

Beyond capital

Putting Solvency II into perspective for small and mid-size insurers

Smaller national and regional insurers are typically among the best capitalised across Europe. Yet, even in a business climate which increasingly appears preoccupied with financial measures of health, Solvency II requires such companies to have a concerted plan of action up to implementation. Rather than regarding this as a regulatory burden, EMB believes the Directive offers great opportunities to those smaller firms willing to embrace them.

Solvency has taken on a whole new dimension as a result of the global economic situation and the plight and mass bail-outs of banks around the world. This has been a double-edged sword for the insurance industry, particularly European companies readying themselves for the introduction of the Solvency II regulations.

In one respect it has put the business practices of insurers under the microscope and shown, for the most part, that they are in reasonable shape to withstand what the global economy is throwing at them. On the other hand, it has tended, mistakenly in our view, to focus the argument about management best practice on to how much capital they hold.

Those who have followed its development will appreciate that Solvency II goes deeper than just financial measures of solvency. It places as much, if not more, stress on the evolution of a company's risk management and governance framework than it does on the quantitative calculation of the capital.

The proportionality principle

At first glance, these requirements may appear to put smaller companies at a disadvantage compared to their larger counterparts and increase the strain on resources. On the contrary, we believe the inherently greater flexibility and shorter decision-making lines of smaller companies leave them well placed to benefit from the blueprint for managing businesses better that Solvency II provides.

If one draws the parallel with the introduction of the risk-based ICAS regime in the UK in 2004, smaller insurance companies almost as one expressed reservations about increased administration and costs of compliance. Today, based on our experience, ICAS is almost universally seen to have forced up management standards, including accountability and transparency.

In any case the legislators behind the Solvency II Directive have recognised that it is unfair and unrealistic to ask small and mid-size organisations to match the processes and documentation required of the multinationals. The 'proportionality' principle establishes the idea that companies should have measures in place that are appropriate to the size of their business and risk exposure.

How do smaller companies prepare?

Whilst 2012 may seem a long way off, companies, regardless of size, should be preparing now. Even allowing for possible further delays in implementation, there is still lots to do.

There are three 'pillars' to Solvency II covering quantitative, qualitative and disclosure requirements, all of which companies will need to satisfy, taking into account the idea of proportionality.

Through these pillars the regulator will examine each company's approach to risk management - from strategic decision making to ensuring that all employees understand their responsibility for risk. Therefore, the companies that really grasp the opportunity of Solvency II will be those that tackle it first and foremost as a cultural change programme. And this means that senior management has to take control, appointing someone, preferably a Board member, to be responsible for the firm's implementation programme.

We would recommend that companies carry out a Solvency II gap analysis; defining their 'target' implementation position, plotting their current position and identifying the gaps to be filled. This provides a business-orientated approach that can then be prioritised and developed into an overall implementation plan.



3 pillars of Solvency II

As the first pillar, one of the early decisions will centre on the quantitative requirements and how best to satisfy them. The increasing participation around Europe in the Solvency II quantitative impact studies (QIS), including the most recent QIS4, demonstrates that many companies, large and smaller, are taking this on board.

Standard approach versus internal model

Solvency II presents insurers with two choices for calculating regulatory capital. The standard approach, while simpler, is based on an EU supplied calculation which, by definition, does not reflect any company's particular circumstances.

Of the 1,412 companies from 30 countries that participated in QIS4, 63% indicated a preference for using some form of internal model, with 24% undecided. The CEIOPS (the body running the Solvency II process for the EU) report stated that "better risk management and governance seem to be the key drivers for seeking internal model approval." However, companies that responded to QIS4 using some form of internal model also reported a generally lower Solvency Capital Requirement, with some reporting a reduction of over 20%.

This reinforces our view that an internal model offers wider benefits to a business of any size as it better reflects the risk appetite and profile of the business. It will enable insurers to reflect the individuality of their business better than any standard formula.

This is certainly the view taken by the rating agencies. Any internal model should not, however, be designed to meet a regulatory or agency requirement but to help run the business better.

The underlying point is that decisions taken relatively soon about Solvency II can have a profound impact on the future shape and operation of a business. Taking what seems like the easy option in the short-term could leave companies playing catch-up with the competition for some time to come.

Since the Solvency II Directive is not currently prescriptive about the nature of internal models, their sophistication can match individual implementation plans and budgets. We anticipate that many small and medium-sized companies around Europe will opt for some form of partial model. Interestingly, of the 710 companies that submitted some details of an internal model for QIS4, 589 were classified as small or medium sized insurers, dispelling the idea that internal models are only for big insurers.

Embedding risk management in business strategy

Beyond the capital calculation, Pillars 2 and 3 deal with the qualitative and disclosure requirements of Solvency II. These pillars are where compliance begins to dovetail with enterprise risk management (ERM).

One of the most important parts of Solvency II for all companies that come under its umbrella will be the Own Risk and Solvency Assessment (ORSA) process. This is intended to be a strategic decision making tool for the business ensuring it has proper processes in place for identifying and quantifying its risks in a coherent framework. Firms will have to demonstrate that the ORSA influences the way the business is run day-to-day and is not just a box-ticking technical exercise.

Benefits of ORSA over the SCR

While the calculation of the Solvency Capital Requirement will give companies the regulatory amount of capital they are required to hold, the formulaic nature doesn't reflect individual circumstances. The ORSA will enable individual interpretation of risk exposures and risk appetite, providing a much firmer base for decision making.

Since supervisors will want to see an internal assessment that reflects specific risks based on company data, the SCR standard formula is clearly inappropriate for the ORSA. Firms will need to highlight assumption differences between the ORSA and SCR - a task that will be simplified with an internal model, however simple or complex.

How might this benefit smaller companies? In simple terms, the better they understand the risk inherent in their business, the more effectively they can manage it and the less capital required. This helps firms to make better informed decisions right across the business, including capital allocation, pricing strategy, reinsurance purchase, reserving and in relations with ratings agencies.

In order to further embed better risk processes and assumptions within the business, Solvency II will require each firm to have corporate governance, audit and actuarial functions. However, the Directive recognises the value of outsourcing for firms where maintaining internal teams is not cost-effective or where existing resources are already stretched. Smaller companies need to be identifying how they will meet these requirements and, indeed, determining whether they need additional resources to help them through their preparations for Solvency II.

Conclusion

The key to success for small and medium-sized insurers will be to implement a business-focused, ERM approach to meeting the Solvency II requirements. It is for the Board to set the direction, drive the process, create a team and allocate responsibilities. A first step is to define what ERM means to the individual firm and how this relates to the external environment. If there is to be an internal model, it can be as complex and ambitious as required to meet the business needs. The important thing is for the business to define its requirements and to understand what it will do, why and how the output will be used.

For those who have not already started, now is the time to do so even given the relative lack of focus on Solvency II from certain national regulators. ERM is an incremental process, involving a significant cultural journey and it cannot be rushed.

The good news is that in some respects national and regional companies are better placed than their larger competitors. If approached correctly, their governance structures and internal models will be less complicated, making it easier to comply with the regulatory approval criteria. Indeed, the proportionality principle in Solvency II recognises and enshrines this advantage. How companies choose to exploit the opportunity to embrace best business practice will be a factor in their future competitiveness.

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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 an 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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