



From Anticipation to Action

Solvency II is coming, bringing a sea change in the way European Union insurance companies will defend their capital adequacy and risk management capabilities to regulators says [David Lightfoot](#)

The new regulations being brought in across the EU implementing Solvency II will usher in a consistent, EU-wide insurance regulatory platform that represents a significant advance

over the predecessor platform, Solvency I. Indeed, Solvency II could well prompt evolutionary change in other parts of the world, which is why even those unaffected by its implementation are well

served by gaining a familiarity with its likely requirements.

The current regulatory regime, Solvency I, became effective in EU member countries in 2004. It established minimum insurer

capital requirements and represented relatively modest changes to the existing regulations. While the final Solvency II directives remain on the drawing board, there has been widespread speculation about the new regulatory framework and recognition that the coming changes are likely to be far more profound than any that have come before. While the first draft of a framework directive is not expected until sometime in 2006, there is already general consensus on some key issues.

ANTICIPATED FRAMEWORK

At the most basic level, Solvency II will likely require all EU-domiciled insurance companies to assume greater responsibility for understanding their risk profile and demonstrating sound risk management and mitigation strategies that align both with their capital structure and business plans. Note that while Solvency II will extend to all insurers in the EU, the following discussion focuses on the considerations and consequences of Solvency II for non-life insurers in particular.

The Solvency II directives are expected to be based partly on the same principles followed recently by banking regulators in evolving the Basel II Accord. Like Basel II, Solvency II is expected to reflect a 'three-pillar' approach:

- **Pillar I consists of quantitative requirements to assure capital adequacy.** These requirements will likely aim to quantify both the minimum level of capital a company must maintain and

Solvency Capital Requirements (SCR), which reflect the amount of capital the company needs to respond to large, unexpected loss events. This pillar will most likely also encapsulate quantification of insurance reserves and investment rules.

- **Pillar II addresses internal risk management processes and supervisory intervention.** This pillar encompasses both internal controls and the supervisory review of risk management and capital quantification processes.
- **Pillar III requires greater transparency.** The call for heightened transparency is expected to be particularly evident in the disclosure requirements of regulators and financial markets and should go hand in hand with advances made by the International Accounting Standards Board (IASB).

Solvency II's pillars – and the synergies between them – are intended to provide all of an insurance company's constituents with the best possible assurance of adequate capital and sound risk management practices.

Solvency II is also being drafted with a focus on ease of implementation and a recognition of the importance of balancing practical flexibility with the need to ensure substantial uniformity in the application of regulations throughout EU member states.

REGULATORY FOREFRONT

Solvency II represents the forefront of regulatory thinking.

Like the already existing advanced insurance regulatory and rating agency systems, Solvency II is expected to use a risk-based capital approach to determine capital adequacy. Unlike many others, Solvency II is anticipated to go beyond the externally prescribed formulaic approach in assessing capital adequacy. Solvency II's risk assessment methodologies will likely introduce both the usage of standard as well as internal models. This internal modelling component is new – and represents a marked departure from most existing systems.

Additionally, Solvency II will consider the adequacy of the solvency capital only as one component of the entire supervisory process. The framework will also address, in an in-depth manner, a company's risk management and internal controls, governance and transparency issues.

BETTER RISK MANAGEMENT PRACTICES

What sets Solvency II furthest ahead of existing regulatory schemes is Pillar II, the risk management pillar. Indeed, this pillar recognises that companies with stronger risk management capabilities are less likely to default on insurance obligations and thus need comparably less financial capital than companies without similar capabilities.

Accordingly, the anticipated regulations are encouraging companies to critically analyse its risk environment to a degree it may not have in the past and to

link risk to its business plans and ultimately its capital base. For example, in a Solvency II environment, before a company can underwrite additional business, it would be expected to determine whether it has adequate capital to do so. As such, the regulations will attempt to foster an environment where proactive, comprehensive risk management is the industry norm by bringing new, supervisory oversight to these processes.

Solvency II is anticipated to also broaden the risk categories to be considered, requiring a company to take into account not only insurance risk covering

meeting capital adequacy requirements, it will likely change the way companies assess and utilise reinsurance.

Reinsurance can affect risk based capital, which is always net of reinsurance, in numerous positive ways. Reinsurance allows companies to leverage down the risk of the balance sheet and can provide a multi-year benefit that matches the run-off of insurance reserves.

Fundamentally, reinsurance is a trade between decreasing insurance risk and often increasing credit risk (through adding reinsurance recoverables to the balance sheet). As regulators

not simply a risk mitigation tool but also a means to achieve solvency capital relief and may therefore be viewed as a capital surrogate.

Companies will be expected to consider how much capital relief reinsurance can provide, how reinsurance can support business plans and strategies and how much this support will cost. As a form of capital, companies will likely be weighing reinsurance against alternative sources of capital, such as traditional shareholder capital and its incumbent expected return on invested capital or capital provided by debt instruments.

In addition, the new “holistic”



Existing regulatory capital benchmarks, including the UK's Enhanced Capital Requirement, Australia's Minimum Capital Requirement and the US' Risk Based Capital, can provide benchmarks

underwriting risk, reserve deterioration and accumulation (catastrophe) risk but also other categories of risk, such as asset risk (including credit, market fluctuation and asset/liability matching), or operational risk. Thus, in order to comply with Solvency II, a company will likely need to have a better understanding of its enterprise risks.

REINSURANCE RAMIFICATIONS

As Solvency II heightens the need to evaluate the various means of

generally believe that insurance risk brings with it a higher stress on capital than credit risk, reinsurance, used effectively, serves to reduce the regulatory capital requirements of an insurance company.

Hence, Solvency II creates more opportunities for companies to use reinsurance efficiently. It is also likely to make reinsurance decisions more critical and complex as there are now additional issues to consider.

First and foremost, viewed in light of Solvency II, reinsurance is

risk management of Solvency II will make companies more mindful than ever of the credit risk they are accumulating with reinsurance, and conscious of the amount of reinsurance recoverable assets being concentrated with any single reinsurer. The end result may likely be the selection of a broader slate of reinsurers.

LINGERING QUESTIONS

While there is consensus on many aspects of Solvency II, many questions remain unanswered. One pertains to the level of

internal modelling versus external, factor-based modelling that will be expected under Solvency II. It is also unclear how Solvency II will account for the varied insurance and legal environments of EU countries. For example, the risk of a company underwriting casualty business will vary dramatically depending on the local litigation environment. What accommodations will be made for this?

In addition, while the intent is to ensure Solvency II's compatibility with international accounting standards, it remains to be seen how new International Financial Reporting Standards (IFRS) pertaining to the fair value of balances arising from insurance contracts, if implemented, will align with the new directives. Another variable is accumulation (or catastrophe) risk: how will this be treated within the Solvency II framework and within various countries? Will it be stress tested?

Most pressing of all are questions surrounding the feasibility of certain quantitative aspects of Solvency II. Certain perils in certain EU countries have yet to be modelled in credible ways. For example, many models in Germany are still driven at the CRESTA zone level. This is substantially limiting as compared to modelling with data based on latitude/longitude addresses or even postal codes, which is standard practice elsewhere. In many cases in the EU, however, robust data is simply not yet available.

Fortunately, modelling capabilities in the EU are becoming more and more sophisticated. Those companies that are successful in collecting fine-level data will be rewarded under Solvency II. They will have a better understanding of their risk profile and more vigorous internal modelling.

NO TIME TO WAIT

While uncertainties remain, it is certain that Solvency II is fast approaching. Following release of the EU concept paper, each member country will have one to two years to translate the framework into local law, and the new regulations are expected to be implemented EU-wide in 2009 or 2010.

Insurers cannot yet get their arms around the full detail and implications of the final directives. Nevertheless, they can and should be actively preparing for the future regime – particularly its quantitative capital adequacy and internal risk management requirements.

PREPARING FOR SOLVENCY II

What should companies be doing now to prepare for Solvency II?

- First, companies should keep abreast of the proposed regulations in the EU and in their individual countries. Some member countries, including the UK, have introduced new regulations in advance of Solvency II.
- Companies should begin working to understand their own insurance, asset and operational risk environments

and develop and implement systems and strategies for mitigating these risks.

- Companies should analyse how their economic capital will likely be viewed under Solvency II methodology. While Solvency II continues to evolve, existing regulatory capital benchmarks, including the UK's Enhanced Capital Requirement, Australia's Minimum Capital Requirement and US' Risk Based Capital, can provide benchmarks. Importantly, existing regulatory and rating agency frameworks can help a company analyse not only its current capital structure, but how this structure aligns with business strategies.
- Companies should begin mining data and developing internal models to evaluate capital and SCR.
- Companies should work to make informed reinsurance purchasing decisions that consider the coming requirements and anticipated capital adequacy requirements.

A new day is dawning on the EU insurance industry, and its impact may well reverberate around the globe. It will be a day marked by deeper capital assessments, holistic risk management processes and enhanced transparency in interactions with policyholders, shareholders, regulators, and rating agencies. Those companies with the foresight to embrace this new day will be better positioned for success in the years ahead.