

QIS4: an assessment of the Solvency II landscape

The findings of QIS4, published by the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) in November 2008, demonstrate an increasing engagement with the Solvency II directive around Europe and some useful insights on certain key issues such as capital requirements under the standard and internal models. So what headline lessons can insurers learn from the findings?

Background

As part of the continuing development of the Solvency II directive, the fourth round of quantitative impact studies took place from April to July 2008. 1,412 companies, representing all 30 European Economic Area countries took part in QIS4, an increase of 37% on QIS3. Participation of cross-border groups more than doubled to over 100 organisations. Encouragingly in our view, all of these figures surpassed CEIOPS' targets.

A copy of the full CEIOPS report is available at <http://www.ceiops.eu/media/files/consultations/QIS4/CEIOPS-SEC-82-08%20QIS4%20Report.pdf>

Lessons learned

- The vast majority (98.8%) of participating companies meet the minimum capital requirement (MCR). Failure to meet the solvency capital requirement (SCR) reduced from 16% under QIS3 to 11% of participants in QIS4. Overall, the aggregated capital surplus has decreased by about 3% from QIS3.

It might be possible for a large part of the European insurance industry to conclude that its capital reserves are sufficient ahead of Solvency II. However, QIS4 indicates discrepancies in how participating companies allocate capital to cover the risks associated with their assets and liabilities. Building a better picture of specific risks within the business is fundamental to Solvency II and the long-term health and stability of companies, as part of the Pillar 2 Own Risk and Solvency Assessment (ORSA) process.

A number of smaller and mid-sized respondents to QIS4 appear to have struggled to provide actuarially robust estimates of liabilities. Lack of data was cited as the primary problem; this is an area where companies may need to seek advice and support on structuring of data sets. CEIOPS is expected to provide further guidance on what techniques might be used in the Level 2 implementing measures.

- One of the major areas of focus for the study was internal models. Those that used an internal model in the QIS4 process generally estimated a lower capital requirement under the SCR compared to the standard model, with around half estimating a saving of over 20%. Even so, the report stressed that none of the participants' internal models would currently be considered as fully 'Solvency II compliant'. Some 63% of respondents said they were considering a full or partial internal model to help them improve their risk management and governance.

These findings support the view that there are sound business reasons for adopting an internal model approach rather than just as a means of complying with regulation. The report notes that companies without a model of any sort found it particularly difficult to realistically allow for operational risk in their SCR calculation.

For those companies that indicated a preference for the internal model route, there is clearly a lot of hard work to do, particularly if they are to meet the requirements of the 'use test' aspect of the directive. Unless they are able to show the model is an established business process, they may not be able to benefit in the short-term from the lower capital requirements the results suggest. It's worth noting that all entities will have to use some form of internal "model" in order to comply with the ORSA requirements, since each must take into account its unique risk profile, risk appetite and business strategy.

- *The SCR calculation for Groups is less decisive in favour of internal models, although based on a small sample.*

A smaller percentage saving is still a sizeable sum for Europe's larger insurers. While the focus of QIS4 was obviously on testing Pillar 1 quantitative elements of Solvency II, the fact that relatively few Groups took the opportunity to put models through their paces points to how far there is to go to fully implement effective, group-wide models, as well as highlighting a danger of missing the wider point of Solvency II. For groups in particular, Solvency II should be more beneficial if seen as a means of promoting a better allocation and greater cultural understanding of risk in the business rather than as a compliance exercise.

Of course, events since publication of the report have put the whole Group supervision objective of Solvency II in doubt. The European Commission and the CEA have indicated they will push back strongly the resistance from a number of countries that came to light at the end of November, although the impact on the overall implementation timetable is still not clear. The evidence from QIS4 of a 21% reduction in capital requirements for groups from a consolidated European supervisor clearly points to benefits for the industry.

- *On average, firms took 3.2 man-months to complete their QIS4 submissions, with larger groups and composites taking the longest.*

QIS 4 participation was allowed on a 'best efforts' basis. These figures highlight the resource overhead for which companies will have to be prepared and the need for efficient access to a broad range of materials and data.

Despite the continuing uncertainties with the Solvency II development, companies should be progressing with their preparations now. The sooner the senior management team gets to grips with the requirements of Solvency II, the more it's possible to consider how the directive can act as a driver to improve your business, irrespective of some of the finer regulatory detail.

To learn more about Solvency II, visit www.solvency-2.com or contact EMB via solvency-2@emb.com