

Introduction

The purpose of this series of briefing notes is to assist with an understanding of the key principles of the Solvency II legislation and how this then translates into tangible deliverables and actions for an implementation programme.

In the first of these briefing notes some of the key elements of Solvency II are discussed together with the initial challenges for planning an implementation programme.

Further briefing notes in the series will cover topics such as uses of technology and the organisational design implications of Solvency II.

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Solvency II— What Is it?

Solvency II 's aim is to introduce, by October 2012, consistent principles of risk and capital management across all EEA regulated Insurers. Solvency II is similar to the banking regulations (Basel II) and has a framework composed of three main areas (pillars):

Pillar 1 covers the capability of an insurer to demonstrate it has adequate financial resources (a sufficient level of capital) in place to meet all its liabilities

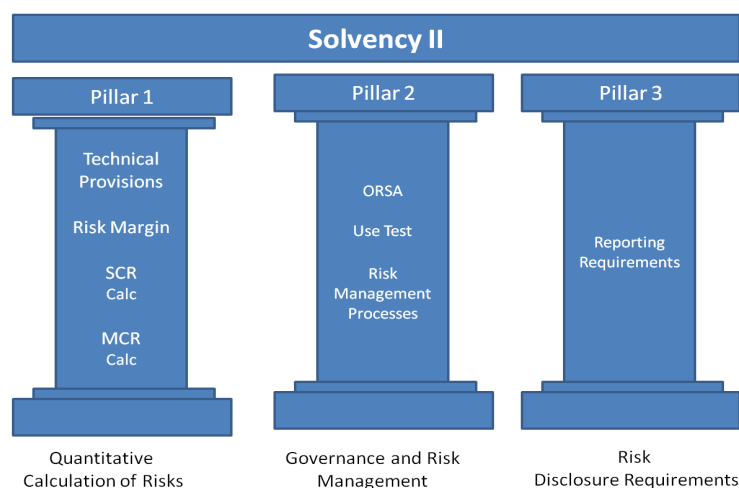
Pillar 2 sets out requirements for the governance and risk management framework that identify and measure the risks against which capital must be held

Pillar 3 focuses on disclosure and reporting requirements around these risks and capital requirements.

The implementation of the three pillars of Solvency II will introduce significant change in the way most insurers calculate and manage risk within their organisations, as well as in the way they disclose these risks to the regulator and other external bodies (such as rating agencies and the general public).

Focus Point

Solvency II has 3 pillars which cover different aspects of the calculation and reporting of risk capital



Key Terms

Focus Point

Regulators will focus on two key capital numbers the MCR and the SCR

There are a few key terms that Solvency II introduces that need to be mentioned at the outset. These are the:

MCR (Minimum Capital Requirement) is the minimum amount of capital the insurer needs to cover its risks. If an insurer's risk capital falls below the MCR they will be prohibited from writing any further business.

SCR (Solvency Capital Requirement) is the level of capital which if reached, will likely result in some regulatory intervention and require remedial action.

ORSA (Own Risk and Solvency Assessment) is the process by which the company will demonstrate how the SCR will continue to be met whilst executing its business plan. It is the key linkage between the company's risk capital modelling capability and the way the business operates.

Solvency II Key Deliverables

Technical Provisions and Risk Margin Calculations

Whilst an explanation of the calculation process for technical provisions and risk margins is beyond the scope of this overview paper it is useful to be aware that the valuation of liabilities, which is determined by these two elements, will be significantly different from Solvency I and therefore may require significant effort from the Actuarial and Finance department to implement.

SCR and MCR Calculations : Internal Model vs Standard Calculations

The SCR and MCR are the headline numbers that an insurer will produce for the regulator. They can be viewed as the regulatory benchmark for whether the insurer is meeting its solvency requirements. Insurers can base their calculations for the SCR and MCR on the EU 'Standard' formula, their own 'Internal' model or a combination of the two, a 'Partial model'. If an Internal Model is developed for any aspect of an insurer's business then it will have to be formally approved by the regulator and any differences in capital requirements, when compared to the Standard Formula, carefully explained.

It should be noted that whilst an insurer can choose which model approach they wish to use (Standard, Internal or Partial); they must be able to demonstrate the rationale for their choice in the calculation of SCR and MCR. By implication, an insurer will need to have done sufficient internal modelling to confirm their rationale for using the Standard Formula.

ORSA (Own Risk and Solvency Assessment)

Regardless of the type of model an insurer decides to adopt, there will be a requirement to carry out an ORSA. The production of the ORSA can be thought of as the entire set of business processes that will be used by the company to demonstrate how it will meet both its regulatory capital and internal capital targets. Its aim is to assist in the understanding of risk exposures within an insurer and demonstrate the effect of any mitigating actions. The ORSA will therefore require a structured and well managed approach to integrating Risk Management across the organisation and may require some complex modelling not far removed in sophistication from that used in developing an Internal Model.

Focus Point

Insurers will need to have done sufficient work to confirm their rationale for using a Standard Formula.

Internal Model

If an Internal Model is developed it will need to be supported by key aspects of the business decision making processes such as business planning and product development. The Internal Model is not just a calculation engine but is an integral part of the overall Business Operating Model of the insurer. The Internal Model provides the capability to assess risks within the business and translate these risks into quantifiable capital requirements.

Current legislation implies that Insurers will probably have to use/gain approval for an Internal Model if the standard formula doesn't adequately reflect the key risks within their organisation.

The Use Test

The Use Test is a key part of gaining regulatory approval to an Internal Model. It enables the insurer to demonstrate that there has been sufficient discipline in the development of its Internal Model as well as ensuring that there is robust governance around the ongoing management of any changes.

In addition, the Use Test needs to demonstrate that the Internal Model 'plays an important role in' the management of the insurer. The work required to support the Use Test and demonstrate, to the regulator, that the model is 'widely used in the management of the firm' will certainly not be insignificant and will encompass many areas of the organisation. In addition to the Use Test there are a number of other tests that the regulator will require for approval of the Internal Model.

Key Programme Workstreams

Developing the Risk Model

To develop a model that quantifies capital requirements and supports the ORSA may require significant development work from many functions most notably Actuarial. Key areas of focus in model development will be around model documentation, calibration, validation of data sources and integration of the model into key business processes.

Certain tests must be successfully completed if Regulatory approval is to be given to allow SCR and MCR to be calculated using an Internal Model. These consist of the Use Test and a range of other tests which are listed below:

P&L Attribution – how does the Internal Model 's assessment of risk adequately explain the actual sources of profit and loss?

Validation – is there a regular cycle of model validation to ensure it remains appropriate?

Documentation - is there sufficient documentation to adequately explain the entire model. Is it adequately maintained?

Calibration – How is the model benchmarked? What sensitivities and reconciliation to the SCR are carried out?

Statistical Quality – Is the model based on adequate actuarial and statistical techniques?

Internal Models can cover all the business risks (Internal Model) or only some of the business risks or business units (Partial Internal Model). If using a Partial Internal Model (PIM) insurers will have to integrate the results from that model with the results from the standard formula for any businesses/risks not modelled.

Focus Point

An Internal Model must undergo a range of tests if it is to be accepted by the regulator to calculate MCR and SCR

ORSA – Developing The Risk Management Framework

To develop an effective ORSA will require early integration into the formal business planning cycle of the insurer. Its development will require a cross functional team comprising of Finance, Actuarial, Risk and IT personnel, plus other subject matter experts such as investment, tax and reinsurance. The scale of the work involved in the development of the ORSA will depend on the existing risk management processes of the insurer and how these processes currently integrate with the current business planning cycle.

Focus Point

ORSAs will need to be integrated into the existing business planning cycle

Regulatory Approval and Reporting

Solvency II will require additional disclosure of information related to the risks being managed within the insurer. These disclosure requirements, as well as generating more in-depth discussions with the regulator, may also influence other external bodies such as rating agencies or investors.

There is therefore significant work required to assess and understand what reporting information will be required; how it will be produced; and what influence the new reporting requirements will have on future business strategy and planning.

Finally even if a Standard Formula is used for calculating risk capital it will be necessary to plan a series of managed engagements over an extended period of time with the regulator. These engagements will need to be well planned to ensure that resources from the regulator are made available to provide the necessary feedback in a timely manner.

The Challenges of Programme Initiation

Implementing Solvency II will be a major challenge for all organisations and will require significant effort from many different business functions. Translating this into an implementation programme is likely to result in a number of key management challenges that will include:

Clarity of Objective: Obtaining clarity around what the Solvency II Programme is trying to achieve in terms of capital savings will inform a number of key decisions around the costs and benefits of implementing a full or partial Internal Model.

Programme Structure: The impact of Solvency II is not just financial and may include amendments to current organisational roles and existing customer propositions. Ensuring that there is a clear unambiguous programme structure that will provide leadership to the organisation on the changes necessary for Solvency II will be critical in implementing all the necessary changes.

Liaison with the Regulator: Understanding the timescales and process for liaison with the regulator throughout the approval process will be key to avoiding any last minute regulatory concerns.

Prioritisation of Projects: Defining how projects within the Solvency II programme will be prioritised and whether there are opportunities to implement aspects of Solvency II as part of other ongoing programmes of work could reduce the overall programme cost to the organisation.

Involvement of Expert Resource: Planning and estimating the level of involvement of Subject Matter Experts (SMEs) and the provision of cost effective solutions to address project or workstream resource shortfalls during periods of peak activity, such as year end, will minimise the impact on key business-as-usual activities.

The implications for Solvency II implementation are such that effective planning and organisation is required now if a smooth and effective implementation into the organisation is to be achieved.

LPI2 focuses exclusively on supporting organisational and technological change within the Life, Pensions and Insurance market.

For further information on how LPI2 can support the resourcing of your Solvency II Programme with experienced individuals please contact **Nick Quigley** on **020 3292 0148** or email nick.quigley@lpi2.co.uk