The knowledge Solvency II

THE BIG STORY

Internal models versus the standard formula

Right now, most UK insurers are focusing on the pillar I aspects of Solvency II: that is, calculating their solvency capital requirement (SCR) and demonstrating that they have the financial resources to cover it.

Companies have a choice as to whether to use the standard formula to calculate their SCR, or develop an internal model that better reflects their own risk profile.

It's also possible for insurers to apply the standard formula to some parts of their business, while using a bespoke model for others – known as a partial internal model.

If insurers decide to develop an internal model, it must be approved by the FSA. A total of 77 UK insurers have indicated they will seek internal model approval, with the current window for applications set for April and May 2012. The FSA is handling these applications in two tiers: the top 10 largest insurers plus Lloyd's of London; and the rest. The bar is equally high for both groups, although tier one will receive closer scrutiny.

The big challenge for insurers is to demonstrate to the FSA that the internal model is embedded within their business decision-making right up to board level. "For the regulator to be able to rely on the model for calculating the SCR, it must be able to see that the company is also relying on it to make decisions," says PricewaterhouseCoopers partner Charles Garnsworthy. "Companies are finding this challenging because it's more a principle than a set of tasks to fulfil."

Read more on the standard formula on pages 20-22.

How UK insurers are preparing for Solvency II

934 INSURERS REGISTERED WITH THE FSA

Internal model
- Seventy-seven UK firms want internal model approval from the FSA
- There are two tiers: the top 10 insurers and Lloyd's; and the rest
- April and May 2012 is the application window
- There are a total of six tests
- 'Use' is the most challenging test because firms must prove that they use the model
- 'Use' can refer to pricing, mergers and acquisitions, and reinsurance strategy

Partial internal model
- Companies can use a partial internal model, which applies standard formula to some risks, and internal model to other risks

Standard formula
- All firms need to be aware of the standard formula
- Most insurers go for this option
- €50m (£44m) premium is the cut-off point, above which Solvency II applies
- Suitable for firms with a relatively simple risk profile

PILLAR ONE
Capital requirements
An insurer calculates its standard capital requirement using the standard formula, an internal model, or a partial internal model.

Orsa (own risk and solvency assessment) is a hot topic right now. It requires firms to **demonstrate risk management at all levels**, in one document.

PILLAR TWO
Governance and supervision
Companies need to show that they have an effective risk management system in place.

Quality and depth of data disclosed must be better quality, more frequent, and timely.

PILLAR THREE
Disclosure
This focuses on disclosure to the FSA and publicly. Transparency and data quality are the watch words.

Who's who in the whole thing

GABRIEL BERNARDINO
CHAIRMAN, EIOPA (EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY)

Bernadino cut his teeth at the Portuguese Insurance and Pension Funds Supervisory Authority. He later joined Eiopa's forerunner, Ceiops, dealing with pillar II and pillar III of Solvency II. (See interview, p16.)

HECTOR SANTS
CHIEF EXECUTIVE, FSA

Sants was appointed chief executive of the FSA in 2007, having joined in May 2004 as managing director of its wholesale and institutional markets division. He has been a crucial force in promoting Solvency II.

PETER VIPOND
DIRECTOR OF FINANCIAL REGULATION AND TAXATION, ABI

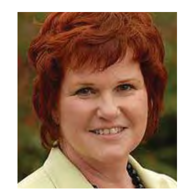
Vipond represents UK insurers in discussions with regulators and government, and at the European umbrella organisation for national insurer trade bodies, CEA (Comité Européen des Assurances).

LUKE SAVAGE
DIRECTOR OF FINANCE, RISK MANAGEMENT AND OPERATIONS LLOYD'S OF LONDON

Savage's job is to ensure that Lloyd's and all its syndicates are prepared for the new regulations, including keeping agents up to speed with the capital model transitions and overseeing cultural shifts.

PETER SKINNER
LABOUR MEP FOR THE SOUTH EAST OF ENGLAND

Skinner published a report in March 2008 with key amendments to the directive, introducing a more flexible approach to surplus funds; more efficient management of risk; and a lead supervisor to set SCR across the EU.



SHARON BOWLES
LIBERAL DEMOCRAT MEP FOR THE SOUTH EAST OF ENGLAND

Bowles is the chairwoman of the European Parliament's committee on economic and monetary affairs – the first Briton to do so – and is the Liberal Democrats' shadow to Skinner on Solvency II.

EXPERT VIEW

SOLVENCY II: A POSITIVE REGIME AFTER THE CRISIS

GERALD DODDS
UK CHIEF RISK OFFICER, ZURICH INSURANCE

Solvency II is the most significant reform project of insurance and reinsurance regulation in Europe. It comes at the right time and goes in the right direction, and now we have to get it right. Insurers need to be well capitalised in order to protect policyholders.

As an industry, we cannot and should not maintain artificially low capital requirements, and the pricing of our insurance products should properly reflect the risks we are taking.

The right side of safe

Solvency II will strengthen existing consumer rights by making more transparent the risks and capital requirements associated with products that offer significant protection against short-term or longer-term risks. Zurich strongly supports an economic, risk-based approach for prudential regulation, which Solvency II should deliver.

Equally, regulators must avoid the temptation to set conservatively high capital levels and onerously detailed requirements, just to be on the 'safe side.' Doing so could lead to excessive costs to customers and stifle economic growth.

The introduction of Solvency II is not for the purpose of creating a zero-failure regime, and regulators need to strike a balance to guarantee a fair and level playing field. One of the key aspects is to ensure that it is consistently implemented across Europe to create a harmonised and efficient prudential regime for every jurisdiction.

There is still a risk that Solvency II could turn from a common sense principle-based framework into a rule-based compliance behemoth. That would be counter-productive and make Solvency II costly and primarily bureaucratic. We as an industry have to continue to make the case against this happening to the regulators implementing the regulation.

Important for all

At the nub of the matter: insurers must remain well capitalised, as Zurich is. They also need to implement or maintain strong enterprise risk practices and use them effectively to make decisions. Such a discipline cannot and will not be replaced by any prudential framework and supervisory authority.

Swiss-based insurance companies are already subject to a regulatory regime that is equivalent to Solvency II. The Swiss Solvency Test (SST) has been a legal requirement in the Swiss market since 2006, so Zurich has experience in meeting such regulation changes.

So to the UK broker's reading: it is certainly hard to miss out on this crucial development. We need everyone to understand its implications. It is an economic and risk-based capital framework that has strong risk management principles embedded within it.

Invest some time reading and digesting this issue of The Knowledge, as we near the future world of Solvency II.

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