

# No Room for Complacency

**As the ICAS regime celebrates its third birthday, Mike Wilkinson of EMB discusses whether this gives UK insurers a competitive advantage for Solvency II.**

Thanks to the FSA's ICAS regime, the UK insurance industry is further advanced on the road to Solvency II than most of its European counterparts. Now in its third year, the regime is well-established, with improvements in risk management, technical competence, business processes and above all, accountability. However it is significant that it has taken so long for insurers to understand fully the business implications and how to make the best of ICAS.

Although there are many similarities, Solvency II will still be different from ICAS and UK management cannot be complacent. Even so, coming so soon after the upheaval for ICAS, there is an understandable sense of change fatigue.

Significant differences between the two regimes include:

- New prescribed calculations for solvency and minimum capital requirements
- The option to calculate the solvency capital requirement with a full or partial internal model, with prior regulatory approval
- The requirement to prove that any 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

UK insurers must take a rational and economic approach to the requirements of Solvency II. This will involve careful planning and a detailed assessment of the main differences, not only between the ICAS regime and Solvency II, but also between the ICAS target and their own current implementation of it.

## **Hang on to the good**

One challenge will be to ensure that the benefits of ICAS are retained and enhanced. Any further changes must be consistent with the firm's business objectives, rather than presenting just another regulatory hurdle. A key benefit of the ICAS regime has been the introduction of an Enterprise Risk Management (ERM) culture within firms with the adoption of internal models at its core. These models are now starting to be used as strategic-decision-making tools.

UK (re)insurers can expect a great deal of support as the FSA wishes to sustain the advances of the past few years. This support should be welcomed. It would be a retrograde step if insurers with internal models were to revert to the relatively simple Standard Formula for Solvency II. It would be less reflective of the actual risk in the business, probably necessitating a higher level of capital and reducing their ability to manage the business effectively.

The use of capital models in the UK has increased dramatically over the last few years for both regulatory and sound business reasons. Solvency II will require all internal models to be approved by the regulator for use in their submissions. And even when the model has been approved the Standard Formula will need to be followed for a minimum period of two years. Therefore, the internal model could be seen as an additional overhead and firm will need to perceive and demonstrate value from the model to continue usage. This value could be a reduced solvency capital requirement, improved information for running the business, or both.

# Through understanding comes success

## When to start

We are sometimes asked when to start the Solvency II implementation. Such a question suggests that Solvency II and the broader principles of ERM are seen as merely a regulatory chore. We would argue differently:

Both ICAS and Solvency II define principles to assist insurers to manage their businesses better. The business and competitive benefits of ERM are well established, regardless of any regulatory imperative.

Therefore, the question should focus on the business case for realising these benefits. All businesses have limited resource and many competing priorities. The benefits of improved ERM should be weighed against the opportunity cost of other initiatives, with the proviso that there is also a regulatory deadline.

For insurers who are already some way down the road and have an internal model, much will depend on where they are in the development cycle. They should consider what remains to be put in place to meet the expected requirements - including how long this is likely to take and at what cost. And since any change will take some time to bed in and will still need incremental enhancement, the earlier the new requirements are adopted the better. In addition, as supervisors will be required to approve internal models within a six-month period, being fully ready in advance could be of significant benefit.

## Where do we start?

The single most important step for any UK (re)insurer considering how to embed their internal models into the business, for both regulatory and economic benefit, is the so-called 'use test'. The (re)insurer needs to demonstrate that the model is so integral to the way the company works that senior management use it in strategic decision-making.

The final details of the 'use test' are still to be defined but the FSA has already set out general principles similar in approach to Basel II:

Directors must understand the structure and principles of the model, its underlying assumptions and key parameters. The model must be 'embedded' in the business. It must be demonstrably used for taking strategic and major decisions. For instance, the Board must be informed on a regular basis about the performance of the internal model, weaknesses and material risks through reporting of Key Risk Indicators and available capital compared to required.

Consideration of how a model will be used within the business and identification of the key business benefits should take place before it is developed, and initial discussions should include not only the actuarial department, but also business users. Once a model is up and running, it becomes a key component of Business As Usual and as such, should perhaps be owned and run by an 'operational' department, thereby achieving greater visibility and wider understanding within the business. Over time this should lead to broader usage.

## Reasons to be cheerful

We believe that the UK is generally ready to consider the next step of increased sophistication and to really grasp the potential business benefits that the ICAS and forthcoming Solvency II regimes offer. Provided these steps are approached in a systematic way, and communicated throughout the organisation, they should not be unduly onerous. More than that, they could be seen as a natural and beneficial extension of the direction already started under the FSA's ICAS regime. It generally takes several years for organisations to experience the full benefits of ERM, and the steps outlined above will help realise them.

## So what should UK re/insurers be doing now?

No two (re)insurers are the same. The actions they should be taking now will depend on a variety of factors, including their progress to date with ERM, corporate objectives, appetite for risk, the types of business they write and their ambition as far as Solvency II is concerned. There are, nevertheless, a number of necessary steps common to all:

1. Understand the differences between the ICAS regime and Solvency II, including a realistic assessment of the shortcomings in their current ICAS implementation and plans
2. Educate the Board about their own internal model.
  - What it is, what it does and why, what it does not do, current enhancement plans and how the model compares with competitors
  - The potential for enhanced value from the internal model - what it must be used for under Solvency II and other 'added value' uses, together with the likely resource, cost and organisational implications
  - What 'embedding in the business' actually means to them: for instance how they best achieve consistency of approach and process for both decision-making and solvency
3. Assess what changes are required to 'embed' the internal model in the business and to conform to the 'use test', together with how the organisation can get greater value from the model
4. Consider the expected capital benefits from maintaining an internal model for solvency purposes compared to the Standard Formula on the basis of current information.
5. Look at the implications of the treatment of international groups both from their own perspective (if relevant) and their competitors, including the potential for differing interpretations of the regulation in different territories
6. Map out a high level programme of activity between now and 2012 to maximise the value achieved from what is, in effect, a mandatory change programme

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