

CrossCurrents

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Ready, set, go! Insurers gear up for Solvency II

by Phil Vermeulen and Phil Whittingham

Key points

- ▶ Insurers benefit from participation in the consultative program known as QIS, which is testing the industry impact of Solvency II.
- ▶ QIS has advanced considerably in aligning the pending regulations with industry requirements.
- ▶ Solvency II implementation requires action now.
- ▶ Insurers must explore new risk management models and document processes.

Since late 2005, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has engaged in consultation with the European insurance industry to test the impact of proposed Solvency II regulations. Companies are involved in the process, known as Quantitative Impact Studies (QIS), on a voluntary basis. CEIOPS is administering the QIS at the request of the EU Commission.

Members of the Chief Risk Officer (CRO) Forum benchmarked QIS 3 results against their internal company models.

A brief history of QIS

QIS is the primary means for testing the design of the future European Standard Formula and for determining the correct calibration of required capital and technical provisions. The studies are also instrumental in collecting data on the potential impact of the new regulations.

Industry participation has steadily and significantly increased since QIS 1. The potential framework for Solvency II is now well developed, and the changes being tested in QIS 4, currently under way, are far less significant than in previous QIS.

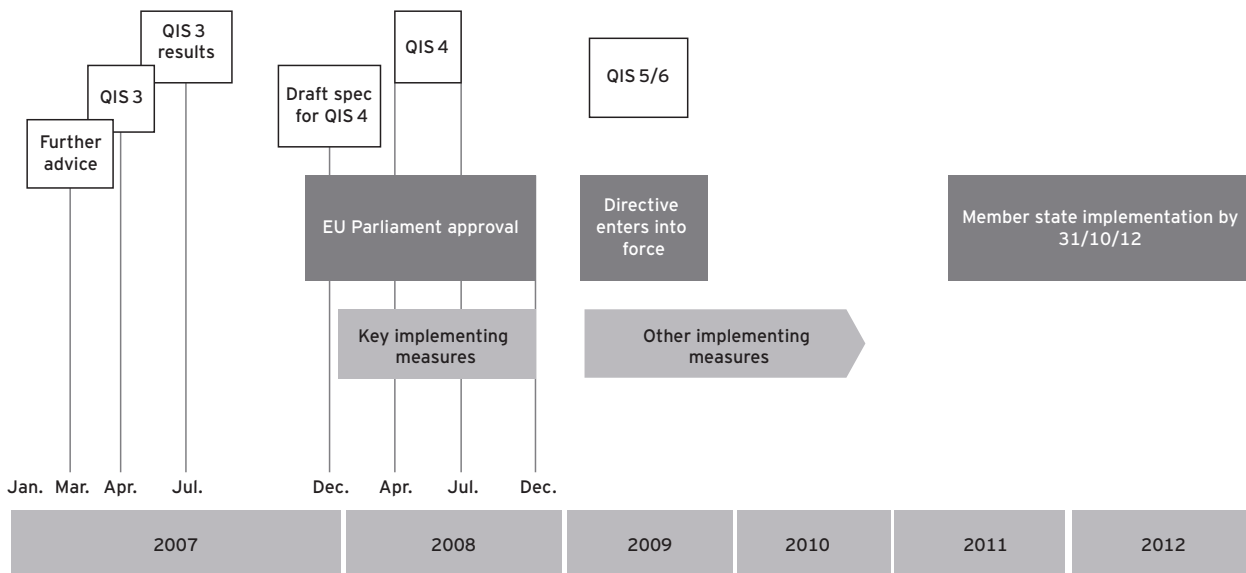
Therefore, this is the ideal opportunity to perform a trial run of the Solvency II specifications and test the impact on your business.

QIS 1 was intended to test an approach for setting the technical provisions, while QIS 2 focused on a methodology for assessing required capital or the Solvency Capital Requirement (SCR). QIS 3 focused on improving the calibration of the standard formulas for the Minimum Capital Requirement (MCR) and SCR calculations. CEIOPS released the draft specifications of QIS 4 on 21 December 2007. This interim

specification was subject to consultation with the Coordination Group until 15 February, and the final specification was approved at the end of March. QIS 4 will run from April 2008 until July 2008. (Figure 1 below illustrates the QIS timeline for consultation and implementation.)

CEIOPS also released Consultation Paper 23 (CP 23), which provides guidance on how to determine the technical provisions (Best Estimate and Risk Margin) when data and/or expertise are missing in the company. These simplified methods will also be tested in QIS 4.

Figure 1.
QIS timeline



Lessons learned from QIS 3

The objectives of QIS 3, the first study to focus specifically on calibration, were to:

- ▶ Measure the financial impact on balance sheets of the adoption of QIS 3 specifications
- ▶ Collect feedback from the participants on the practicality and suitability of the calculations
- ▶ Test the effects on insurance groups for the first time

Impact on balance sheets

The numerical results of QIS 3 provided several insights related to the potential impact of Solvency II on the regulatory balance sheets of insurance companies:

- ▶ Technical provisions tended to decrease, with the release of the prudence margin in Solvency I being greater than the additional risk margin under Solvency II.
- ▶ The decrease in technical provisions was more than matched by an increase in the capital requirements. On balance, the overall solvency ratio tended to decrease. This was most significant for non-life companies, where the solvency ratio decreased for the majority of participants. Life companies showed a combination of increases and decreases in the solvency ratio.
- ▶ QIS 3 showed that 98% of firms meet the MCR and 84% of firms meet the SCR, so a large-scale capital injection is unlikely. However, some reallocation of capital may be needed, reflecting the increased risk sensitivity of the proposals.



No time for complacency

Insurers need to start preparing now for Solvency II. Key implementation considerations are outlined below:

- ▶ Solvency II is a cross-business program that requires rigorous project management and strong executive buy-in. The directive covers many areas of the business, from the setting of technical provisions to internal controls, capital tiers, governance arrangements, financial reporting and calculating capital requirements.
- ▶ The directive expects adopters to demonstrate that regulatory compliance activities are embedded within the business itself. As such, compliance encompasses all aspects of the organization, with implementation requiring varied skill sets. In the past, firms that have not taken project management seriously have found it harder to meet regulatory requirements.
- ▶ Currently, the Lamfalussy structure* sets forth relevant implementation requirements. However, the draft directive will not include a complete instruction manual; implementation guidance and other aspects of regulation will likely be released in the future. To a certain extent, firms are aiming to meet an unknown benchmark. Good programs will need to demonstrate the presence of mechanisms to monitor regulatory developments and to adapt the program accordingly. Firms that aim above basic compliance are likely to be more successful.
- ▶ Solvency II needs to be linked to other change programs, in part to avoid duplication of effort. Insurers might wish to link their Solvency II and International Financial Reporting Standards (IFRS) Phase 2 programs, given the common underpinnings of the balance sheet and technical provisions. However, firms should also examine whether other programs (e.g., technical pricing) should be linked as well.
- ▶ Existing risk models will probably not be good enough. While most insurance companies have risk models and risk management processes in place, a number of firms will likely face challenges in adapting existing risk-based capital models to meet Solvency II requirements. Organizations must be able to document key model development processes, validation testing assumptions and conclusions.
- ▶ Data requirements will be considerable, even for companies using the standard formula. Identifying appropriate data that meet standards will be more difficult and labor-intensive for firms pursuing internal modeling. Finding the right quantity of good quality, usable data will be challenging, particularly in areas such as operational risk. Other areas, such as persistency, must be re-examined to assess whether policyholder-level data are sufficient to allow full analysis.
- ▶ The debate in Solvency II has centered on the standard formula for Pillar 1 capital calculations.** However, those organizations that focus primarily on Pillar 1 will find Pillar 2 to be equally challenging. In particular, it can be a difficult task to demonstrate that risk management is embedded within the business culture and an essential part of the process. Insurers that leave the Pillar 2 qualitative requirements until the last minute will find the organizational change a challenge.
- ▶ The requirements for an Own Risk and Solvency Assessment should not be underestimated. This takes into account the insurer's specific risk profile, approved risk tolerance limits and business strategies. The recent risk management paper issued by the Committee of European Insurance and Occupational Pensions Supervisors provides a good indication of how the thinking is evolving and why some insurers may struggle to meet the expectations.

* The European Union's structure for developing and adopting financial services legislation at the European level.

** This refers to the three-pillar structure of the Solvency II reporting regime. Pillar 1 relates to quantitative requirements; Pillar 2 addresses internal and external verification procedures; Pillar 3 addresses market transparency and discipline.

QIS 3 was the first consultation to address the issues related to management of insurance groups.

The Chief Risk Officer (CRO) Forum, representing the 13 largest European insurers, benchmarked the results against their internal company models. They found that the QIS 3 specification tended to result in an SCR approximately 40% higher than internal models, largely due to differences in the calibration of the insurance risk SCR. Clearly, companies can still benefit from taking part in further consultations to align these calibrations.

Risk margins and profitability

QIS 3 results were well received, and participants were positive about moving toward market-consistent valuation and risk-sensitive solvency requirements. They had this feedback on key areas:

- ▶ **Risk margin.** The risk margin approach should be more clearly defined and market risks should be excluded to avoid double counting. QIS 4 addresses these issues by providing guidance on simplified approaches for projecting the SCR and changing the specification to exclude market risks. Additionally, participants felt that the 6% cost-of-capital rate was too high; however, CEIOPS has not addressed this in QIS 4 pending more industry research.
- ▶ **Reduction for profit-sharing.** The proposed method for assessing the risk-absorbing ability of future discretionary profit-sharing (known as the KC) was strongly criticized. This method was based on: calculating all SCR components, assuming no change to discretionary profit-sharing benefits in stress scenarios; aggregating these; and reducing the overall SCR by a factor to reflect the risk absorption

capability of future profit-sharing. QIS 4 has moved to a calculation of SCR components “net” of management actions, which is more aligned with current market practice.

- ▶ **Operational risk SCR.** The formula is insufficiently risk-sensitive, includes an inappropriate charge on unit-linked business and does not diversify with other risks. The formula and diversification benefit have not changed in QIS 4 – CEIOPS stated that this was better addressed under Pillar 2.¹ Addressing industry feedback, the charge for unit-linked business is now based on expenses.
- ▶ **Lapse risk SCR.** QIS 3 included an assessment of lapse catastrophe risk, based on a mass lapse of 75% of the company unit-linked portfolio. This was criticized as being too onerous and has been reduced to 30% in QIS 4. The new rate is now extended to apply to all businesses where there is a surrender loss on lapse.
- ▶ **MCR.** The approach set out for the MCR was believed to be too volatile and impractical and demonstrated an unintuitive relationship with the SCR for many life insurers. QIS 4 is now proposing a “linear” approach, which is less risk-sensitive; however, this is by no means the final view.

Issues for insurance groups

QIS 3 was the first consultation to address the issues related to management of insurance groups. A key industry criticism was that the QIS 3 treatment of insurance groups did not allow for adequate

geographical diversification benefit. The approach to subsidiaries outside the European Economic Area (EEA) was also challenged. To address this, QIS 4 has requested different calculations to investigate other approaches for recognizing group diversification benefits. One of these assumes consolidation of non-EEA entities in an attempt to apply more consistent standards and include diversification benefits.

New issues in QIS 4

The main objectives of QIS 4 are to test:

- ▶ Simplifications for smaller insurers (the principle of proportionality)
- ▶ Simplified approaches to estimating technical provisions
- ▶ Further refinements to the calculations and calibrations of the SCR standard formula

Simplified approaches

CP 23 provided guidance on “proxy” calculations for the technical provisions, and these approaches will be tested in QIS 4. These are simplified, market-consistent valuation methodologies aimed at overcoming the problem of a lack of data, or of a lack of actuarial expertise in assessing technical provisions, for less material lines of business. In addition, QIS 4 will provide simplified formula-based proxy calculations for the SCR.

The aim of these proxies is to provide simple estimation techniques to avoid disproportionate calculation effort for small lines of business. The criteria for application of these techniques is that liabilities must

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be simple by nature and not exceed €50m for life (€10m for non-life) or 15% of the total technical provisions or SCR of the company. These techniques can also be applied in the projection of the SCR in future time periods as proposed by the risk margin calculation for those who cannot project the SCR. This can be a good alternative to the formula-based SCR runoff.

Further refinements

In addition to responding to industry recommendations, QIS 4 contains changes from QIS 3. Most are relatively minor changes to the SCR assessments (such as for the market risks) although some are significant enough to warrant mention.

In QIS 3, swaps were the favored proxy for risk-free rates as opposed to government bonds. QIS 4 now appears to favor the use of AAA-rated government bonds although entities may deviate from this (e.g., use swaps) if they deem it more appropriate. This generally implies a significant increase in the technical provisions and a reduction in available capital. Current practice in the market: consistent embedded value reporting tends to favor swap rates because of the existence of more liquid swap markets.

QIS 4 includes guidance on the valuation principles for additional assets, which brings company pension schemes into the scope of consultation. The specification states that the IAS 19 treatment of a pension fund is an acceptable proxy and hence brings surpluses and deficits onto the balance sheet.

Final implementation

Solvency II is all about improving risk management and rewarding existing good practice, all of which takes time. Insurers need to start preparing now if they do not want to be caught out when Solvency II comes into effect. Insurers can glean good indicators of leading practice from other large-scale change projects such as the International Financial Reporting Standards initiative, which is running parallel to Solvency II for insurers.

Many companies are using the QIS as a catalyst to launch a full-scale gap analysis into Solvency II preparedness, processes and capabilities. Insurers should not underestimate the time required to implement a program with the complexity, scale and far-reaching implications of Solvency II. Indeed, QIS exercises demonstrate that there are considerable

challenges, even for those seeking to follow the standard formula approach to the capital calculation.

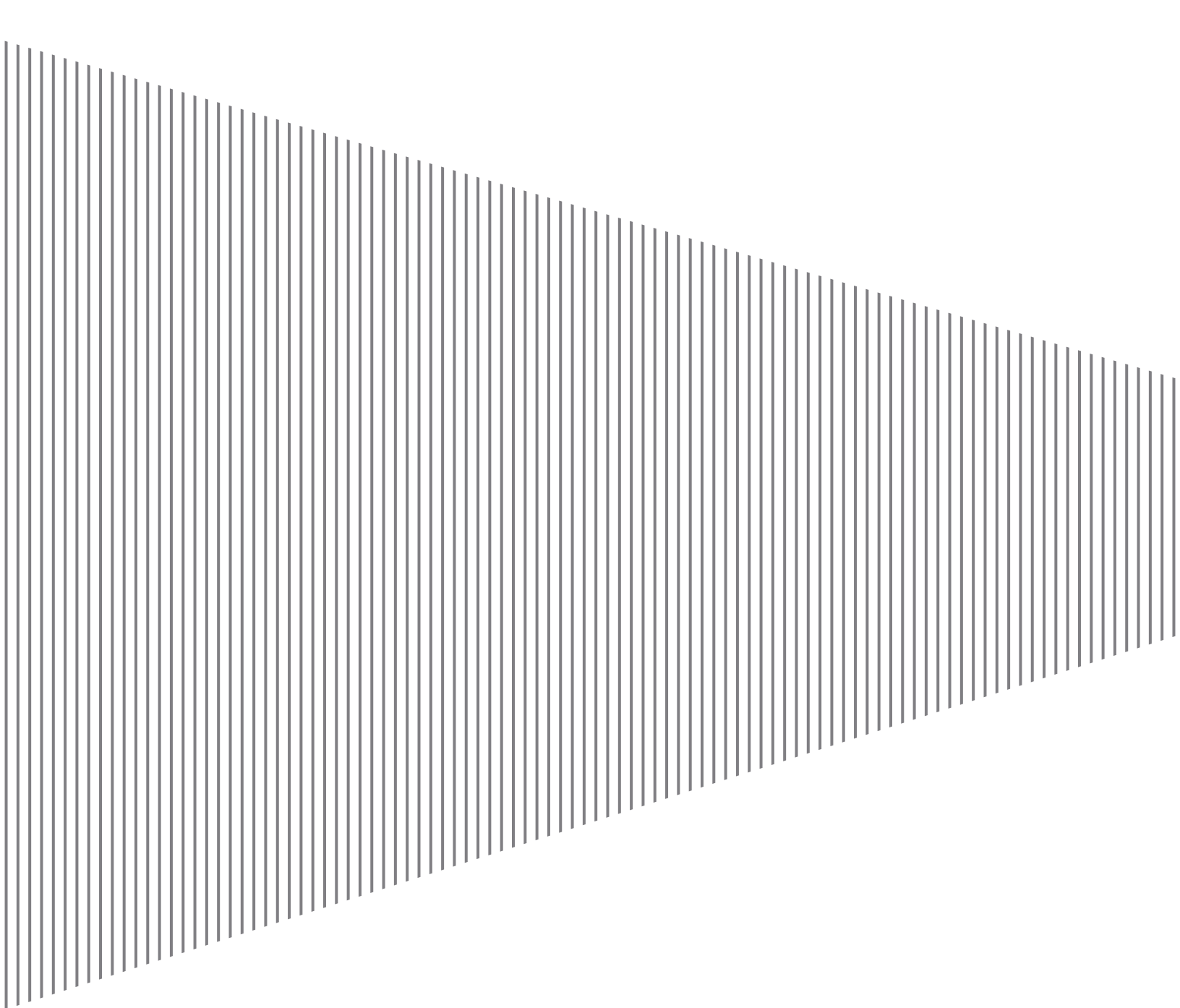
Insurance companies face many challenges in achieving a Solvency II-compliant state. The more conscientious firms will view Solvency II not as a series of hurdles to be met by a small margin, but as an opportunity to drive change within their organizations. Their goal will be to manage risks more effectively and to better understand the business drivers for enhanced decision-making.

Many companies, recognizing the scale of the challenge, have established working parties and project teams. Delay is likely to increase costs and reduce the chances of success. While the implementation date of 2012 offers some reprieve, it should be seen more as an opportunity to do things better rather than as a reason to procrastinate.

Leading insurance companies will view Solvency II as a cost/benefit transformation. These firms will embark on a path of improvement informed by the regulation, but in all likelihood, ahead of it – making their businesses more competitive. Δ

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