

Born Survivor:

The impact of Solvency II on Lloyd's

As Europe prepares to undergo the changes required for Solvency II, Richard Millns and Andrew McGuinness of EMB assess the impact for the oldest insurer - Lloyd's of London.

Solvency is a fundamental issue for Lloyd's. As the world's leading insurance market specialising in extreme and unusual risks it potentially faces the most volatile liabilities. And yet it is confident in its claim to insure anything that's insurable.

Hit hard in the 1980's and '90's Lloyd's has undergone a process of radical reform and restructuring. Without wishing to reduce the innovation and specialised skills of its underwriters it has put its house in order. It has established a sound system of governance, pushed through major organisational and process reforms, built up a strong corporate management structure and become a leading light in the measurement and management of risk.

There has also been significant consolidation. In 1993 there were 228 syndicates with an average capacity of £39m and by 2007 there were 68 syndicates with an average capacity of £239m. No wonder that its iconic building in Lime Street looks as though it's been turned inside-out.

Now it faces new challenges. This venerable institution has to come to terms with the latest wave of Brussels bureaucracy to hit these shores - Solvency II. Will Lloyd's finally lose its regulatory special status?

Self Regulation

Today Lloyd's enjoys special treatment under the UK regulatory regime - the Individual Capital Adequacy Standards (ICAS). The managing agents produce an ICA (Individual Capital Assessment) for each syndicate and these are reviewed by the Society on behalf of the FSA. The Society also produces an overall ICA for the market as well as setting capital at both the market and syndicate levels.

The FSA only reviews syndicate ICAs selectively to ensure consistency of standards and allow comparison with other insurance companies. If it deems that the level of capital held is inadequate then it will impose an ICG (Individual Capital Guidance) that is, demand an increase in the level of capital held. The FSA also expects that the Society will hold sufficient funds centrally to support the business demands of both syndicates and members.

Lloyd's interest in monitoring the syndicates makes perfect sense. As a mutual organisation it has an obligation to ensure that no syndicate poses an undue risk to the central fund. Its annual review looks at mitigation as well as capital requirements, and it needs to maintain a consistency between ICAs due to the effect on member capital setting. Finally the ICAs are a key source of information for the setting and management of the central assets which underlie the overall security of Lloyd's.

Lloyd's general approach in reviewing individual ICAs is to consider the reasonableness of the calculation methodology and results, recognising that not all syndicates need the same degree of modelling complexity. Likewise, the degree of calculation sophistication needs to match the nature and materiality of the underlying risks of the business.

Solvency II presents challenges...

Solvency II and ICAS

The UK solvency regime introduced by the FSA in 2004 has been widely recognised as groundbreaking in its approach, which is both risk-based and principles-based. The three principles of ICAS are:

- The coherent and complete assessment of the risks faced by the business
- The clear common definition of survival ensuring that there is a 99.5% confidence level over a one year timeframe in liquidity
- The assessment must be sensible and document the underlying reasoning and judgements

All of these principles are also present in the proposed Solvency II regime. However the European approach also introduces some significant developments including:

- A set of prescribed calculations which may be used for solvency and minimum capital requirements, together with the option to calculate the solvency capital requirement with a full or partial internal model
- Regulatory approval required for any internal model used to calculate solvency capital requirements, including a requirement to prove the internal model is embedded in the business by passing a formal 'use test'
- The supervision of international groups by a lead regulator, liaising with the other relevant territorial regulators
- An explicit requirement for firms to have defined actuarial and risk management functions
- The requirement for public disclosure of key solvency information

Lloyd's position under Solvency II

Like other UK insurers, Lloyd's' experience under ICAS has put it in good stead for the proposed Solvency II regime. Many syndicates have taken an early lead in the use of financial models to simulate potential risk exposure, proving that even relatively small organisations can use models effectively to their benefit.

However, in our opinion Solvency II raises some questions for Lloyd's.

Supervisory structure

In the UK the FSA recognised Lloyd's as a unique and complicated structure and allowed it to remain as a self-regulated market within a market. Although there is no doubt that Lloyd's would prefer to continue with the same supervisory structure this has yet to be finalised.

Calculation of the Solvency Capital Requirement (SCR)

The calculation of the SCR as it is laid out in the Directive presents a number of specific issues for Lloyd's.

Many syndicates today hold capital in the form of Letters of Credit (LOC), but these are categorised as Tier 2 Ancillary Own Funds for capital calculations and can only be used for a maximum of 2/3 of eligible own funds for the SCR. Lloyd's is negotiating to get this reviewed, or syndicates may have to raise capital to hold in other forms.

Today, Lloyd's uses over 40 General Insurance classes for direct business, but Solvency II currently only recognises 12, reducing the potential for claiming diversification benefits. This is particularly an issue given the specialised nature of some Lloyd's outfits.

There needs to be a sufficient gap between the SCR and MCR to give firms time to react when a problem has been realised by the regulator before they are forced to stop writing business. The QIS 3 exercise tested alternatives for calculation of the MCR, and the results for Lloyd's showed that for some syndicates that the gap between the calculated MCR and SCR was as low as 15%. The approach for determining the MCR is an area of focus for QIS 4, and a revised approach to calculation will be tested.

The arrangements for model approval will be important. Lloyd's syndicates tend to be specialised in nature with complex reinsurance programmes and unusual gross risk profiles. It is unlikely that such entities would be fairly represented by the 'one-size-fits-all' standard formula. It is therefore desirable that syndicates will be able to use their existing internal models straight away rather than having to use the standard formula (with capital implications) whilst the regulator approves their models.

...adaptation is the key

Group Supervision

The Solvency II Directive takes a highly innovative approach in the supervision of multinational insurance groups. It recognises that groups have the ability to move capital around and that their diversification typically reduces the level of risk. The proposal is that whilst each subsidiary is subject to the jurisdiction of their country regulator, supervision should be co-ordinated across the organisation in Europe through a group supervisor. This will also reduce the burden of regulation across a group.

Lloyd's, however, does and does not exhibit the attributes of a group. On the one hand it has the complexity of a group with, currently, 75 syndicates and 46 managing agents. It has a central fund of capital and a corporate governing body and management structure. It writes business across the world and covers a highly diverse range of risks.

On the other hand, the members who provide the capital act as individual entities and are explicitly not responsible for each other's losses; it therefore cannot move capital between syndicates. Many syndicates are highly specialised reducing the level of diversification and since Lloyd's is a franchise not a true enterprise it is unlikely that it can gain the same benefits as larger corporate groups.

A further issue to be resolved is the treatment of those syndicates which are themselves part of large groups. How will they be supervised? Will they be considered as primarily part of Lloyd's or will they be supervised along with the rest of their group? Will it be both?

Conclusion

It is important to bear in mind that although the Solvency II Directive came from broad agreement within CEIOPS, it is still at the proposal stage undergoing tortuous negotiation through the corridors of Brussels. Much has yet to be decided. Lloyd's is active in lobbying the Solvency II parties to address its concerns and issues such as the retention of its special status have yet to be resolved.

But Lloyd's has a strong sense of self-preservation and over 300 years has demonstrated a Darwinian ability to adapt to new challenges and survive - flexibility and innovation are its core strengths.

Indeed the new rules may also provide a unique opportunity. Lloyd's now has strong controls, a management structure and technical modelling skills that place it at the forefront of risk-based capital management. This is a sure footing on which to build its current rapid expansion overseas and maintain its competitive advantage in the years to come.

Richard Millns and Andrew McGuinness are key experts on Solvency II:

Richard Millns (FIA) is a Director at EMB specialising in financial modelling. He has worked on the majority of EMB's large group DFA projects over the last 6 years, including group capital models, reinsurance and catastrophe exposure analysis projects, and asset models. In particular, he has spent much of his time helping clients to implement internal capital models in order to comply with the FSA's Individual Capital Adequacy Standards (ICAS) regime and plan for Solvency II.



Andrew McGuinness (FIA), a Senior Consultant at EMB, specialises in EMB's industry-leading software financial modelling products Igloo 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 including EMB's Solvency II web portal www.solvency-2.com.



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