HOW READY IS THE INSURANCE INDUSTRY FOR SOLVENCY II?

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Executive Summary

This article reviews the readiness of the insurance industry in the UK for Solvency 2. It is based both on direct discussions with clients and industry bodies, and on information from various publicly available sources – including regulator feedback on the QIS4 exercise carried out between April and July 2008.

Engagement in the Solvency 2 process is clearly increasing, but the industry as a whole and smaller firms in particular have much ground to make up. Guidelines from the FSA[2] and Avantage Reply's own assessment of implementation timelines both make it clear that the time to act is now.
Uncertainties in the way that subsidiaries of cross-border groups and Lloyds syndicates will be regulated are no reason for delay: enough is known about the shape of the final Solvency 2 requirements for insurers to begin work, and delays now will be costly in the future. This is particularly true for firms that plan – or at least want the option – to seek internal models approval.

All firms, whether they plan to implement internal models or not, need to give thought to the implications of the framework's Pillar 2 requirements, mandating high standards for risk and capital management at enterprise level and throughout the business. These requirements are being underlined by turmoil in the financial markets, and by perceived over-reliance on mechanical application of economic capital models.
Expect renewed emphasis on proactive use of a wider range of risk management tools, including stress testing.

I. Background

Solvency 2 is currently scheduled for full implementation across the EU by late 2012. Detailed requirements are not yet finalised: the EU 'implementing measures' are due to be issued in draft during 2009 and adopted formally in 2010. The framework directive was adopted by the European Parliament on 22 April 2009 and endorsed by the EU's ECOFIN on 5 May.

Details on the supervisory calculations for technical provisions and capital requirements can be found by working through the QIS 4 materials published during 2008. We believe that these documents are an adequate basis for mobilising a Solvency 2 programme and carrying out planning and gap analysis activities.

II. Governance and mobilisation

Solvency 2 is expected to be at least as challenging for insurers to implement as Basel 2 was for banks – probably more so. Insurers in the UK have been exposed to the ICAS process since 2004, and this is directionally similar to Solvency 2, but Solvency 2 goes significantly further. Regulators and industry experts alike expect Solvency 2 implementation activities to take years: even though the new framework is not expected to go live before late 2012, firms should already have a Solvency 2 programme in place, with clear implementation plans and governance, including senior sponsorship, preferably at board-level.

Firms should develop their own requirements and gap analysis, and allocate organisational responsibilities for implementation. As part of the gap analysis, firms should have already carried out the QIS4 exercise: completed rigorously this is a good way to understand where implementation difficulties are likely to lie[3]. Regulators comment that insurers coming newly to the QIS programme have significantly greater data quality problems than experienced participants.

Industry readiness Most larger firms have a Solvency 2 programme in place with appropriate sponsorship, but many smaller firms have either minimal programme organisation, or none at all, and lack clear sponsorship at senior level.

FSA feedback on QIS4 published at the end of 2008[4] indicated that less than onethird of authorised UK insurers had submitted responses. Participation rates were markedly lower among smaller firms. Some firms completed the process, but with extensive use of proxies: in many cases these should now

[1] Avantage Reply is an advisory, design and implementation support firm specialising in the financial services markets.

[2] *Insurance Risk Management – The Path to Solvency II* (FSA DP 08/4, September 2008)

[3] See the *QIS 4 Technical Specifications* (European Commission, March 2008) and subsequent amendments and errata at http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm.

[4] FSA *UK country report – The fourth Quantitative Impact Study (QIS4) for Solvency II* (FSA, December 2008). See also CEIOPS' *Report on its fourth Quantitative Impact Study (QIS4) for Solvency II* (CEIOPS, November 2008).

feed into the planning process as implementation gaps.

III. Valuation and technical provisions

Solvency 2 includes changes to valuation approaches and, as part of the quantification of technical provisions, includes both discounting and the calculation of a new 'risk margin'.

Industry readiness The FSA reports that QIS4 participants had fewer issues with valuation of assets and liabilities, and with evaluation of technical provisions, than with other aspects of the exercise. Still, several areas stood out as causing difficulties. Many non-life firms have difficulties in carrying out valuations as required, based on discounting of the probability-weighted average of expected future cashflows, and some also reported uncertainty about the handling of potential future large claims that might be significantly under or over-represented in firms' own data due to small sample size. Reporting according to the required business line segmentation and/or converting from underwriting year to accident year basis also causes problems in some cases. The new risk margin calculation, which in principle (under QIS4) requires the projection of future capital requirements over the portfolio run-off period, was widely seen as difficult and time-consuming; but regulators appear keen to retain this approach.

IV. Own funds

The definition of own funds changes significantly under Solvency 2, with a new tier structure and new eligibility rules. Off balance sheet capital, such as letters of credit, is downgraded by one tier and becomes ineligible for the Minimum Capital Requirement (MCR).

Industry readiness UK firms participating in QIS4 had few difficulties assessing their available own funds. In some cases, more often in the case of non-life firms, own funds were higher than at present; in other cases firms reported a reduction in own funds. Even in the former case, due to the impact of the new eligibility rules, the more limited usefulness of hybrid and offbalance sheet capital instruments frequently resulted in a lower solvency ratio overall. We conclude that firms that have not carried out the QIS4 exercise should do so partly in order to understand whether they may need to plan for changes to capital structure.

V. Capital adequacy – SCR/MCR

Solvency 2 introduces a new two-tier capital adequacy calculation: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). Standard supervisory formulae will be defined for both (the current draft can be found in the QIS4 Technical Specification). But although firms obtaining internal models approval will be able to make use of their own models in place of all or part of the standard SCR calculation (SF), they will need to implement and report on the SF calculation during a two-year transition period. If internal models approval is refused or delayed, the regulatory formulae could be in use for much longer.

Industry readiness Many firms are finding the SCR/MCR calculations given in the QIS4 technical specification complex. Participants frequently resorted to proxies that may not be allowable when the requirements are finalised. Insurers had difficulty with policy-by-policy calculation required for catastrophe and lapse risk, and contract-by-contract counterparty risk calculation for reinsurance. Firms need to plan to build SF calculation capability.

VI. Capital adequacy – internal models

The FSA reports that over two-thirds of UK participants in QIS4 plan to seek approval for the use of internal models. This is a significantly higher proportion than in the EU as a whole – perhaps a reflection of the use of internal capital models in the UK as part of the ICAS process. But obtaining internal models approval for Solvency 2 SCR will be significantly more onerous. The 'use test' requires that an internal model must be fully embedded into the management of the business, for example, into pricing and product development, reinsurance strategy, and risk and performance management. The model must therefore operate at a sufficiently granular level, and allow calculations to be performed regularly – not just once or twice a year. Model controls, documentation, statistical validation, and validation of supporting data will all be subject to high standards. In addition to covering all the material risks to which the firm is exposed, the use of internal models to determine economic capital requirements must be supplemented by scenario analysis and stress testing in order to capture the impact of extreme events. Firms using their internal models to replace the supervisory SCR calculation wholly or partly will be required to meet the regulatory capital standard of a one-year forecast and 99.5% confidence, even if a different approach is used for assessing internal capital under Pillar 2. Early adopters will need to be ready to participate in FSA dry-runs which are likely to begin in mid 2010.

Industry readiness Although firms are currently using internal models, e.g. to support their ICA submission, very few would be able to meet the criteria for approval in full without significant effort. Recent surveys suggest that a majority of firms would struggle to meet the use test. Considerable work on embedding of internal models into the business and into risk and capital management processes will be needed. But compliance with the use test is far from being the only issue. Many firms – we believe a majority – are still addressing statistical weaknesses and data quality issues that would stand in the way of meeting model validation criteria. Moreover, few firms would be able to demonstrate adequate model governance, controls and documentation – both surveys and informal discussions suggest that fewer than one-third of UK firms have begun to address these issues. The use of outsourced analytical services by smaller firms is equally an issue. Senior management can outsource the calculation process, but not the obligation to understand and act as the owner of the process. There are gaps in coverage of risk types: while underwriting risk is typically well addressed, and market and credit risk are frequently covered as well, other risks such as operational risk are often covered poorly or not at all. For Pillar 1 this may mean reverting to the SF for some parts of the regulatory capital calculation. Finally, use of stress testing and scenario analysis will come under more regulatory scrutiny: we believe that this is an area where firms will need to invest significantly over the coming years.

VII. Risk and capital management

Under Pillar 2, Solvency 2 imposes the requirement for an effective enterprisewide risk and capital management framework, over and above the requirement to make capital adequacy calculations. Insurers need to demonstrate that they are able to articulate risk appetite at firmwide level to stakeholders, to align risk appetite, business strategy and capital, and to reflect that appetite consistently throughout the firm, by means of effective risk monitoring and controlling, risk mitigation techniques and limit management processes.

Industry readiness Most insurance firms have been striving for some years to implement effective enterprise-wide risk and capital management frameworks. Industry studies, and also enterprise risk capability studies carried out by rating agencies such as S&P, indicate that insurers have made significant progress in this area. The same studies, and informal discussions, also suggest that most progress has been made in the development of internal economic capital models (see above) and in formulating risk appetite at the enterprise level. Where a majority of firms still struggle is in effectively aligning risk management and decision throughout the firm with risk appetite and available capital, and in steering the portfolio accordingly.

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