

Providing model solutions

Utilising an internal model in your Enterprise Risk Management (ERM) process can turn a regulatory burden into a competitive advantage, writes **Frank Achtert**



The much-anticipated regulatory requirements of Solvency II are now expected to be fully implemented by the end of 2012, two years later than previously estimated. As has already been documented, The European Commission published the 'Framework' or 'Draft Directive of Solvency II,' on July 10, 2007. In summary, the Draft Directive follows the proposals developed previously by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) with regard to market consistent valuations of assets and liabilities and the calibration of the solvency capital requirement (SCR) with a strong emphasis on sound risk management and robust internal controls.

The Framework suggests a two-tiered approach for the determination

COMING UP TOMORROW

LAURENT DIGNAT and FREDERIC MORLAYE look at the capital markets.

of regulatory capital adequacy: first, the minimum capital requirement (MCR), below which an insurer will not be able to write business; and secondly, the solvency capital requirement (SCR), below which an insurer likely will need to discuss remedies with the regulator.

MODEL CHOICE

Companies will have to choose a method of calculating the SCR. They may use the standard formulaic model, an internal capital model or a combination of both. The standard model will be easier to implement and treats risks consistently across companies. For small companies, this approach may be adequate. However, the standard model will not reflect any unique characteristics of the firm or its jurisdictions, and thus it may lead to a more conservative estimate of the required capital.

Internal models can overcome these limitations, but they require expertise and resources for parameterisation,

model building, validation, interpretation and communication. Per the Draft Directive, internal models also will require supervisory approval, a process that is just starting to be addressed by CEIOPS and other interested parties.

COMPETITIVE ADVANTAGES

There can be many advantages gained by utilising an internal model in a firm's enterprise risk management process, including evaluation of the consistency between the firm's risk appetite and its risk profile, quantifying the impact of changes in reinsurance and investment strategies, consideration of capital management requirements by regulators and rating agencies, as well as the evaluation of returns on capital for specific business segments. Furthermore, it allows a company to recognise the relative contributions of the major categories of risk (non-cat losses, catastrophes, reserve, credit and market) to the company's overall risk profile.

In fact, integrating an internal capital model into key enterprise business processes can turn a regulatory burden into competitive advantage.

[For more on Solvency II regulations, see the new paper published by Guy Carpenter entitled "Internal Models – A Winning Solution for Solvency II," available at gccapitalideas.com.]



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