


The shark lurking under Solvency II



There is a shark circling the good ship run-off, beneath the surface of Solvency II. Patrick Nolan, deputy chief actuary with Pro, says the group capital

requirement threatens to scupper the business model for run-off acquirers

This article concerns a shark lurking in the sea of Solvency II. It threatens to attack the life rafts provided by the specialist run-off industry and may, taken to its logical conclusion, result in the ship-wrecks of distressed companies being left to sink on their own.

And yet it is a threat that has so far been largely ignored. Until recently, I encountered a general feeling that it could not be the case. It appears, 



however, that the threat is real even though, as I hope to show, I believe that it goes against the Financial Services Authority (FSA)’s fundamental principle of protecting the policyholder. But what is this lurking menace?

Set-up

In order to understand the problem, it helps to consider a simple example. But first it is crucial to understand the motivation of a specialist acquirer of run-off. Why is this actively traded in the first place?

Suppose an acquirer of run-off has two companies in run-off, A and B. They each have reserves of 100 and they each have capital requirement of 50. Furthermore, suppose each company actually has assets of 175.

Each company, then, has a balance sheet that looks like this:

Assets	175
Liabilities	
Reserves	100
Capital requirement	50
Excess capital	25

Each company can now look to release their excess capital of (up to) 25 meaning the owner of the run-offs can make a total payment to shareholders of (up to) 50.

As payments and commutations are made (at the expected reserving level), the capital requirement reduces. The freed capital then also becomes available for extraction.

This gradual release of capital (capital extraction) is the basis for the market in run-off. If company A is bought for less than its total capital of 75 (ie. 50 + 25) then the aim over time will be to release the total capital of 75 quickly enough to justify the acquirer’s return on the price they have paid.

For example, an acquisition price of 50 and releases of 25 in year one, 15 in year two, 10 in year three and five in years four to eight gives a return on capital of 15.6 per cent¹

¹ This is given by the rate of interest j that solves:
 $50 = 25/(1+j) + 15/(1+j)^2 + 10/(1+j)^3 + 5/(1+j)^4 + 5/(1+j)^5 + 5/(1+j)^6 + 5/(1+j)^7 + 5/(1+j)^8$. The answer to that equation is $j = 15.6\%$ – try it and see!

The lurking shark

Suppose the run-off specialist is interested in buying company C, a large and distressed insurer. Imagine that company C has reserves of 1000 and a capital requirement of 500.

But this company only has assets of 1250. This might be typical of a large company that has suffered serious distress, for example through systemic historic problems in its reserves – exactly the kind of company a regulator should want a specialist run-off manager to acquire and bring back to health!

Company C has the following balance sheet:

Assets	1,250
Liabilities	
Reserves	1,000
Capital requirement	500
Excess capital	-250

This shortfall in its capital should not be a problem to the acquirer. The company is still solvent and, run off correctly, should ultimately yield releases of 250 (ie. 1,250 assets less 1,000 reserves), which should have a value to the acquirer.

But here comes the shark. Its name: ‘group capital requirement’.

Solvency II requires groups to calculate and maintain a group capital requirement too. The actual group capital requirement will depend on the level of diversification between the companies within the group, but it’s a mathematical certainty that it will be at least as large as the largest individual company’s capital requirement, which in this case is 500.

For the sake of illustrating the point, we will suppose that the group capital requirement is 550 (more than 500 but less than the sum of the individual capital requirements of 50 + 50 + 500).

The group balance sheet after acquisition will look like this:

Assets	1,600
	(175 + 175 + 1,250)
Liabilities	
Reserves	1,200
	(100 + 100 + 1,000)
Capital requirement	550
	(as above)
<hr/> Excess capital	<hr/> -150

So at the group level, the combined entity fails to meet its capital requirement test. This would mean no company in the group – including A and B – will be able to extract any capital!

So what? Isn't this providing long term security to policyholders?

I would suggest not, at least not in this case. A, B and C will typically be completely separate companies acquired from completely independent original carriers, with absolutely no legal ability to make calls on each other's capital. They merely happen to have been gathered under the overall umbrella of a single specialist professional dismantlement unit.

The whole notion of the group capital requirement in such circumstances has no logical consistency because even if C fails, there is nothing A and B can do about it. There is no more capital to come to company C – it will always just have to make do with what it has. This is precisely why it needs a specialist manager in the first place.

The purpose of a group capital requirement should be to protect the policyholders of live insurers. For example, it stops live insurers getting round capitalisation problems with old books by setting up new subsidiaries. For such purposes, it is good regulation. But where we have completely independent companies that merely happen to have been gathered under the banner of the same group via acquisition, there is no logic for forcing a group requirement onto them.

The end of the endgame?

This group capital requirement means that those companies regulators have

wanted, and should want, specialists to acquire and manage will be exactly the same companies specialists will have to avoid at all cost! This is because they could prevent the specialist from extracting ANY dividend from ANY group-owned company, even if these are perfectly overcapitalised from their portfolio. This would obviously be an unacceptable situation for the professional run-off managers and owners.

Run-off acquirers will have serious problems in acquiring large distressed run-offs. To do so will essentially prevent them from pursuing their capital extraction business plan for the entire rest of their group! It will be many years before a carefully managed company C reaches a healthy enough state to mean that the group as a whole passes its group capital requirement and so can extract from the heavily overcapitalised A and B. In fact, A and B may essentially have no liabilities left at all by the time their capital can be extracted.

Far from being just a theoretical example, this is a situation that we know very well. When Tawa acquired CX Re, it had reserves of \$2 billion and would have fallen well short of a Solvency II capital requirement. Through careful management, it clung on to its solvency – even through a period that turned out to be more difficult than anybody had anticipated – and, ultimately, emerged as a resilient run-off.

Thanks to hindsight, we now know with cold, hard certainty that without the actions undertaken by Tawa, CX Re would most definitely have become insolvent.

But under Solvency II, neither Tawa nor any other specialist player could have taken over CX Re. It was so massive (the second largest run-off after Equitas in the London market at that time) that it would have swamped the rest of the business and prevented the operation of the extraction business plan for years to come.

So the CX Re policyholders would

have lost out. They would have become policyholders in an insolvent company. How is that in their interests? How can that possibly sit with Solvency II's aim to first protect policyholders?

Nor is this restricted to the EU. The group requirement acts across the whole group, for any companies that sit below any EU holding company. That means if an EU parent buys a US run-off subsidiary, the US company becomes part of this group capital requirement. Even distressed US carriers start to impact the extraction from totally independent EU sister companies.

What can we do?

This is not an issue which appears to be solely in the FSA's hands. If it were, and given the perfect understanding the FSA has of the benefits of professionally managed dismantlement of run-off books, it could be dealt with rationally. Unfortunately the waters in which we are all fishing are part of the Solvency II Directive. Given the potential severity of the consequences, however, I would like to think that there is still time for the insurance sector in general, and the run-off sector in particular, to lobby EIOPA to have the group requirement revised to take these concerns into account.

Failing that, it would seem that the only option for an acquirer is to contain the problem within the EU by ensuring the parent is not EU-regulated and that all EU risk carriers are funnelled into a single EU holding company. This still leaves recently distressed EU insurers in the position of being left to sink alone. However, at least it means that the run-off specialists can concentrate their efforts beyond the EU without ultimately being fed to the sharks. ●