

# Solvency II and Its Impact on Discontinued Business in Non-Life Insurance

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## Abstract

In order to harmonise regulation of insurance industry and to increase protection of policyholders, the European Commission has adopted a Directive on the taking-up and pursuit of the business of Insurance and Reinsurance, known as Solvency II. One of the most important innovations of the Directive is introduction of a risk-based solvency model, according to which insurers are required to allocate capital against certain categories of their risks. This results in higher capital charge for many firms. The impact of the upcoming rules on the live insurance market has been discussed at length by academics as well as practitioners. However, Solvency II also affects the inactive business i.e. the business, underwriting of which for various reasons has been discontinued (so-called run-off). This paper seeks to provide a discussion of the upcoming Solvency II regulation model highlighting its impact on discontinued business in non-life insurance industry. Accordingly this article uses analysis of the current and upcoming solvency legislation together with relevant literature and various secondary data.

It is shown that the impact of the Solvency II on discontinued insurance goes beyond the capital requirements. The rules of regulatory supervision and disclosure also have serious ramifications. Thus, apart from generating little to no profit for insurers, a run-off portfolio under Solvency II creates additional pressure on company's capital and human resources. Consequently passive management of discontinued business is no longer a feasible option for majority of the undertakings. Most of them therefore will be forced to seriously deal with their run-off books, often for the first time. As a result the demand for active run-off management and exit options is likely to increase.

Understanding the implications of Solvency II will facilitate the choice of mechanisms for managing discontinued business and underline the importance of proactive dealing with run-off. Considering the lack of attention to the topic of discontinued business, current article is aimed to trigger academic discussion by setting the basis for further discourse.

## Introduction

The First Directives, coordinating solvency regulation on the EU level, were adopted in the 1970s.<sup>1</sup> They set the basis for minimum harmonisation of insurance rules in order to decrease the differences in national legislation of the member states. Despite their numerous revisions, it became evident during the reform of the insurance legislation in 2002 (known as Solvency I<sup>2</sup>) that the current Directives did not provide a necessary level of harmonisation and protection for policyholders. Therefore it was decided to conduct a full-scale review of the existing rules. As a

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<sup>1</sup> First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance [1979] OJ L 63/1 (No longer in force); First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance [1973] OJ L 228/3.

<sup>2</sup> Directive 2002/12/EC of The European Parliament and of The Council of 5 March 2002 amending Council Directive 79/267/EEC as regards the solvency margin requirements for life assurance undertakings [2002] OJ L 77/11 (subsequently repealed by the Directive 2002/83/EC of The European Parliament and of The Council of 5 November 2002 concerning life assurance [2002] OJ L 345/1 (Life Directive)) and Directive 2002/13/EC of The European Parliament and of The Council of 5 March 2002 amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life insurance undertakings [2002] OJ L 77/17 (Non-life Directive).

result, the Directive, known as Solvency II, was adopted in 2009.<sup>3</sup> According to the latest amendments it will fully<sup>4</sup> enter into force on January 1<sup>st</sup> 2016.<sup>5</sup> Among the numerous changes, the Directive introduces market-consistent valuation of assets and risk-based capital requirements for the companies. This means that insurance undertakings will have to back their risks by additional capital. The riskier the company's profile is the more capital it will have to hold to cover its exposure.

The new legislation does not only affect the life insurance industry but also discontinued business. In relation to insurance the term 'discontinued business' or 'run-off' means a part of business underwritten in the past, for which there are still existing obligations (actual and potential insurance liabilities), but no new business is underwritten and in most cases it no longer generates premium income.<sup>6</sup> Under the upcoming rules majority of insurers will have to allocate additional capital to cover the risk exposure of their discontinued business, resulting in higher capital charge for some companies. The firms are expected to actively resort to the tools for managing of run-off portfolios in order to minimise their risk exposure, consequently increasing the importance of such tools. In order to fully understand the issue of managing a run-off portfolio, it is necessary to realise the full extent of implications of Solvency II for discontinued business.

There has been a lack of interest from the academic community to the issue of run-off. It is mostly discussed by practitioners in the studies of the discontinued insurance market<sup>7</sup> and some of the loss portfolio managing options.<sup>8</sup> Additionally certain firms issue brief consultations on the possible effects of the capital requirements of Solvency II for run-off.<sup>9</sup> On the academic level there are only a few papers more or less directly addressing the topic. For example, a couple of articles analyse various exit mechanisms in the run-off market<sup>10</sup> while more recent ones concentrate on the issues pertinent to Germany<sup>11</sup> or German-speaking countries in general.<sup>12</sup> There are also studies investigating particular tools for managing loss portfolios, which however do not discuss the issue of run-off itself in detail.<sup>13</sup> Even though some of the mentioned works talk about the impact of Solvency II on discontinued business, their discussion does not reach beyond the analysis of impact of capital requirements.

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<sup>3</sup> Directive 2009/138/EC of The European Parliament and of The Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance [2009] OJ L 335/1 (Solvency II).

<sup>4</sup> Strictly speaking, some of the provisions of the Directive are already in force, for example the rules on transposition of the Directive into the national laws.

<sup>5</sup> Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority) [2014] OJ L 153/1 (Omnibus II Directive).

<sup>6</sup> Darag, 'Where does Run-off occur?' <www.darag.de> accessed 24 February, 2015.

<sup>7</sup> See for example PWC, *Unlocking Value in Run-Off: A Survey of Discontinued Insurance Business in Europe* (8th ed, 2014) and previous editions; KPMG, *Run-off survey 2010: Run-off in property/casualty insurance and reinsurance in Germany, Switzerland and Austria* (KPMG, 2010); KPMG, *The KPMG UK Run-off survey: Non-life insurance* (KPMG, October 2012).

<sup>8</sup> Quane A et al, 'Loss Portfolio Transfers. 2002 GIRO Working Paper' (2002) General Insurance Convention; Hartington A et al, 'Managing a business in run-off' (1995) General Insurance Convention.

<sup>9</sup> Endres K and de Galhau V, Solvency II and the capital charge for run-offs (2010) <www.axa-lm.com> accessed 21 February 2014.

<sup>10</sup> Carter S, Bailey B and Butcher T, 'Exit Strategies in the Run-Off Market' (2006) 56(2) FDCC Quarterly 219; Jean Kwon W et al. 'Can Insurance Firms Easily Exit from the Market? A Global Comparative Analysis of Regulatory Structures' (2005) 30 The Geneva Papers on Risk and Insurance - Issues and Practice 268.

<sup>11</sup> Paetzmann K, 'Discontinued German life insurance portfolios: rules-in-use, interest rate risk, and Solvency II' (2011) 19(2) Journal of Financial Regulation & Compliance 117.

<sup>12</sup> Eling M and Pankoke D, 'Discontinued business in non-life insurance: an empirical test of the market development in the German-speaking countries' (2014) 4(1) European Actuarial Journal 31.

<sup>13</sup> See for example Ho LC, 'Solvent Schemes for Insurers - A Touch of Class and Jurisdiction' (2006) 3(1) International Corporate Rescue 14 November 2014; Mäntysaari P, 'Erkännande av ett försäkringsbolags solvent scheme' (2013) 2012/13(3) Juridisk Tidskrift 582; Bugler N et al, 'The Future of Solvent Schemes of Arrangement for Insurance Run-Off' (2006) 13(1) Journal of Reinsurance 29.

Thus there is a clear need for more research of the issue. Understanding the impact of Solvency II on run-off will bring to the spotlight the value of exit mechanisms and facilitate their choice according to each company's situation. After all, it is necessary first to understand the issue in order to be able to provide any recommendations for solutions. The practical importance of the topic is also illustrated by the size of the European non-life run-off market, which according to the latest survey is EUR 242 billion, a EUR 7 billion increase comparing to the previous year.<sup>14</sup> Considering that the European insurance industry is the largest in the world<sup>15</sup> the impact of the upcoming legislation deserves a closer attention.

This paper uses the analysis of the upcoming rules and existing literature, combined with the experience of practitioners (reflected in reports and surveys analysing the market) in order to outline the impact of Solvency II on discontinued business in non-life insurance. It offers a hypothesis that the consequences of the new rules will reach well beyond the increase in cost of capital. Furthermore, the goal of this article is to stimulate further academic discussion about run-off business and provide possible directions for future research. Additionally the discussion presented in this paper is likely to be useful for insurance practitioners willing to better understand the impact of Solvency II on their insurance business.

The remainder of the paper is organised as follows. In order to facilitate the understanding of the new rules, Section 2 presents a brief introduction of Solvency II regime. Section 3 provides the discussion of the impact of Solvency II on discontinued business. Section 4 summarises the discussion and outlines possible directions for further research.

## **Solvency II: new rules for the insurance business**

The new full-scale solvency reform introduces a large number of changes to the insurance regulation and has a wide impact not only on the business inside EU but also worldwide.<sup>16</sup> While it is not devoid of certain shortcomings, its introduction has received a general support from the industry.<sup>17</sup> The main drivers for adoption of Solvency II are the following:

- to improve policyholder protection;
- to enhance financial stability in Europe;
- to take a step towards a single market in insurance supervision by moving to a maximum harmonising approach;
- to bring the existing regime fully up to date so that it rests on a set of modern risk-sensitive principles and requirements.<sup>18</sup>

Solvency II has adopted a three-pillar structure, drawing on the experience of Basel II regulation in the banking sector.<sup>19</sup> The first pillar focuses on the capital requirements, the second deals with governance of the undertakings and their supervision, and the third concerns the transparency and public disclosures of insurance companies.

### *Capital requirements*

Solvency I employs a fixed-ratio model where company's capital requirements are calculated based on the amount of its technical provisions. For non-life firms the solvency capital requirements are determined based on annual amount of premiums or average claims for the past three years, depending which one is higher.<sup>20</sup>

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<sup>14</sup> PWC, *Unlocking Value in Run-Off: A Survey of Discontinued Insurance Business in Europe* (8th ed, 2014).

<sup>15</sup> Insurance Europe, *European Insurance — Key Facts* (August 2014)

<<http://www.insuranceeurope.eu/uploads/Modules/Publications>> accessed 14 April 2015.

<sup>16</sup> See for example Vaughan T M, 'The implications of solvency II for US Insurance regulation' (2009-PB) Networks Financial Institute Policy Brief 03.

<sup>17</sup> It should be noted, however, that Solvency II is still being often subjected to criticism on theoretical as well as practical levels. Some of this critique will be presented in the following chapters.

<sup>18</sup> Solvency II (n 3), Preamble.

<sup>19</sup> Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version* (2006).

<sup>20</sup> Non-life Directive (n 2) art 16(a).

Solvency II changes this approach introducing a market-consistent valuation of the whole balance sheet together with applying a risk-based model. Consequently the capital requirements largely depend on the riskiness of company's profile – the higher the risks a firm is underwriting, the more capital it needs to have to back them. The purpose of the new model is to stimulate proactive risk management and reduce the chances of failure. In practice that means greater capital charges for some companies, especially those where lines with relatively low volume of premiums contain high risk policies. As a result the importance of efficient capital allocation and management increases substantially.

#### *Governance and supervision of undertakings*

The second pillar addresses the issues related to supervisory matters of insurance firms, their internal and control systems as well as governance, the so-called 'qualitative requirements'. It defines the Supervisory Review Process carried out by the member states' supervisory authorities. The process is aimed at ensuring firms' compliance with requirements of the Directive, identifying the undertakings with deteriorating financial conditions and monitoring how such weaknesses are dealt with.<sup>21</sup>

Additionally the Pillar II promotes an effective governance system and requires companies to have written policies in relation to their risk management, financial and actuarial functions, among others.<sup>22</sup> As a part of the effective risk management component undertakings are required to carry out their own risk and solvency assessment (ORSA). It reflects company's own view on its risks profile and financial situation. The assessment's implementation is decided by every firm based on the specifics of their business. During the ORSA companies have to evaluate their compliance with calculations of technical provisions and solvency capital requirement (SCR), among others, on a continuous basis.<sup>23</sup>

In general the second pillar is intended to monitor the financial health of the undertakings enabling a prompt discovery of any deterioration which should be subsequently remedied by the companies themselves or by supervisor-imposed measures.

#### *Supervisory reporting and public disclosure*

The Pillar 3 ensures the transparency of undertakings' insurance activities. To achieve this goal the firms are required, apart from submitting to the supervisory authorities the information necessary for the purposes of supervision, to publicly disclose report on their financial condition and solvency. The report has to be disclosed at least annually in either printed or electronic form.<sup>24</sup> In case the disclosure will result in the company's competitors gaining significant undue advantage or the firm is bound to secrecy and confidentiality by its agreements with policyholders or other counterparties, the undertaking may be exempted from the obligation to disclose such information.<sup>25</sup>

#### *Summary*

The list of features of Solvency II presented above is by no means exhaustive and only indicates the most important innovations, relevant for the discussion in this paper. However, it is already evident that Solvency II represents an all-encompassing fundamental reform of the EU insurance regulation. As any project of such a scale it has received a fair amount of criticism from the opponents. The main issues raised were the extra complexity of the rules, especially those related to the calculation of solvency capital requirements, inherent uncertainty of the norms and high costs of the new risk assessment models.<sup>26</sup>

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<sup>21</sup>Solvency II (n 3), art 36.

<sup>22</sup>ibid art 41.

<sup>23</sup> ibid art 45.

<sup>24</sup>ibid art 51.

<sup>25</sup>ibid art 53.

<sup>26</sup>See for ex Eiling *et al*, 'The Solvency II Process: Overview and Critical Analysis' (2007) 10 Risk Management and Insurance Review 69; Andrew Haldane, 'The dog and the frisbee'. Speech at the Federal Reserve Bank of Kansas City's 366th economic policy symposium, "The changing policy landscape", Jackson Hole, Wyoming, 31

However, the arguments of some of the opponents are based only on the analysis of the first pillar and do not take into account the fact that all the three pillars are blended into direct framework creating a holistic approach to the insurance regulation. Therefore the limits of one pillar are covered by the advantages of another. While it is true that certain provisions of Solvency II are extremely complex, the further guidance and consultations aim to solve those issues. For instance, according to the feedback received during The Fifth Quantitative Impact Study (QIS 5), the determination of SCR for counterparty default risk was perceived by a majority of companies as ‘extremely laborious and complex’.<sup>27</sup> However, as a result of the consultations the complexity of the calculation has been reduced, although not completely. The same can be said about the uncertainty of the rules which is gradually eliminated by further guidelines and delegated acts.

Despite of the criticism, compared to the existing rules, the new regime will offer a higher level of regulatory harmonisation and increase protection of policyholders, forcing insurers to better understand the risks they are underwriting and allocate sufficient resources to cover them. Moreover greater risk awareness and management is expected to increase Europe’s competitiveness on the international insurance market.

## **Implications of Solvency II for discontinued non-life (re)insurance business**

### *Definition of discontinued business*

Insurance companies face situations where they have to stop underwriting all or certain lines of their business. The reasons for that vary, the most popular being the shift to other business segments, exit from the lines with low profitability or complete exit from the insurance market.<sup>28</sup> Even though non-life insurers in such cases may not receive premium income anymore, the known claims and claims incurred but not reported (IBNR) have still to be settled. Thus the companies are obliged to keep sufficient amount of technical provisions to cover those claims. Such discontinued lines of business are often referred to as ‘run-off’. Run-off is considered completed when all the existing claims have been settled and no new ones are expected.<sup>29</sup> It should not be confused with a run-off triangle used to estimate expected future claims.<sup>30</sup>

Run-off, or discontinued business, sometimes is also referred to as ‘legacy’ or ‘inactive’ business. On the other hand practitioners sometimes use the term ‘run-off’ to describe a part of discontinued business which is being proactively managed.<sup>31</sup> For the purposes of this paper, however, all four terms are used as synonyms.

Considering that the research of insurance run-off business is a relatively new field and only a handful of academic works address the subject directly or incidentally, there is no strict definition and classification of ways to manage it. However, based on existing practices and studies, certain approaches to managing it can be determined.<sup>32</sup>

Legacy business can be managed passively, when a company deals with claims as they arise without any proactive attempts to decrease the size of the portfolio. On the other hand, active management requires certain actions from a firm to decrease the size of discontinued portfolio and achieve finality sooner than its natural course. It can be done internally (in-house) by the company itself or externally involving third parties. There are numbers of ways for that, most important of which are commutations, schemes of arrangement, loss portfolio transfer or reinsurance. The detailed discussion of each method is outside of scope of the current paper and is left for future research.

August 2012; Alberto Floreani, ‘Risk Measures and Capital Requirements: A Critique of Solvency II Approach’ (2013) 38 *The Geneva Papers* 189; ‘Solvency II uncertainty. A reality.’ (*Solvency II Wire*, 13 October 2014).

<sup>27</sup> EIOPA ‘Report on the fifth Quantitative Impact Study for Solvency II’ (EIOPA-TFQIS5-11/001 2013 (QIS5)) 76.

<sup>28</sup> Casualty Actuarial Society, ‘The Business of Run-Off’ (2011) <[www.casact.org](http://www.casact.org)> accessed 24 February, 2015.

<sup>29</sup> Darag (n 6).

<sup>30</sup> Eling M and Pankoke D (n 12).

<sup>31</sup> KPMG, *Run-off survey 2010: Run-off in property/casualty insurance and reinsurance in Germany, Switzerland and Austria* (KMPG, 2010).

<sup>32</sup> See *ibid*; ‘Maximising Run-Off Strategies’ *Insider Quarterly* (Spring 2006)

<[http://www.insiderquarterly.com/assets/\\_files/documents/jan\\_10/ii\\_1264613260\\_Maximising\\_Run-Off\\_Strategies.pdf](http://www.insiderquarterly.com/assets/_files/documents/jan_10/ii_1264613260_Maximising_Run-Off_Strategies.pdf)> accessed 28 March 2015; Eling M and Pankoke D (n 12) for various classifications of the run-off management options.

According to the latest survey the size of the non-life legacy market in Europe alone is EUR 242 billion.<sup>33</sup> It has been characterised by a continuous growth in the last years and by growing focus in the continental Europe. Due to its massive market size and increased importance the impact of Solvency II on the run-off industry becomes a relevant topic for many companies.

### *Impact of Solvency II on discontinued business*

This section highlights the ramifications of Solvency II for discontinued non-life insurance. In order to provide a better structure, the impact of each pillar is analysed separately.

#### Pillar I (Quantitative requirements)

Probably the most tangible effect on the run-off industry will have the capital requirements of Solvency II. According to Solvency I, as discussed before, the SCR for non-life insurance is determined based on the higher of premium and claim indices for the past three years. Since run-off portfolios as a rule have low volume of premiums, the claims burden is mainly relevant. If a company has sufficient reserves it can effectively cover requirements for run-off portfolios without large amounts of extra capital.<sup>34</sup> This will be changed by the new rules.

Pursuant to Solvency II the available capital position of a company (assets minus the market consistent value of liabilities) is compared to the risks of the policies it underwrites. Those risks must be supported by a capital, the amount of which is quantified according to a separate formula for each kind of risk.<sup>35</sup>

Solvency II is presumed to require majority of insurers to hold more regulatory capital, and capital of a higher quality, compared to Solvency I. While there is no definitive answer, a couple of recent studies support this assumption. For instance, Gurenko and Itigin, using a sample portfolio with five lines of business and disregarding market, operational and default risks, estimate that the new capital requirements will be approximately 40% higher than the current ones.<sup>36</sup> On the other hand, Eling and Pankoke use an example of a company with three lines of business to estimate SCR for non-life premium and reserve risk.<sup>37</sup> According to their calculations a company with a premium income of EUR 1 000 and reserves of EUR 2 000 will have SCR of EUR 1 565. Under Solvency I the same company would have had SCR of EUR 321. However, it should be noted that their study did not take into account the effects of diversification and reinsurance, which would result in lower capital requirements.

Although there is definitely a need for more empirical studies of the issue, a certain indication of higher capital requirements is nonetheless present. It is safe to assume that ultimately the level of the increase will depend on the particular characteristics of each company's business.

A logical step for the firms facing an increase in their capital charge would be to reassess their ongoing insurance business and transfer the lines with low profit or put them into run-off. An indication of that is the feedback from the industry naming Solvency II to be one of the most important drivers for restructuring in Continental Europe in the next five years.<sup>38</sup> However, for the companies discontinuing certain lines of their insurance business, passive run-off may not be a suitable option since having discontinued business on a balance sheet is likely to attract a disproportionate capital charge.

If a company discontinues certain lines of business but still keeps them on the balance sheet, it has to back those run-off liabilities, as any other liabilities, with sufficient capital. However in case of run-off this does not generate any respective benefits since the amount of premiums received is much lower or even non-existent compared to live business. Additionally, according to the risk-based model, portfolio volatility, large amount of long-tail liabilities or

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<sup>33</sup> PWC (n 14).

<sup>34</sup> Labes H, 'A Trigger for Consolidation' (2011) 36 Run Off & Restructuring 16.

<sup>35</sup> Solvency II (n 3), Annex IV.

<sup>36</sup> Gurenko E and Itigin A, 'Reinsurance as Capital Optimization Tool under Solvency II' (2013), Policy Research Working Paper 6306, <[openknowledge.worldbank.org/handle/10986/12188](http://openknowledge.worldbank.org/handle/10986/12188)> accessed 28 March 2015.

<sup>37</sup> Eling and Pankoke (n 12) 44-45.

<sup>38</sup> PWC (n 14) 14.

poorly rated reinsurers<sup>39</sup> increase capital charge even further. Regarding a run-off portfolio, its charge may get extremely disproportionate tying up large amounts of capital which could otherwise be spent on developing new businesses or improving the current ones.

There are a number of practical examples proving this point. Eling and Pankoke, as a part of their study mentioned above, show that the proportion of non-life run-off business is 23.3% of the total Solvency II capital requirement with the entire value of discontinued business alone almost equal the whole SCR under Solvency I.<sup>40</sup> Furthermore one company conducted its own assessment of capital requirements for run-off portfolio under the upcoming rules. According to their calculations capital charge of a run-off portfolio under Solvency II could be ten times higher than under the current regime.<sup>41</sup> The similar sentiment is expressed by other practitioners<sup>42</sup> and the industry in general, where according to the most recent survey 57% of respondents (a 10% increase from the previous year) stated that Solvency II is likely to raise the cost of capital for run-off business.<sup>43</sup>

There is a clear need for more quantitative research estimating the impact of Solvency II on run-off business. However, due to sophisticated nature of Solvency II standard formula and large number of factors that have to be accounted for, the results are likely to vary significantly depending on characteristics of different portfolios. Nevertheless, despite not taking into account all the factors contributing to calculation of capital requirements, the studies discussed show how discontinued business may contribute to the increasing of the cost of capital.

### Pillar II (Qualitative requirements)

Whereas the impact of quantitative requirements on discontinued insurance is pretty straightforward, Pillar II implications are not that clear from the first glance.

First of all, one issue of run-off, especially if it is very advanced, is that it is often managed by a limited staff. Therefore it may be a challenge to find a person for an internal audit or any other risk-management function and employing somebody just for this specific task is not efficient either. As a result some of the staff responsible for the live businesses may be diverted to attend to the discontinued lines, disrupting the normal flow of company's operations.

Moreover, if the relevant insurance business is old, which is quite often the case for portfolios in run-off, there could be an issue of getting access to the data due to the limited availability of the records. For example in case those records were paper based they may be problematic to locate. Alternatively they can be in a poor condition. Additionally older data can be incomplete or less reliable and the staff with a direct knowledge of the portfolio or responsible for the data may no longer be working at the company for various reasons. All these issues make dealing with run-off business for the purposes of Pillar II and in general quite challenging.

As a part of the pillar's risk management component companies are required to carry out their own risk and solvency assessment (ORSA), discussed previously. Although it is not used to calculate capital requirements<sup>44</sup> and therefore does not directly result in higher capital charge, the insurers will have to estimate the uncertainty associated with the future value of their assets and liabilities and their potential changes. In this case having a run-off portfolio, especially of high volatility and with long-tail liabilities, complicates an overall analysing process and drains more administrative resources from a company. For example, the recent evidence shows that some companies are already facing challenges with obtaining asset data for ORSA purposes.<sup>45</sup> Considering that ORSA has to be conducted at

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<sup>39</sup>The counterparty default risk (Solvency II art 105(6)) is largely affected by the rating of insurers' counterparties. See: Swiss Re, 'What do you know about Solvency II? High-level introduction for interested parties from Non-EU regions' (2013) 18 for the analysis of a relationship between the rating of reinsurers and the SCR.

<sup>40</sup>Eling and Pankoke (n 12).

<sup>41</sup> Endres and de Galhau (n 9).

<sup>42</sup> Labes H (n 34).

<sup>43</sup> PWC (n 14) 18.

<sup>44</sup> Solvency II (n 3) art 45(7).

<sup>45</sup> Solvency II Wire, Regular Meeting Group report <[www.solvencyiiwire.com/solvency-ii-wire-regular-meeting-group-report-october-2014](http://www.solvencyiiwire.com/solvency-ii-wire-regular-meeting-group-report-october-2014)> accessed March 4 2015.

least annually<sup>46</sup> the indirect financial costs and resource demands of the process might become too burdensome for some firms.

Another component of Pillar II is the supervisory review process (SRP) which comprises the assessment by supervisory authorities of insurers' compliance with various provisions of Solvency II.<sup>47</sup> Among others, the authorities conduct assessment of compliance with the rules for calculation of technical provisions and capital requirements.<sup>48</sup> The Directive does not define the frequency of the process, leaving it to the authorities to establish it together with the scope of the review. In case following the SRP a supervisory authority concludes that company's SCR does not represent a correct illustration of its risk exposure due to the nature of the firm's risk profile, it may impose a capital add-on on such company.<sup>49</sup> The calculation of the add-on has to ensure the compliance with the SCR. This results in a higher capital charge for the undertaking, meaning an increase in capital requirements for run-off portfolios as well. Additionally in this case having a discontinued portfolio with a deviant risk profile on a balance sheet might be the main reason for the capital add-on. Consequently it is possible to assume that discontinued business increases a chance of supervisory intervention. After all, the less number of risks a company is exposed to the less is the possibility of error in calculations and deviations from the SCR.

### Pillar 3 (Reporting standards)

The implications of the Pillar 3 requirements on discontinued business are probably the least discussed. The main elements of the pillar are supervisory reporting and public disclosure. Accordingly companies have to submit to supervisory authorities all the information necessary for the purposes of supervision.<sup>50</sup> This also concerns the information related to run-off portfolios. Thus the impact of supervisory disclosure on the legacy business is the same as for any other portfolio and complications may arise only if the information concerning run-off portfolios is hard to obtain or systematise.

On the other hand, the role of public disclosure is quite different. According to Solvency II insurance and reinsurance undertakings shall disclose publicly information relating to their solvency and financial condition. Such report shall contain, among others, descriptions of company's business, risk exposure, technical provisions and their methods of valuation.<sup>51</sup> The discontinued business has to be reported as well. Therefore if a company has put a significant part of its business into run-off, it will be reflected in the report and is most likely to send a negative message to policyholders, which can result in a loss of clients (current and potential) as well as general deterioration of financial position. As a result maintaining reputation becomes one of the main challenges for insurers with run-off portfolios, as was demonstrated by the results of the recent survey.<sup>52</sup> This hypothesis is an interesting subject for a further research, which could investigate the policyholders' reception of a company's decision to discontinue certain lines of its business and possible financial implications of such decision.

Moreover, rating agencies are conducting their assessments based on the information obtained during public disclosures. The impact of run-off portfolio on company's rating is at best neutral, considering such portfolio is well managed.<sup>53</sup> Furthermore, according to Solvency II, as was discussed above, having poorly rated reinsurers, results in higher capital charge for insurance firms through the counterparty default risk. As a result run-off portfolios not only create additional reporting obligations, but also may have serious financial and reputational consequences for the firms.

*Specific implications for the non-life (re)insurance companies solely in run-off*

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<sup>46</sup> EIOPA 'Final Report on Public Consultation No. 14/017 on Guidelines on own risk and solvency assessment' (2015), EIOPA-BoS-14/259.

<sup>47</sup> Solvency II (n 3) art 36(1).

<sup>48</sup> *ibid* art 36(2)(b), (c).

<sup>49</sup> *ibid* art 37.

<sup>50</sup> *ibid* art 35.

<sup>51</sup> *ibid* art 51(1).

<sup>52</sup> PWC (n 14).

<sup>53</sup> Singer P, 'Solvency II and Run-Off' (2008) Casualty Actuarial Society <<http://www.casact.org/education/spring/2008/handouts/singer2.pdf>> accessed 29 March 2015.



The companies that have decided to completely exit from the insurance market and discontinue all of their insurance books of business (pure run-off companies) will face serious difficulties in case they have to comply with Solvency II requirements. Although neither the rules of Solvency II nor of the Solvency I are adjusted to the particular circumstances of insurers and reinsurers in run-off, the impact of the former is more profound.

First of all as a result of ceasing to underwrite new policies the amounts of premium income decrease substantially. At the same time the firms are still required to hold enough capital to cover their obligations until the insurance contracts run their full course. On top of that, under Solvency II, the reserve risk dominates the risk profile of run-off undertaking requiring it to hold large amounts of capital to cover the risk exposure. However the company does not have any sufficiently profitable lines of business anymore to generate such additional capital. Moreover it still has to comply with the requirements of all the pillars of Solvency II, discussed earlier in this article. As a result some of the run-off companies risk failing to comply with MCR which will ultimately lead to revocation of their authorisation and winding-up. This will have negative consequences for policyholders who still have ongoing contracts with the company as such reinsurer or insurer will most likely be unable to pay its contractual obligations to the policyholders in full.<sup>54</sup> Thus the effectiveness of policyholder protection is undermined, which is contrary to the goals of the Solvency II regime.

Recognising the specific situation of such undertakings, the Solvency II Directive stipulates an exemption for pure run-off firms. According to the article 308b insurance and reinsurance companies that have stopped entering into new insurance or reinsurance contracts before 1 January 2016 and are concentrating on running-off their existing obligations are not subject to the Solvency II requirements provided they manage to terminate all their activity before 1 January 2019 (1 January 2021 in case the undertaking is subject to reorganisation and an administrator has been appointed). In order to be eligible for the exemption the company shall not be a part of a group with active insurance business, has to notify its supervisory authority about its application for the transitional provisions and provide the authority with an annual progress report.<sup>55</sup> Thus it seems that Solvency II grants a substantial relief for the run-off companies which cannot afford to comply with its requirements. However, in reality it is unclear whether the firms will benefit from the exemption.

The rules do not elaborate what evidence the companies have to produce in order to convince the supervisory authorities that their activity will be terminated before the given date.<sup>56</sup> Apparently it is left for the national supervisory authorities to establish detailed rules for the process, which may result in the requirements' discrepancy across various Member States.

In the UK the Prudential Regulation Authority (PRA) launched in August 2014 a large-scale consultation concerning the transposition of Solvency II as amended by the Omnibus II Directive.<sup>57</sup> As a part of the consultation the issues concerning transitional measures for firms in run-off were mentioned. Particularly in the draft Supervisory Statement the PRA pointed out that it expects companies seeking the exemption to apply well before January 1<sup>st</sup> 2016 to allow it enough time to determine whether it is satisfied that the conditions are met. Additionally the undertakings need to have 'a credible plan for transferring or extinguishing all their existing insurance liabilities' before the beginning of 2019 or 2021, depending on their circumstances.<sup>58</sup> Thus a company is required to have in place a defined run-off strategy for its business.

However development of such strategy requires special expertise, which might not be immediately available for some of the firms. For those undertakings that do not already possess the necessary knowledge, the recruitment of

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<sup>54</sup> Schiffer L, 'My Reinsurer Is in Runoff. What Do I Do Now?' (2010) IRMI Online, accessed 10 April 2015<<http://www.irmi.com/expert/articles/2010/schiffer06-insurance-reinsurance-law.aspx>>.

<sup>55</sup> Solvency II (n 3) art 308b(3).

<sup>56</sup> Ruxley Ventures, 'Solvency II - Exemption for Run-off Companies - Is It Enough?' (2012)(2) Ruxley Research, accessed 10 April 2015<<http://digi.intellimag.com/?id=ruxleyresearchjanuary12>>.

<sup>57</sup> Prudential Regulation Authority, *Transposition of Solvency II: Part 3* (PRA Consultation Paper CP16/14, 2014).

<sup>58</sup> *ibid*, Appendix 2.5, 14.

such expertise demands additional costs and time.<sup>59</sup> Additionally it may be challenging to find suitable experts as a company without new business has a lower level of attractiveness for employees.<sup>60</sup> Furthermore, while 3 or 5 years may seem like a sufficient period to exit from the market, it is not enough to settle certain contracts, especially those with long-tail liabilities. The experts from German Federal Financial Supervisory Authority (BaFin) point out that not all run-off companies will be able to qualify for the exemption due to the short time scale provided by Solvency II.<sup>61</sup>

On the other hand, for the companies that qualify for the exemption there is no guarantee that the national regulators will not require them to conduct preparations for Solvency II all the same, as a safeguard in case they are not able to complete their run-off on time. Consequently they may not gain much from the exemption despite all the efforts required to obtain it.

Another possible exemption from Solvency II rules is for small companies due to their size. However the limits of EUR 5 million of annual gross written premium income and EUR 25 million of gross technical provisions<sup>62</sup> make it impossible for majority of the small firms to qualify for this exemption.

The bottom line is that whereas Solvency II recognises specific circumstances of the sole run-off entities, the uncertainty and onerous requirements make it hard for the companies to benefit from the provided exemptions.

## Conclusions

This article provided a brief introduction to the Solvency II regime and discussed its impact on discontinued insurance business. Although being criticised for the complexity of calculations and general sophistication of the process, among others, the necessity of the reform is recognised by the industry.

Whereas the Solvency II discussion has been on agenda of various researchers for a while, the issue of discontinued insurance is still relatively untouched. This article aims to fill this gap and trigger future academic discussion by analysing the impact of the upcoming regime on discontinued (re)insurance business. It was illustrated that Solvency II is likely to have a serious ramifications for (re)insurance run-off, making its cost explicitly visible. Risks pertinent to inactive business need to be supported by capital as well, making its maintenance more expensive. The amount of required extra capital depends on various characteristics of each run-off portfolio, such as its volatility, diversification and reinsurance solutions used.

The additional capital charges, although the most serious, is not the only implication. Discontinued business is also subject to supervisory and reporting requirements. Run-off portfolios have to be taken into account during risk management and control procedures, requiring extra staff and administrative resources. Moreover, being liable to disclose publicly their financial information, insurers may adversely affect their reputation by having too large a part of discontinued business on their balance sheets. It is also likely to attract negative response from rating agencies and a drop in a company's rating as a result. Thus, apart from generating little to no profit for (re)insurers, a run-off portfolio under Solvency II creates additional pressure on company's capital and other resources.

The situation is still worse for the companies discontinuing all their lines of business and exiting the insurance market (firms entirely in run-off). They find the new rules disproportionately expensive considering the limited sources of revenue and decreased attractiveness for investors of such undertakings. At the same time they have to comply with the capital, regulatory and reporting requirements of Solvency II. The exemptions provided will not benefit all the companies due to the high qualification criteria and often unrealistic timelines. It remains to be seen how the run-off firms will adapt to the new legislation.

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<sup>59</sup> Ruxley Ventures (n 56).

<sup>60</sup> Schaumlöffel K, 'Run-Off: Supervision of insurance undertakings with portfolios in run-off' (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), 2014), accessed 10 April 2015.<[www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2014/fa\\_bj\\_1403\\_run-off\\_en.html](http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2014/fa_bj_1403_run-off_en.html)>

<sup>61</sup> *ibid.*

<sup>62</sup> Solvency II (n 3) art 4(1).

However, despite all the negative changes for the firms with discontinued business, the Solvency II could bring them large benefits in the long run. Considering that passive management of discontinued business is no longer a feasible option for most of the undertakings, they will be forced to re-evaluate their run-off portfolios and, perhaps for the first time, look for the ways to actively manage them. This will increase the firms' understanding of their business profile and allow unlocking additional capital, tied up in those legacy portfolios. The released capital could be then directed to the development of new business lines or improvement of the existing practices. The insurance industry expects that the demand for active management of discontinued insurance business and exit mechanisms is likely to increase. The latest survey of the run-off market shows that 47% of insurers think that Solvency II will result in higher focus on exit options for discontinued business.<sup>63</sup>

Therefore the analysis and comparison of the options for active management of run-off portfolios should become a focus of further research. As result innovative management methods, which have not been previously considered, may be discovered. It could be investigated which exit mechanisms have more advantages depending on the circumstances and needs of particular types of companies (small, medium-sized, insurance groups, etc). The ways in which insurance companies can take advantage of the harmonising EU legislation (eg Cross-border merger Directive<sup>64</sup>) for optimisation of their discontinued business also warrant consideration. As an alternative, the impact of the active run-off management on the insurers' relations with their customers could prove to be an interesting area for investigation. Finally, the quantitative impact of Solvency II specifically on discontinued business should be researched further on the examples of various run-off portfolios.

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<sup>63</sup> PWC (n 14).

<sup>64</sup> Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies [2005] OJ L 310/1.

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