, market risk, counterparty risk and operational risk. **In QIS 4, market risk accounted for around two-thirds of the SCR for European life insurers.**



Market risk is further broken down into interest rate risk, equity risk, property risk, concentration risk, currency risk, illiquidity risk (for liabilities) and spread risk (for fixed income securities). Spread risk is likely to have the largest impact on U.S. subsidiaries, due to their substantial investment in fixed income securities, and the fact that **the stress calibrations are over four times more severe under Solvency II than under NAIC RBC for a typical fixed income portfolio** (see Figure 6, next page). Unfortunately, the use of an internal model will likely not solve this problem: most observers believe the difference between internal models and the standard formula will be less for market risk than for the other risk modules.

Figure 6



For the other risk modules, companies should be given broad latitude to make specific adjustments based on their experience, product mix and design. Nevertheless, in the early years (for benchmarking purposes) they will also be required to show regulators their calculations based on the standard formula.

EXECUTIVE TAKEAWAY

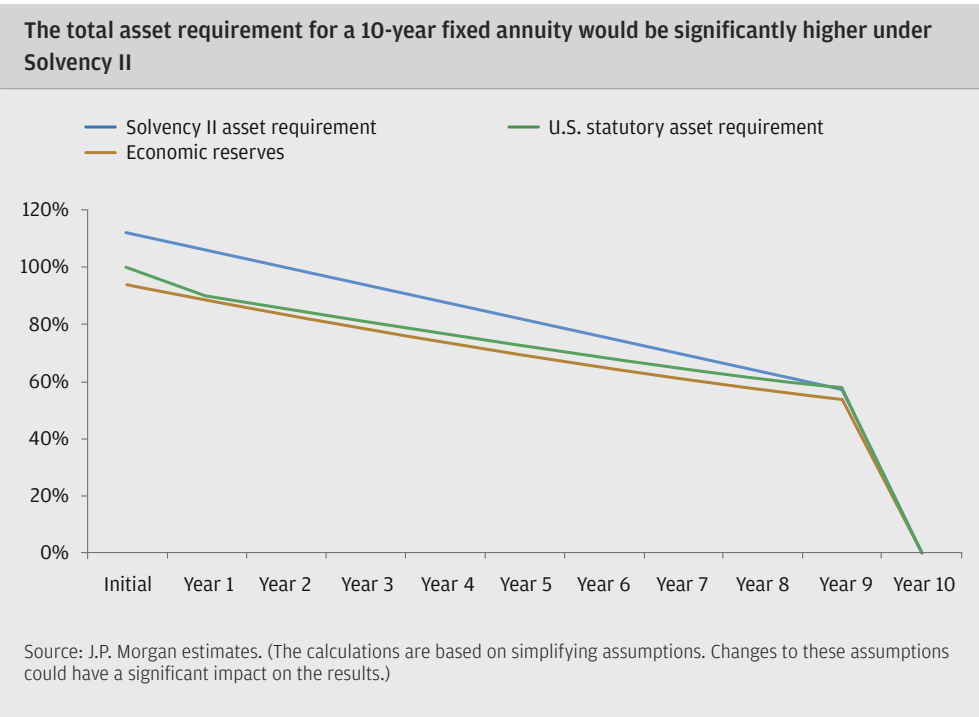
Market risk is expected to account for the majority of the capital requirement of European life insurers. Of this, spread risk is likely to have the biggest effect on U.S. subsidiaries. This is likely to have a significant impact on the strategy of these companies with respect to any asset-intensive business.

4. Impact on specific products

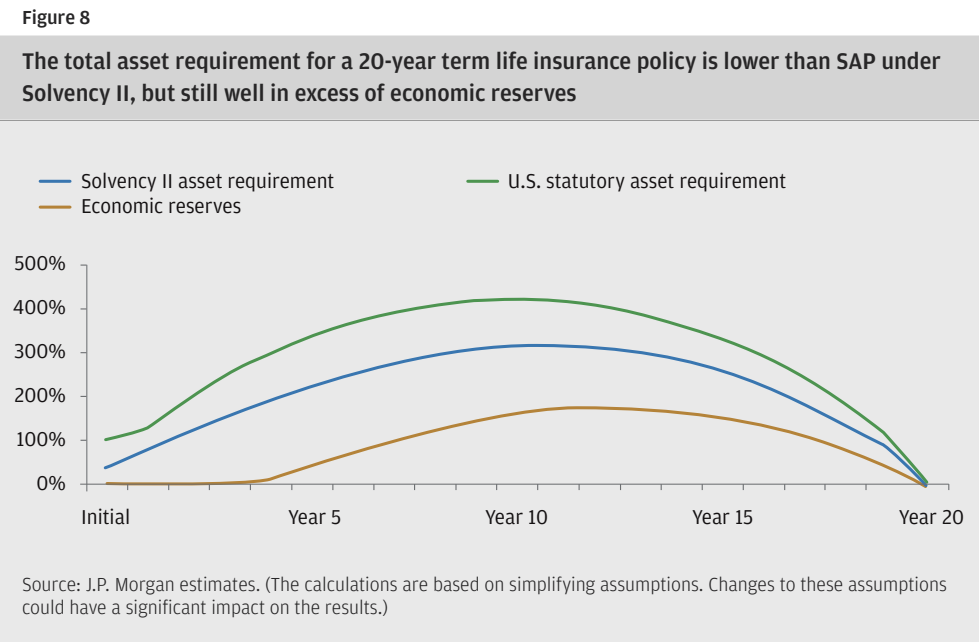
The impact of Solvency II will vary significantly based on product and design. We have performed some illustrative calculations based on the standard formula to evaluate the impact for several of the most popular products sold by life insurers in the United States.

Fixed annuities: We expect fixed annuities will be the product most impacted by Solvency II (assuming Solvency II calculations are applied to U.S. subsidiaries)—the capital requirement (total asset requirement over economic reserves) is 1.5 to 12 times higher than required under NAIC RBC. Not only do fixed annuities have a large amount of inherent spread risk; unlike other asset-intensive products, they typically have no mortality margin to absorb the capital impact. In addition, the reinsurance market into which Europeans could offload their substantial existing exposures is limited at this time.

Figure 7



Term life insurance: Term life insurance is significantly less asset intensive, leading to total asset requirements that are 20%–65% lower than under U.S. statutory requirements. This is largely due to the very prudent reserve levels under Regulation XXX. However, U.S. life insurers often meet these XXX reserve needs with debt or recourse financing solutions, whose benefit may now be materially lessened for their European-owned competition: the group SCR associated with the recourse mechanism may offset the SCR reduction from any recourse XXX solution.



Variable annuities: The impact on variable annuities is less clear at this time. Although both Solvency II and U.S. SAP/RBC use principles-based approaches, there are substantial differences. First, while Solvency II looks at VaR, the U.S. approach looks at Conditional Tail Expectation (sometimes known as Tail VaR), which is significantly more sensitive to tail risks. Managing capital to both metrics, as well as to IFRS, is likely to pose a significant operational challenge to European VA writers. Second, while Solvency II looks at market inputs, the U.S. approach is based on actuarial estimates of intrinsic value, typically based on long-term historical means—for example, for equity volatility, Solvency II would use implied volatility, while the U.S. looks at historic volatility. Third, though it is unclear how Solvency II will recognize the effectiveness of dynamic hedging programs, it is likely to be substantially different than under the U.S. framework (VA CARVM and C-3 Phase II). **Currently, it is not apparent which approach (if any) will lead to higher capital requirements, but there is likely to be significant tracking error over time.**

EXECUTIVE TAKEAWAY

The impact of Solvency II will likely be most dramatic for asset-intensive businesses. Nevertheless, European life insurers will likely have to rethink their strategy for all products, as they all will be affected.

5. Application to U.S. subsidiaries

The treatment of U.S. subsidiaries will be driven by two key determinations. The first determination, made by the European Commission, will be whether the United States is an equivalent solvency regime. If the United States is not given equivalence, **U.S. subsidiaries would have to calculate their SCR as if they were a European company, while still having to meet local regulatory requirements.** In addition, it is unclear whether they could get an internal model approved, forcing them to use the standard formula.

In our view, **it is unlikely that the United States will be given equivalence by the time Solvency II is implemented.** CEIOPS has indicated that conducting an assessment by then would be challenging, pointing to the lack of a single U.S. insurance regulatory authority with which to work. The NAIC has been aggressively lobbying CEIOPS, however, to include the United States in its initial wave of equivalence assessments. The NAIC has underlined that many of CEIOPS' concerns would be addressed by the NAIC accreditation process, the Dodd-Frank Act and the Solvency Modernization Initiative. While CEIOPS continues to express doubts about the feasibility of such an assessment, it has agreed to heed the European Commission's guidance on this point. CEIOPS has also indicated it will propose a transitional regime until it makes an equivalence determination.

An assessment will have to contend with the significant differences in approach—in particular, CEIOPS has flagged **the absence of group supervision** in the United States as a major stumbling block to overcome. Because of this, it is far from clear what the outcome will be.

The second determination will be the permitted methods to include U.S. subsidiaries in the group solvency calculation. Solvency II's founding directive expresses a preference for the group solvency calculation to be based on a consolidated view of the organization; however, it allows for it to be based on an alternative method where consolidation would not be appropriate. If the consolidation method was prescribed, U.S. subsidiaries would have to hold as much capital as if the United States were not deemed equivalent. If the alternative method was allowed, though, and the United States was deemed equivalent, U.S. subsidiaries could be added to their parents' group solvency calculations based on statutory figures. **In this case, the impact of Solvency II on U.S. subsidiaries could be fairly muted.**

Regardless, rules regarding the consolidation of own funds will make it much more challenging for European companies to manage their international capital allocation. Solvency II only allows companies to credit their group solvency position with own funds available to the group within 12 months—in combination with U.S. dividend restrictions, this could lead to the inadmissibility of most of the excess capital remaining in the U.S. subsidiaries.

EXECUTIVE TAKEAWAY

There is still extreme uncertainty over Solvency II's long-term impact. If the EC and CEIOPS allow the use of U.S. statutory figures in group solvency calculations, the impact may well be fairly muted. If not, the impact will be dramatic.

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