Twists and turns

Phil Whittingham outlines what the re/insurance industry can learn from other large-scale change projects such as Basel II and IFRS if it is to successfully implement the new regulatory framework in Europe.

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There were more than a few deep sighs of relief around the insurance sector when the deadline for Solvency II recently was pushed back to 2012, but this brief respite allows no room for complacency. The delay in implementation, announced with the publication of the recent draft directive, reflects a very real recognition that 2010 was just too tight a deadline for most of the sector to achieve. What we have now is a road map for the journey and some very clear milestones that need to be achieved during the next five years.

THE DRAFT DIRECTIVE

As expected, the draft directive sets out the three pillars of the Solvency II regime as a series of articles in a slightly different order. Those who viewed earlier drafts of the directive suggest that significant work was undertaken and content changed before this draft could be released, in particular around Pillar 2 and 3 issues. This reflects the current debate around these issues and the challenges in developing the directive. The fact is that the final directive continues to evolve. The timing is now crucial in terms of shaping and preparing for the directive. There are groups lobbying on behalf of insurers and other voices to be heard that will influence future decisions.

Insurers should not underestimate the time required to implement a programme with the complexity, scale and far-reaching implications of Solvency II. Indeed, the quantitative impact studies (QIS) exercises have demonstrated that there are considerable challenges even for those seeking to follow the standard formula approach to the capital calculation. Already the timetable is tighter than it was for Basel II and the struggles that some in the banking sector had in meeting those requirements are well known. Clearly, there are lessons to be learned and the onus is on companies to start now.

LESSONS FOR THE NEW TIMEFRAME

Fortunately for insurers, there are some good indicators of best practice when it comes to large-scale change projects. There are benefits and valuable experience to be derived from other initiatives like International Financial Reporting Standards (IFRS), which are running parallel to Solvency II for insurers:

1) It is a cross-business programme that requires project management and strong executive buy-in: Solvency II touches on many areas of the business, from the setting of technical provisions, to internal controls, capital tiers, governance arrangements, financial reporting and calculating capital requirements.

   In addition, the directive expects to see a clear demonstration that the approaches required for regulatory compliance are not just being done for compliance reasons, but are being embedded within the business.

   As such it touches on all aspects of the organisation, with implementation requiring varied skill sets. Solvency II is a cross-business programme that needs coordinating. It is also a project that will be significant in scale, requiring proper project management skills. Past experience has demonstrated that firms that have not taken project management seriously as a discipline have found it harder to meet the regulatory requirements.

2) Mechanisms are needed to allow for the constantly evolving regulatory environment: Because the Lamfalussy structure sets forth the requirements, the draft directive will not provide a complete instruction manual of what firms need to do. Implementation guidance and other aspects of regulation will likely be released over time. However, the scale of the Solvency II programme dictates that the process should start now. To a certain extent, firms are aiming to meet an unknown benchmark. Good programmes will need to demonstrate two attributes to overcome this challenge: firstly, they will include mechanisms to monitor regulatory developments and to adapt the programme accordingly; secondly, they will aim to introduce good risk management processes, notwithstanding the regulation. Firms that aim above basic compliance are likely to be more successful.

3) It needs to be linked to other change programmes: Too often, there is a duplication of effort between projects. It is easy to suggest insurers might wish to link their Solvency II and IFRS if it is to successfully implement the new regulatory framework in Europe.

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Equal Risk and Solvency Assessment (ORSA) should not be underestimated. This takes into account the specific risk profile, approved risk tolerance limits and business strategies. The recent risk management paper issued by the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) provides a good indication of how the thinking is evolving and why many insurers would struggle to meet the expectations.

7) Documenting the process and drawing the right conclusions: Building internal models will be a challenge for many. However, alongside this are challenges in demonstrating the thinking behind the models and the parameterisation. Getting the right data for the models is only one aspect. Organisations will need to be able to demonstrate a clear thought process in developing internal models and documenting the processes, assumptions and conclusions.

THE TIME IS NOW
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 organisations. The ultimate goal is to manage risks more effectively and to better understand the business drivers that will enhance the decision-making process.

Given the scale of changes that are anticipated, firms need to start their Solvency II projects now. Indeed, many companies already have set up working parties and project teams, recognising the scale of the challenge. The industry should not delay as this is likely to increase costs and reduce the chances of success. While the delayed implementation date of 2012 offers some reprieve, it should be seen more as an opportunity to do things better than as a reason to procrastinate.

It is worth reflecting that winning insurance companies will look at Solvency II from a cost/benefit transformation perspective. Those firms will embark on a path of improvement that will be informed by the regulation but will, in all likelihood, be ahead of the regulation. The question is: do you want the winners to be you or your competitors? ®

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5) Data requirements underscore the need for quality: Based on experience completing the QIS exercises, there will be considerable data requirements even for companies using the standard formula. Identifying appropriate data that meets standards will be more difficult and labour-intensive for firms pursuing an internal modelling route. In gathering data, particularly in areas such as operational risk, they will be challenged to find the right quantity of good-quality, useable data. Insurers will have similar issues with risks that they already understand. Other areas, such as persistency, will have to be re-examined to assess whether policyholder level data is sufficient to allow full analysis.

6) It is not just about getting the Pillar 1 mathematical issues right; Pillar 2 is a significant challenge: So far, the debate in Solvency II has centred on the standard formula for Pillar 1 capital calculations. However, while this is clearly a significant issue, those organisations who 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 organisational change a challenge.
Too much capital and not enough catastrophe has been the story in 2007. Together with increasing scrutiny on re/insurers from regulators, rating agencies, quasi-governmental bodies and investors, this means managing that capital effectively is now a central boardroom concern. Our expert panel gathered with Richard Banks in Baden-Baden to debate the issue further.
The Review: How has the amount of capacity needed by the international markets changed over the past decade?

EP: It has definitely changed a lot. If we go back as far as 1997, I think we have had a couple of shocks since then, and the broker would say an over increasing demand of capacity, sometimes met by a very significant capacity provided by reinsurance and sometimes a very significant squeeze.

CW: I would say that is true, I think there have also been regulatory and modelling changes on the back of some loss activity that pushed up the capacity requirements and really changed the way people had to manage catastrophe risk in particular.

BM: While I would agree with the strong increase, it has been rather uneven and some risk segments required a lot more capital and others did not and that introduced some difficulties. What would have helped this would have been to have much more flexibility and diversity in terms of capital instruments and insurance linked securities which can specifically deal with some of these peaks without the negative consequences of having an excess capacity elsewhere.

HG: The most profound change probably occurred post-Katrina where all the modelling companies changed their models and introduced new loadings. It seemed to me that casualty all of a sudden became the line that did not need any capital anymore because everybody rushed into it, some were pushed by the rating agencies and if anything that has caused and accelerated softening in that sector.

YP: The degree of sophistication of the capital instruments that are available to insurers and reinsurers has evolved tremendously.

The Review: So we have got neutral standards, we have got mutual sophistication of models, what could the effect of that be? Is that something that we are going to see developing further, going forward or have we reached plateau do we think?

DP: I do not think we have reached a plateau in terms of capital modelling at all. Although there has been a lot more sophistication in the last 10 years, people are not really far enough along yet – for example when we come to talk about Solvency II, they probably have developed a sophistication without fitting future specific requirements.

EP: I would agree. In fact it is a journey that is not finished. A lot of companies, certainly the bigger ones, have had to do a lot of work on their internal models. If you get internal models, it means you have got to understand the risk and you are careful at it.

BM: I would agree that the modelling will continue to push forward what is an ongoing development. But I would like to caution that on the underwriting side, if you get too model-biased and if you put too much trust in that and forget common sense and the general expertise which comes from the risk side, then I think we are opening ourselves to a risk, maybe even to a systemic risk. Even though Solvency II anticipates that sophisticated companies will use their own risk model you can expect that this is going to gravitate to maybe three basic types of model, and if everybody plays the music to the same tune you could ask the question: ‘What introduces the systematic risk?’

YP: Potentially at the end of the day there might be a risk around models converging in the same direction but hopefully Pillar 2 [of Solvency II] should safeguard some insurers and reinsurers against blind faith given to internal models, but that is certainly a risk in the long run.

CW: You have to be very careful that the goal of Solvency II is to put everyone on the same footing but to a degree there is a self-graded exam if you have got an internal model. It is going to be very important for the regulators to figure out where the weaknesses are in those models, from a qualitative standpoint as you are alerted to with Pillar 2.

BM: I think this point raises another question. The question that is being asked, is ‘how prepared are companies for Solvency II?’ The other question is how prepared are the regulators for actually executing what is required on Solvency II?

YP: There is a big discrepancy between European regulators regarding their preparedness for Solvency II. The UK regulator is clearly ahead of all the other ones because it has already implemented some regulatory measures that are very close to what will be required according to Solvency II. Second is the Swiss regulator, although Switzerland is not part of the EU. The Swiss solvency test provides quite a robust platform that again is good anticipation for Solvency II. Then in third you have got the regulators from some smaller countries that are looking at implementing Solvency II in advance of 2012, countries like Portugal and Sweden, for instance. The last group is made up of big country regulators including Germany, France and Italy where Solvency II will require a complete change of mindset. There will be the investment in terms of resources, manpower and then technical resources if you want to check an internal capital model. Some of those regulators still have not got the technical ability to do this.

HG: We can take this one step further. There are over 200 insurance companies in Germany and the top 10 of them probably know what Solvency II really means and what it takes to implement it in their organisations. But if you go through the mutual sectors they are light years away from it.

The Review: So what is the effect of that going to be?

HG: Like always, there will be a mad rush to catch up at the very end, but as the full implementation of Solvency II is also being delayed year after year, I could imagine that some companies take the view, ‘Well this is five years out and we are going to deal with it when we get there.’

CW: Some of it will be dependent upon how much more rigorous the standard approach is over and above Solvency I and if that is really involved it may change the environment quite substantially for some of the smaller companies. If they feel as though they can handle it with not a huge amount...
of resource allocation it may not be that big a deal.

EP: I would maybe question the common wisdom that we need consolidation because a small company has a lot of options including reinsurance. Some of the sophisticated tools may gradually become available for smaller less sophisticated players.

DP: When you talk about how rigorous Solvency II is, it is often in terms of the figures but I think two other challenges are the actual techniques and processes. Going back to Pillar 2 one thing we have not mentioned is the use test – the requirement for insurers not just to go through the processes demanded by Solvency II but to show that they are using these processes for capital allocation and pricing in their internal management.

The Review: Do you think it is correct that the regulators should give pressure in that direction?

DP: I have a hard time believing that any regulator can fully assess how well a company is run. They cannot be the experts in that.

BM: They set the framework and they set some of the rules of the game and in retrospect it is important that they do not introduce a bias which has no economic sense or economic value. Beyond that competition is probably an excellent force to make sure that companies move forward rather than backwards. Regulators all need to catch up on the insurance side but on the reinsurance side I think it is not quite the same. How many regulators can actually afford the responsibility to get up to the level needed to properly supervise the insurance entities?

HG: I just wanted to give a word of caution in submitting tons of information to regulators. First that calls for more information, more questions and over-regulation. My view is that they need to set the framework and they need to monitor compliance with the framework and then pick out the bad apples and deal with those generally. Within the EU the implementation and the depths by which each regulator will make it work will be different and in the end that is another competitive differentiation. It is not surprising that more companies are moving to Luxembourg as it is perceived to have a lighter regulatory regime than the UK, for example, where they have already been beaten up for not doing too much, although it is more than others have done.

The Review: Solvency II is predominantly a European issue. What sort of implication is it likely to have outside the EU?

CW: The public markets require so much more than what the regulators require right now that in between that and the rating agency framework there is already a fair amount of compliance going on.

DP: There is the general need for Enterprise Risk Management [ERM] or, looking at another area, an almost global ambition for a market consistent view of balance sheets of insurers and the initiatives from the International Accounting Standards Board. While these things move forward and create a global ambition, Solvency II is in an interesting position in that it has now made some decisions – although I think some of us have been frustrated how slow it has been. It has set some clear protocols, put some templates in place, it has made the selection of the cost of capital approach to risk margins on the balance sheet. And so these things are possibly two or three years ahead now of some of the other global initiatives. I think that is putting Solvency II in an interesting position. Some commentators dislike the consequences of that, particularly some American insurers who are unhappy with the lead that has been taken by Solvency II, on the balance sheet, particularly on cost of capital. They question, is that sort of approach really leading to a true fair value balance sheet?

HG: I think the standards are clearly converging and to me one good practical example is in Switzerland with the Swiss solvency test. We undergo the treatment twice. Once at political level and once at the company level and if you are under group supervision it sucks all the foreign entities that are not part of the EU, under the same set of standards. In the end it drives how you are dealing with it in Singapore, or wherever else you may be. I think where the difference will be in the end is the implementation by the regulator that supervises a group, whether that is in Switzerland or in Germany or it is in France. That is going to make a difference.

DP: Yes I think we have seen the same thing with multi-national groups whose head offices are in the UK, it has that effect. Even the 2005 ICAS regime from the UK is having an effect on your business units that are in Canada, or Singapore or Hong Kong.

YP: Countries like China or India are looking very closely at Solvency II. If successful it becomes the global standard. The regulatory momentum in the 1990s was pretty much in the US with the introduction of risk-based capital models, and then you have other countries like Australia or Canada who implemented some ambitious regulatory reforms. Now it is pretty much Solvency II. It is going to be quite interesting to see how the US regulators, in particular, react to these reforms. Because at the moment the US insurance industry is claiming that there is a big level playing field issue but that is about lots of different aspects, including accounting so there will be some very interesting developments over the next few years to see how global discussions, particularly between the US and the EU evolve around this.

BM: To what extent do you think that the fact that in the US there is not federal supervision is going to be an impediment to proper, relatively fast reaction?

YP: That’s the main problem. It is impossible for the US regulators to speak with one voice. I think there will be repeated occasions where in the US you will see some cracks with regulators who have a vested interest in keeping the attraction of their local markets. There will be increasing pressure on them to move in one direction.

CW: They really have to move
forward to a framework like banking, where you have a federal charter if you want it. You have got 50 different regulators in the US; they are all a little quirky. Imagine when you split the regulatory regime 50 ways, the level of expertise is all over the map. The New York regulator has always been the defacto leader but it is no way to run a system. But if you want to be a federally chartered company, you ought to be. I think moving that way is going to have to happen. On the back of what the FSA [the UK regulator] has done and what Solvency II is going to be doing, I think there is going to be an understanding that the US regulatory regime is not adequate going forward.

DP: I think when we are talking about the differences and the quirks of 50 different regulators in the US, we perhaps should remember that we have not quite reached the promised land in Europe yet. We have actually had harmonising directives in life and non-life in insurance in Europe since the early 1970s and clearly we haven’t harmonised everything yet. The application of internal models, the choices we make between internal models and the standard formula, the approaches the national regulators will make to the more judgemental aspects to how they intervene, how they visit, how they do on-site work with insurers, I am sure will remain national varieties. And the idea that there should be a lead regulator in Europe, designated, for large multi-territory groups – that is by no means clear how it is going to work.

CW: But at least their heart is in the right place. The whole idea is to increase the level of solvency and to put people on an equal footing. When you look at that in comparison to Florida and the circus that is going on there. You have companies that actually buy more reinsurance, are more solvent and are absolutely excoriated by the regulator for not giving back more regularly. It is mind boggling.

The Review: Moving on I would like to examine the impact of the capital markets. Is the capital market’s interest in the insurance sector a passing fad?

EP: The biggest effect of the capital markets is the reduction of the cost of capital. We have a solid foundation for the insurance market which I think won’t be disappearing whatever happens. But cheaper forms of capital are here to stay and I perceive a growing demand, as all this framework that we have been discussing is pointing out to increasing capital needs.

BM: The level of interest, I think that is basically a risk-return. If you think back to the past several years with moaning about the soft reinsurance market, if you look at the very soft credit market over the last several years, it was not really worth taking any risk. Obviously, as any investor, you look then at what are the alternatives. And if insurance or reinsurance risks are paying better, why not? So the level of interest fluctuates in terms of what are the opportunities or the alternatives.

The Review: Is there a danger in seeing the capital markets – as you seem to be suggesting – as a help, you know the capital is extremely sophisticated and extremely powerful in their own right, are they going to be happy to be seen as a crutch, as it were, to the insurance industry?

YP: If you saw some of the reactions when there were some significant share buybacks over the past 12 months. We did say that we viewed that as a positive action from management. We said that when there is surplus capital identified by management and our own evaluation of capital, we viewed it as a positive action to return it to shareholders, instead of...
getting into the bad habits of either making bad or ill-considered acquisitions or driving prices down in the market. And for a rating agency that is quite a big change, but I suppose we always try to learn the lessons from the past. And so there were quite a few examples over the past few months where we did say that share buyback was appropriate at that moment. It actually was contributing to more disciplined underwriting and capital management.

DP: But I think it is right to say that the regulatory view is unlikely to define for you how much capital you can give back to shareholders. I think in particular the regulatory view, and maybe to an extent the rating agency’s view is a snapshot. It does not take account of the ambitions that a business has for the next two, three or five years. I think business plans on capital will have three year/five year horizons so it is on those sorts of time horizons that you want to decide if you really have any surplus capital, despite your growth ambitions.

BM: It should start with the executive management. They should take a view on what the capital requirements are for the profile they have decided for the company. I think you cannot do that other than by having a tried and tested method to allocate capital to individual risk segments. By tried and tested I mean you have run the cycle a few times to let you see how robust it is and how it responds in critical situations. And then you have reasonable comfort to say as management now we have surplus capital because you have to look at all stakeholders. You know, share buybacks are always popular with the investors but at the end of the day you make a financial promise to our clients and we should keep that. That has to do with do we want to run a leverage company or do we want to run a safe company? Make that decision and then be open about it. Communicate what kind of a risk profile as a company you have and manage to it.

YP: This is where ERM can be a useful tool. It is knowing how much capital you want, what is your capital target and in relation to that what your risk tolerance is in terms of the amount of capital you are prepared to expose, the amount of earnings you are prepared to expose and set it very clearly at the board level. It is pretty much a work in progress for reinsurers and insurers. Very few of them are there yet but all of them are really trying to work very hard there to make it explicitly defined and determined at the board level.

EP: We have talked a lot about transferring risk to the capital markets and managing one’s capital but there is also a related subject, which is very important and this is to show how much value the client is getting from reinsurance. It is basically looking at the same product but putting it in a different light, saying what is that doing to changing the risk profile and changing the capital need on a net basis?

BM: The difficulty is that the new [Solvency II] framework does not seem to give proper credit for reinsurance from our perspective. It focuses very much on capturing everything on a gross basis and being cautious not to underestimate what is needed on a net basis. Automatically people will take the difference as the value reinsurance brings to the equation, which is understimating the value of the reinsurance. And I think you will see that responsible management will buy more reinsurance than would normally be indicated by pure model calculations because common sense tells them it will be unwise to reduce it to the extent where they get full credit.

EP: We have actually seen that from some very big clients. They have gone from saying they were so big they did not need to buy as much reinsurance anymore to needing to find a middle ground of buying something that makes sense in the long-term.

BM: There are clearly cases of companies saying they don’t really need reinsurance and then the discussion comes on what if they don’t make a profit in a quarter and the attitude changes completely.

EP: Explaining more clearly what the value of reinsurance is still a work in progress for both the reinsurers and the brokers.

DP: It is interesting to hear a view that direct writers do not appreciate the full value that there is in the reinsurance. That says to me direct writers are really not very sophisticated in the modelling where it connects to reinsurance optimisation.

CW: I think their motivations can be vastly different. You know you think about the needs of a mutual versus someone who is trying to manage earnings and that sort of thing. It speaks, in a way to the flexibility of the product. The underlying product is a terrific – it can be flexible, yet implemented as to accomplish virtually whatever financial goal you have. You can basically accomplish this through some form of reinsurance.

HG: What I see more is that the buying of reinsurance is getting closer and closer to the CFO’s function and with that it is becoming more and more integrated into capital planning and global financial planning. And the other thing is that Solvency II and the rating agencies will actually drive the recognition of the value of reinsurance, because so far it has just been seen as a cost. So I think our value proposition will be recognised because of all these external factors that are coming down on our clients.
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