

Obstacles and opportunities arise from Solvency II

The insurance sector faces the major challenge of implementing Solvency II by 2013. A panel of experts discusses ways to meet this tight deadline and benefit from the process

Do you think the time frame outlined by the recent Omnibus II directive is realistic for the insurance industry?

Bruce Porteous, Standard Life: The industry is still very much on track to implement by 2013. Omnibus II is quite a short document by Solvency II standards, but it's also quite complicated – very technical and very legal. It appears to give the European Commission (EC) the opportunity to adopt delaying transitional powers. We need to understand the EC's intent of actually using these powers.

Toby Ducker, Brit Insurance: Omnibus II provides additional uncertainty to the process and that, in itself, creates costs. And the industry is already spending a lot of money getting ready for Solvency II. It's important for all stakeholders to understand the balance between the cost implications of some of the things they are asking for, the risk of getting it right and it being in place on January 1, 2013.

Norman Black, SAP UK: As a solutions provider to the sector, we must recognise the balance of cost and benefit. What we need is an approach that is very adaptable and agile enough to cope with the degree of change we continue to get under Solvency II, but also complements existing investments. We want to be able to lay down a platform that builds upon what insurers have got already and focuses on some key areas that require enhancement due to the particular demands of Solvency II – such as risk systems, data management and reporting.

How significant an issue is the lack of clarity with Omnibus II?

Porteous: Even before Omnibus II came out, there was a huge amount of regulatory uncertainty and it has added to that. What we have to do is make judgements against where we think the regulations are actually going to land – use a common-sense approach, be pragmatic, practical, and plan and deliver work as we intend to implement it for January 1, 2013. It's going to involve what you might call appropriate risk-taking in terms of judgement of the regulations. The more clarity supervisors give, the better.

Ducker: There's a key point in that as well – that Solvency II is a principles-based regulation as opposed to a rules-based one. It enables companies to get on with the work, assuming they can sit within those principles because,

The Panel

Emir Mujkic, Policy adviser, Financial regulation, Association of British Insurers

Toby Ducker, Solvency II programme director, Brit Insurance Representative, Methodware

Norman Black, Head of Insurance Solutions, SAP UK

Bruce Porteous, Head of Solvency II and regulatory development, Standard Life

as we get more detailed guidance, it is only going to add colour to what is already there, it's not going to change or add new rules that are complete outliers.

Emir Mujkic, Association of British Insurers (ABI): It will be important that firms continue their work. Even though we have seen proposals for transitional provisions in certain areas of up to 10 years, the deadline of January 1, 2013 is likely to be when the new regime comes into force. As you can imagine, that doesn't mean Solvency II will start 10 years later, it just gives the EC the opportunity to smooth the transition to the new regulatory framework for a number of years, where required. And the 10 years doesn't mean it will start in 2023.

Does the EC have the option to delay Solvency II for up to 10 years if it wishes?

Mujkic: Not to delay it, but certain areas of Solvency II could be transitioned for a certain time. Ten years sounds a long time but, if we talk about the liquidity premium, for example, it needs some time until existing business runs off, which was priced on Solvency I basis. But, according to current proposals, 10 years is the maximum – it could be less.



Norman Black

Does the UK industry's experience with the fifth Quantitative Impact Study (QIS 5) suggest insurers are on top of the challenges posed by Solvency II?

Mujkic: What we've heard so far is that the UK submissions for QIS 5 seem to be at a good level compared to the rest of Europe. So, in my view, the UK is doing well. In terms of results, at this stage, the overall outcome looks good. But there are still some areas of concern like the definition of contract boundaries, the application of an illiquidity premium, the calculation for intra-group reinsurance arrangements and the calibration of the non-life underwriting sub-module. As I said, there are still some areas that require further work and we would, therefore, advise firms not to publish their QIS 5 results because these could be subject to misinterpretation. It's just too early in the officiating process.

Black: An observation we've made is the volume of data and calculations with Solvency II that is now clearly required. There has always been a traditional issue around data management – quality, availability, getting to the right granularity, and common terminology across the whole enterprise. But, to a great extent, the insurance industry has done a good job over the last 10 or 15 years to get that under control. Under Solvency II, however, there are particular aspects to consider such as: the volumes of data; how deep we have to go into systems; going internal and external – and the governance around managing that; and also the computational power that is necessary to actually perform some of these calculations. For the traditional actuarial office, it is a radical change – Solvency II makes whole new demands in terms of data management.

Will there be a QIS 6?

Porteous: We've been told by the Financial Services Authority (FSA) that there won't be a QIS 6. There might be a smaller calibration exercise half way through this year to check those bits of QIS 5 that didn't work. I don't think we need a QIS 6. We just need fine-tuning of the current proposed regulations, especially in view of all the other activity going on in the market this year.

Mujkic: The European Insurance and Occupational Pensions Authority has been asked by the EC to set up a number of task forces in order to form a better idea of what can be done, what can be changed. I – or we at the ABI – haven't heard that a possible QIS 6 would take place. As far as I know, at the moment, there will not be a QIS 6.

What are the main issues for insurers in terms of data governance for Solvency II and how can they really get on top of them?

Black: When it comes to data governance, confidence in the processes and systems that source the data is fundamental. It's confidence you can then demonstrate to the regulator when it comes to having the model approved, and confidence your colleagues have when that model is used throughout the organisation. Appropriate internal reporting on Solvency II that is usable and understandable will also greatly help confidence in the rest of the organisation.

Ducker: First, it's about putting the power around data back into the

business as opposed to the back office. Ultimately, data governance is about creating the business ownership of data and ensuring that it is recognised in the right parts of your business. The second point is about the 'use test', and it's quite a clever test in that it will assess the use of those numbers in your business. As Norman says, if there's no confidence, there's no use. The question would then be about why the numbers turn up on the page, rather than what to do about it and what decisions to make off the back of it.

Methodware: What we are also starting to see is a shift towards the management of the process, and confidence in the process regarding risk management and risk reporting, as much as the data. This is probably not unusual as companies seem to be now turning to Pillar II and Pillar III requirements, whereas before the focus was on Pillar I and the capital model. It's as much about business-as-usual needs for Solvency II compliance, and getting into the details of what that looks like to satisfy the different regulators in a cost-effective way. I'm surprised at the degree of variation in approach and challenges that we see in this industry.

Porteous: The actual requirements are not hugely clear, so we need help from the supervisors to interpret them. We also need them to adopt a proportionate approach, otherwise we're going to end up spending huge sums of money on over-engineering data. We see work to be done in mapping the end-to-end process and providing evidence of the controls concerning the data process. We also have to remember that we already report to the market and those reports are subject to heavy audit. How much more is actually needed to meet Solvency II requirements without spending huge sums of money?

The captive sector has been vocal in its criticism of the proportionality principle. Does the panel share the view that proportionality hasn't been interpreted correctly under Solvency II?

Ducker: Everyone has their own take on proportionality and that's kind of the point. Each European regulator will have a slightly different view and each company within those jurisdictions will have a different view. Best practice will emerge over time. We all want the answers now, but we are all learning as we are going, and let's not forget that goes for the regulators just as much as for the insurance companies. It needs a little bit of time to come out. I'm confident we will get there in the end, but that doesn't mean there won't be a few bumps in the road and healthy debates to be had.

A recent industry poll over whether firms would opt for an internal model or the standard formula revealed that 52% of insurers will use an internal model, less than 20% said they wouldn't and 30% are still undecided – are those figures in line with your expectations?

Black: It's interesting because discussions with customers in the last 12 months have suggested a strong move towards internal models, so those figures may show a retreat from where we were before. Perhaps small and medium-sized companies are starting to realise the implications of what is involved with Solvency II and are falling back on the standard formula, as opposed to putting the effort into the internal model.

Ducker: We're certainly aware that a number have dropped out of the FSA's process over the last few months, in terms of those who originally showed interest compared to those who finally applied. But, it is not quite as dramatic as those figures suggest.

Mujkic: These figures partially surprise me, but we know from the FSA that, last year, about 110 firms indicated they would like to apply for an internal model. As Toby said, the number has slightly gone down. However, it's still a very large number compared to other European markets. In the German and French markets there won't be many firms applying for an internal model, at least not at the first stage in the process.

Methodware: To add some context, we intuitively see a correlation between companies choosing their own internal model, being larger and more aggressive in their time scales of dealing with Solvency II.

When QIS 3 and QIS 4 were still being conducted, a lot of people said they didn't think there was enough incentive to use an internal model. Is that still the case?

Porteous: Solvency II is not just about capital or the potential for capital reductions, it's also about best practice risk and capital management. That's where we want to be from a credibility point of view and because that is a better way of running your business.

What's the biggest challenge with systems and governance posed by Solvency II?

Ducker: We start at the top – we look at governance, the risk management framework and how the various other aspects of delivery can support that to deliver into key components, such as operational risk, insurance risk and so on. We've taken that sort of top-down approach and moved our way through the various parts of this business. This has presented some challenges because you're having to look at things that may have been running within the organisation quite successfully for a number of years, and having to challenge those approaches. Inevitably, that creates discussion, debate and takes a little bit of time to work its way through. But, overall, it will help companies to join the dots, to make their organisations more cohesive and bring a lot of people together. We've seen teams working together that historically would have rarely talked to each other, so there are some real positive cultural benefits to this process.

Black: And some of those information systems are key to making that cultural change. There is a lot of focus and energy at the moment, but how do you make that continue into the future beyond the scope of the immediate project? All those organisational and cultural changes are important, and a great way of getting it permanently into the DNA of an organisation comes from the systems – reporting systems, data management systems and the risk systems.

How much effort do insurers need to put in to compile their own risk and solvency assessment (ORSA)?

Ducker: Quantity is not necessarily quality in terms of the ORSA. We're



Toby Ducker



Bruce Porteous

aware that firms have looked at anything from a 50-page report to a 500-page report, but I don't think more pages are necessarily better. It's about how articulate you can be in describing your risk management system. The ORSA is going to be a key report but, if it's done right, it can be done with some benefits as well. It's really about how you can integrate the ORSA into your daily process and decision-making processes that will be the measure of how easily you find it. If the process is to put down your tools for a month, write your ORSA and then carry on with your business, then it's disruptive. If you can instead integrate it into the various processes that you have, see it as an output from those processes and use it for the decision-making, you will find it is of lower impact and actually of greater benefit to your organisation.

Porteous: All the components needed to construct the ORSA should already be there – the forecasts, the business plans and the projected balance sheets. Firms should already have that, so the work is going to involve putting it all together into a coherent report. The ORSA is key, it's absolutely fundamental to the way a firm runs its business and understands its risks, strategies and so on – especially if we can persuade and influence the supervisors to be proportionate.

Methodware: There is the danger that focusing on the efforts of producing ORSAs covers up the opportunities open to companies here. At the risk of being shot down for talking about a theoretical dream, we do see real benefits for companies that embrace the business processes around risk management and reporting, and push it further out into their business community. They are not necessarily tangible ones, but softer ones such as the consistency of approach; good change management; understanding of the 'why'; and better quality of input and buy-in of the process. It requires the cultural shift we have touched on already, a positive approach that asks 'how can we use this to our advantage?'. And, if followed through, there is the opportunity to integrate it as part of strategic business planning, which is also a tenet of Solvency II. But, it's not always easy to create that positive approach.

How many insurers do you think will use the internal model to value their operational risk charge for 2013?

Ducker: The subtlety here is whether the operational risk calculation is part of the calculation kernel, whether it is like the stochastic modelling at the heart of most internal models and whether it's calculated separately but still part of it. It must be part of the internal model, but what is your approach – stochastic modelling, a frequency severity approach? Or you can look at a more simplistic view again. It depends on the size of your company and the complexity of your operation as to which approach you end up with.

Porteous: It is undoubtedly a bit harder than the other risks. If you look to Basel II, hardly any banks got advanced measurement approach approval for their operational risk models. A particular challenge lies in implementing the operational risk framework so it sits within the business in a way that generates appropriate data and experience to meaningfully drive capital requirement quantification. It is going to be quite challenging to fully integrate these aspects and ensure that the business operational risk framework and experience genuinely inform operational risk capital management.

Ducker: There's a key link between operational risk and material outsourcing, which is in the prudential source book as part of the FSA's regulation but is enhanced for Solvency II. We all do it without thinking about it. Most large insurers will have investment managers who may not have seen that as a material outsource, but of course it is. All of the loss adjusters, third-party adjusters and all the people in the claim supply chain are material outsourcing as well. The regulator will expect you to understand those things and the operational risks relating to them. Again, outsourcing is no longer out of sight, out of mind. It's about being able to demonstrate your control of those outsourcing arrangements and convincing the regulator you are on top of those operational risk elements.

Is Solvency II an obstacle or is it an opportunity?

Ducker: We definitely see its benefits. One of our key themes is helping the business understand that there are benefits to Solvency II, it's not just about regulatory compliance. It is a key message in terms of driving the cultural change as well. Obviously, it will help to get their buy-in, but there are obstacles. The uncertainty, for one, is an obstacle. If insurers were left to themselves, they would probably get there, but not in the timetable that's currently out there. There are a lot of technical issues to resolve, but there are a lot of opportunities and benefits to be gained if insurance companies think about it and then act rather than react.

Mujkic: The introduction of Solvency II will improve risk management and help firms understand the risks in a different way, but we also have to consider the implementation costs. Having a massive Solvency II programme in place, the budgets can be quite significant. We need to try to avoid over-complexity and have the rules in place as soon as possible so firms can go ahead with the process. Further delays would just increase the cost.

Ducker: To give an illustration of the point Emir is making, Lord Levene indicated in Davos this week that the London markets could expect, in total, to spend £300 million getting ready for compliance on Solvency II. And that's against Lloyd's, which manages an annual premium of circa £29 billion. So that gives you a perspective on quite how much this is going to cost the market. Part of that is due to the timelines provided. It might be that Omnibus II changes that, but understanding the costs and the benefits side by side is important too.

Porteous: We're very strong supporters of Solvency II and have been for many years, but it depends on it not being over-engineered. If, crucially, we don't get appropriate equivalence or equivalence transitional arrangements, then the UK companies that operate in third countries may be unfairly and competitively disadvantaged. They will also have to run these businesses according to two sets of regulatory regimes that are potentially in conflict. This really is a big issue for many UK companies, so it's very important we get this right. In particular, we must get equivalence transitionals in place, and there is a pressing need for clarity on the process, in order to achieve this.

Black: If you view it as an obstacle then these costs you were talking about do create negative press. But, if you view it as an investment – not just for January 1, 2013, but for the long term – then you're laying down an infrastructure and making an effort that will take the business forward in a way you would probably want to do anyway. Hopefully, Solvency II has just given it that impetus, that little bit of carrot and stick, if you like. As an industry, it would have taken us longer to get there, so that's why I believe it's very positive.

Ducker: Just to take half a step back, if you looked across the industry you would find most of Solvency II is taking place already in different parts of different organisations. If you add it all together, it actually creates that flow. Businesses have recognised a lot of this stuff is very valuable to them, maybe not all of it and maybe not in quite the same time frame as you say, but it's very difficult to argue with the principles. Obviously the devil is in the details, as Bruce says, so we have to make sure we don't over-engineer the answer.

Methodware: We see this too and give the same answer – a lot of this is good business management for insurance companies anyway. It's the differences and additional requirements that appear taxing. Be pragmatic, but be courageous. This is an opportunity to roll out good business practice throughout the business, educate your user community, but also to align business operations with core business objectives. It's a real opportunity to create a culture of well-managed business growth. Paring down the costs of implementing Solvency II to the absolute minimum still incurs the costs, but probably not the benefits. Also, challenge your regulator to be clear with what your company needs to do to satisfy them for Solvency II.

This article provides only a flavour of what was discussed during the webinar. To view the entire proceedings, visit the media centre on *Operational Risk & Regulation's* website www.operationalriskandregulation.com