Solvency II Metrics – Limited Use in Insurer Ratings

Prism Factor-Based Model Still Paramount in Fitch's Capital Analysis

Special Report

Solvency II (S2) Metrics Not Comparable: S2 is now in force but Fitch Ratings does not consider S2 metrics to be comparable between insurers, given the different calculation approaches being used. Many insurers are applying various transitional measures, which will strongly affect their metrics; some are using internal models rather than the standard formula; and some regulators are taking a tougher stance than others in how they interpret and apply S2. Given these inconsistencies, we are not using S2 metrics directly in our ratings.

Prism FBM Still Paramount: We will continue to assess insurers' capital based primarily on our Prism Factor-Based Capital Model (Prism FBM; see www.fitchratings.com/prismfbm), as we believe Prism scores are more comparable than S2 metrics. Continued focus on Prism in our capital analysis will ensure that our ratings remain consistent and transparent throughout the change in regulatory regime. We see S2 disclosures as supplementary information, which we will evaluate particularly for insurers with unexpectedly weak or sensitive S2 metrics.

Transitional Measures Distort Comparisons: Widespread use of transitional measures to phase in the effects of S2 over several years will distort comparisons between insurers, as they boost S2 metrics to varying degrees, often significantly. They also mean that S2 is initially not a fully risk-based approach. In contrast, Prism FBM is risk-based. Typically we would expect a lower Prism score for an insurer achieving a particular solvency ratio with transitional measures than for one achieving the same ratio without such measures (i.e. on a "fully loaded" S2 basis).

Internal Models Add Complexity: Many insurers calculate their S2 positions using internal models based on their own risk calibrations. These models are complex, lack public visibility and differ from each other and from the standard formula, often resulting in lower capital requirements, notably for annuity and catastrophe business. With Prism FBM, we assess all insurers, whether internal model users or standard formula users, with a single model.

S2 Sovereign Treatment Unclear: Many insurers hold large amounts of sovereign debt. Internal models must reflect any material sovereign-related risks but standard formula users may escape sovereign charges unless regulators impose an add-on, as eurozone sovereign debt is still considered risk-free in the standard formula. Prism FBM applies capital charges to sovereign debt according to rating level and duration.

Uneconomic Basis: There are significant uneconomic influences on S2 ratios, e.g. the 4.2% ultimate forward rate (UFR) to extrapolate the forward curve for valuing long-term liabilities. This looks high relative to current long-term yields, potentially leading to overstatement of the economic capital position. In recognition of this, the Dutch regulator has said that insurers should take into account the effect of the UFR on their capital when setting dividends.

S2 Likely to Change: There are already plans for S2 to be reviewed in 2018, so there may be important changes still to come. In the meantime, many insurers will be busy refining their existing internal models or preparing new models for regulatory approval in 2016. Reported S2 metrics will therefore be subject to potentially significant restatements that reflect methodology/modelling changes rather than genuine changes in risk profile, at least until the new regime has bedded in for a few years.

No S2-Ratings Mapping: Given the factors above, we are not using S2 metrics directly in our ratings. In the longer term, if S2 calculation methods stabilise and converge or become more comparable, we may indicate solvency ranges we consider commensurate with rating levels.

Related Research

Prism FBM and related documentation

UK Insurer Model Assent Signals Strong S2 Ratios (December 2015)

Delta Lloyd a S2 Outlier, But Highlights Risks (December 2015)

Italian Insurers Most Exposed to Sovereign Capital Charge (November 2015)

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