

Solvency II – a short-term action blueprint for senior management

The FSA's Discussion Paper "Insurance Risk Management: The Path to Solvency II" published on 25th September aims to help UK insurers in their preparations for the new regime by highlighting key elements of the Solvency II Directive where UK insurers will need to change their current practices. Mike Wilkinson and Andrew McGuinness of EMB discuss this important new guidance document.

It is now clear that, despite the Directive not yet being ratified, the FSA is very focused in its aim of driving the UK insurance industry timetable over the next four years to ensure UK insurers will meet the forthcoming Solvency II requirements. The FSA expects that a significant proportion of the industry will wish to seek approval to use an internal model - particularly as feedback from the QIS process suggests a lower capital requirement will be available - and it intends to effect as streamlined a process as possible. The spotlight for this process will be on how internal modelling is integrated into insurers' risk management activity.

The Discussion Paper contains three key messages:

- Solvency II will bring changes to the UK regulatory requirements;
- Insurers should be making effective implementation plans now; and
- The Board and senior management are responsible for making it work.

Taking these three messages in turn, we focus on the relevant questions:

What are the main challenges for UK insurers?

In many ways the Solvency II regime builds on the existing ICAS regime. However, there will be significant challenges for all UK insurance companies. Several of the key risk management building blocks are already in place, but these should be seen as a 'work in progress' for UK insurers and as the FSA noted in its Sector Briefing in November 2006 - and repeated in the current Discussion Paper - there is still some way to go to make the activity fully effective, regardless of Solvency II. In addition, key functions such as actuarial and internal audit will need to be put in place - or their traditional role broadened - to meet the Solvency II governance requirements.

Any internal model will need to be authorised by the FSA if used for regulatory purposes, subject to set criteria including data, statistical quality, calibration, validation, documentation and use in the business. The authorisation process will require active engagement with the FSA for a period of at least two years. And even if a full or partial internal model is used, an estimate of the SCR under the standard formula approach will also be required for at least two years after approval as a benchmark.

Significance of the ORSA

Insurers will be required to develop an Own Risk and Solvency Assessment (ORSA) process. This should be based on their risk appetite and strategy, as an integral part of managing the business. It should cover all of the short and long term risks to which the insurer may be exposed, to ensure that overall solvency needs are met at all times and will require reporting to the regulator.

The ORSA should be used as a strategic decision-making tool and integrated with the internal model, ensuring that all assumptions are consistent between them. It will need to be reviewed on a regular basis and if a material change in business strategy or risk tolerance arises.

Information that is currently provided privately to the regulator will be made public. The scope and content of this information is not yet clear but will include elements of the ORSA and in due course (after a proposed five years) it will include details of any capital add-on imposed by the regulator.

Why are implementation plans required now?

Whilst 2012 may seem a long way off, the FSA has issued a timetable, which shows that if an insurer thinks it may wish to use an internal model, it must begin its Solvency II planning immediately, if it has not already done so. Why is this necessary?

The requirement to approve internal models will create a significant challenge not only for insurers, but for all the regulatory bodies involved. The FSA is no exception. While in many ways they may be better prepared by virtue of the ICAS regime, they - and we - expect a high proportion of the UK industry to seek approval for an internal model. This is due to the heavy investment already incurred in internal models, the increasing recognition of the benefits they bring to running the business and the potential for a reduction in regulatory capital. The approval of internal models will put a strain on resources for all regulators, both in terms of skills and numbers of people. And there will be a risk, from both a regulatory and an insurer perspective, that bottle-necks will limit the number of insurers who are able to have their internal model approved by 2012. The FSA is seeking to manage this risk.

Ideally, the FSA will aim to give firms a 'minded to authorise' letter in the first half of 2012 so that there is adequate time to implement a contingency plan, if required. This means that applications will need to be submitted during the second half of 2011 to give the FSA adequate time to respond. This will follow a period of 'dry-running' during 2010 and 2011 to give firms - and the FSA - the opportunity to test and refine the approach so that when applications are finally made they are likely to be approved.

To make this process effective, there are two key milestones that insurers must note:

- March - June 2009, when they must tell the FSA if they intend to seek approval for an internal model, if they will participate in the dry runs and their plans for doing so;
- June 2010, when they must demonstrate to the FSA they satisfy the dry run entry criteria, having made significant progress towards meeting model requirements, and present their implementation plans.

To ensure that insurers can meet the required timetable, the FSA is clear that insurers need to be developing effective implementation plans now, undertaking a gap analysis exercise to understand the transition required from the ICAS regime and taking steps to determine if they will wish to use an internal model or the standard formula.

What should Board members and senior management do?

The FSA is clear that the implementation of Solvency II is a Board and senior management responsibility. There are two immediate expectations of the Board:

- That the 'Key Messages' section of the Discussion Paper is tabled at the next Board meeting of all UK insurers;
- That each insurer nominates formally a senior (probably Board level) individual to be responsible for the successful implementation of Solvency II.

What are the immediate actions required?

- Initiate Board level discussion on the implementation strategy for Solvency II
- Nominate the individual to be responsible for the Solvency II implementation
- Review the benefits case between an internal model and the standard formula approach and make a decision on the future direction
- Start to assemble a project team with representation from at least finance, actuarial, risk and IT
- Initiate a gap analysis to define the key requirements and identify the scope of work required to meet your future objectives as a first step of the implementation plan
- Seek advice from industry experts.

We believe that these are all sensible steps which will help UK insurers, not only to manage their Solvency II programmes more effectively, but also to better identify and take advantage of the potential competitive advantages that Solvency II can bring.

How can EMB help?

The impact of Solvency II is far-reaching. It is not simply about the technical calculation of capital requirements, but about each company's approach to risk management - from strategic decision-making to ensuring that all employees understand their responsibility for risk. With offices around Europe, EMB can assist in many ways and has substantial experience of defining and developing internal models; supporting regulatory change programmes; advising on risk management strategy and approaches; and delivering professional development programmes. In particular we can provide:

- Board and senior management briefings, to assist you to understand the implications of Solvency II for your business and how to create value from mandatory expenditure;
- A gap analysis framework and approach to help plan the transition between the ICAS regime and Solvency II, taking into account the key objectives of the business;
- Advice on the most effective business use of internal models and their design and development, including use of our market leading software EMB Igloo Professional.

Many of our senior team are working with the FSA and CEIOPS to support the development of the regulation and speak at industry conferences across Europe.

Insurers who will thrive under Solvency II will be those that embrace the reforms, not as the cost of doing business, but to harness the benefits of doing good business.

To discuss your options or arrange a meeting with our expert team contact us on 01372 751060 or email us at solvency-2@emb.com

Mike Wilkinson leads EMB's Risk Management Consulting team

Mike has over 20 years' experience of working with the insurance industry across a wide range of sectors, assisting clients to develop and implement strategic change initiatives. In recent years, he has focused on assisting clients to assess the impact and implementation of risk based regulatory change, such as ICAS, Basel II and Solvency II as well as dealing with the broader issue of Enterprise Risk Management. Mike works closely with both business and actuarial teams to address the increasingly important issue of integrating qualitative and quantitative risk approaches.



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Andrew specialises in EMB's industry-leading software financial modelling products EMB Igloo Professional and Extremb. He has implemented models for a broad range of enterprises, ranging from large Bermudian reinsurers to small Lloyd's syndicates. He is also experienced in economic scenario and asset modelling, and London market reserving. Andrew and his team also leads EMB's research into the new Solvency II regime and populates EMB's Solvency II web portal www.solvency-2.com.



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