

Solvency II

Solvency II – the regulatory capital directive for European insurers and reinsurers - was on its way before the current crisis hit the financial services world. Events of the last 12 months have undoubtedly though increased the focus on companies holding enough capital to see them through the bad times. Regulators must also feel they are in a stronger position to drive substantive change and demand greater openness and rigour from insurers as the world's eyes focus on how the likelihood of more corporate failures can be reduced.

So how does Solvency II plan to make the insurance world a safer place for shareholders and policyholders money?

By making sure that the management of (re)insurance undertakings (as the terminology goes) firstly reserve the funds to meet their liabilities in the event of a winding up – this is called the Minimum Capital Requirement. The MCR is designed to ensure that no insurance company in future will be left needing emergency funding to closedown in a controlled way. This is only the start though. Solvency II also requires calculation of a “gone and going concern” capital level – the Solvency Capital Requirement – which is the capital needed to pursue objectives and business plans, not to just cover commitments if the worst happens.

In calculating these requirements firms have two options. They can either use a standard formula, specified by the European Commission and linked to business metrics or use an internal model, either full - covering all types of risk/business lines or partial where a full model isn't feasible. The expectation is that internal models will generally produce a level of required capital lower than that calculated using the standard formula, giving undertakings a reason to invest time and effort in developing acceptable internal routines. This is the carrot. The stick is that the regulator has the option of imposing an additional reserving requirement – a capital add-on where they do not feel that companies are holding enough capital to cover their risks, whether calculated according to the standard formula or internally. The big stick – the ultimate sanction – is that the regulator can withdraw authorisation from any firm which does not put right inadequacies in their reserving policies and processes.

Anyone with experience of BASEL II may feel that they have seen all of this before, and will be wondering why Solvency II is any different. The quick answer is that it is and isn't different. The principles are very similar to those embedded in BASEL II – and why shouldn't they be? It wasn't the principles of BASEL II that failed the banks, it was the practice. And this is where Solvency II plans to be different. The guidance issued for Solvency II (created by CEIOPS, the Committee of European Insurance and Occupational Pensions Supervisors) is worded to suggest that that the regulators are looking for something new from insurers post implementation of the Solvency II provisions and that tinkering around the edges of current practice will not be enough.

In relation to internal models for example, and the need for the regulatory capital model to be embedded in the business, CP 56 contains the following phrase which is not the formal language we are used to seeing:

- “the Use test philosophy boils down to the following: if an undertaking does not trust its model sufficiently to use it, why should the regulatory authority?”

Any firm looking to have a regulatory capital model and an internal capital model and which cannot reconcile and justify differences between the two should beware.

Around senior management responsibility for and understanding of the internal model

- “responsibility means that management should not, for example, manipulate the internal model to get the results they want”

Really needs no further explanation.

and on the relationship between the risk and actuarial functions

- “The risk management function will need to be aware that if the internal model users are too intimately involved with the internal model, they may have “blind spots” about the effectiveness of the internal model, and the risk management function should provide appropriate challenge.”

The interaction between the risk and actuarial functions is one of the key areas for anyone determining what “good looks like” in the Solvency II world. The regulation specifies what tasks should be carried out by the functions but is at pains to point out that “function” does not mean “department” and that it is up to the organisation to determine what are the right internal structures. It describes however a “calculation kernel” as being something different from the internal model suggesting that renaming the actuarial model the “internal model” will not do.

What will you need to do then to meet the requirements of Solvency II?

The answer is to apply real challenge to your current practice taking note not just of the detailed requirements but of the tone of the guidance. You should also bear in mind that, as well as including requirements for enhancement of risk management practices, Solvency II has embedded in it a new public disclosure requirement – the Solvency and Financial Condition Report.

The fundamentals of Solvency II are that each firm will have to develop an internal routine – the Own Risk and Solvency Assessment (ORSA for short) to look at all risks across the organisation, all funds available to balance as capital against those risks for reserving purposes, and the excess of funds which provides the solvency buffer. This process must make use of the best available information on risk exposure, include explanation and justification of assumptions which underpin any internal models used and allow stressing of assumptions to project possible scenarios and the effect these events would have on stability of the firm.

All the above needs to be documented, capable of being demonstrated as a fundamental part of the management of the firm – to meet the use test requirement – and explained in the Solvency and Financial Condition Report in a way which is suitable for public disclosure.

There is a long way to go on Solvency II. At present, the primary legislation and first tranche of consultation papers have been issued and comments from the industry are being taken into account before more detailed requirements – the Level 3 text – are published. This is due in 2010 and will fill in some of the gaps which currently exist particularly on technical issues, and on such subjects as whether the Solvency and Financial Condition Report should be subject to external audit.

What is clear though, is that the intention of the legislators and regulators is to shine more light on the way in which risk is managed and capital reserved in (re)insurance firms, and that even if you do not think that much of your current practice needs to change, you are unlikely to have articulated or documented it in enough depth to satisfy.

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