

# Solvency II in depth

In this extended roundtable discussion, group editor-in-chief **Ant Gould** and industry big hitters from the UK and continental Europe consider the progress made by (re)insurance as the once-distant spectre of Solvency II now looms large and close

**Ant Gould:** Solvency II in my mind is something that has been with us for years but we are still not there. It has been a long time coming. I had a quick look at our website to see when I first wrote something about this, it was about eight years ago with a KPMG study, which was expected to form the basis of the European Commission's drive towards a new solvency regime known as Solvency II. I would say since then that much has changed and also much has not.

**Ben Carr:** Political agreement on the Solvency II framework was reached in April 2009 when the European Parliament formally voted on the proposal in plenary. The vote was then acknowledged in May by the European Council, which formally adopted the proposal on 10 November, 2009. The proposal has now been signed and published in the official journal.

That is not the end of the process, as everybody knows: that is just setting out the high-level principles, so there is still the development and adoption of the augmenting measures.

CEIOPS has already produced a lot of advice: the final advice is due to come in January. Once all the advice is in, the European Commission will be working with member states to take that advice and turn it into a draft proposal that is due to be adopted by the College of Commissioners at the end of this year. It will then be subject to scrutiny by the European Parliament and by the European Council. Once those Level 2 measures are adopted, which should be in October 2011, then member states, the industry and everyone else will have a further 12 months to get ready before the directive is due to go live in October 2012.

There is still a lot of work to do in terms of hammering out of the Level 2 measures. However, it is clear that there isn't a lot of time for implementation and so everybody should be thinking about implementing now. They should be looking to the Level 1 text, which provides a clear steer on the direction of travel and what hard work needs to be done.

This year is going to be crucial both from an implementation perspective for firms and

## THE PARTICIPANTS

Ant Gould – Group editor-in-chief (insurance), Incisive Media  
 Ben Carr – Head of financial insurance risk, Financial Services Authority  
 David Russell – Director, risk and governance, Barbican  
 Gary Wells – Principal and consulting actuary, Miliman  
 Peter Tavner – Deputy group actuary, Amlin  
 Eric Paire – Managing director and European solutions group leader, Guy Carpenter  
 Rob Jones – Managing director and European insurance criteria officer, Standard & Poor's  
 Nick Lowe – Director of government affairs, International Underwriting Association  
 Jason Doughty – Actuary and Solvency II project manager, Hiscox

for some of these key issues that are being discussed in terms of the negotiation.

One important other point, I think, in terms of timetables that people should be thinking about is QIS5, which is due to be run in the second half of this year. The specification will be finalised by the Commission in mid-June and I think that will be a key next step. So I think there will be a lot of discussion around those specifications and what they should be; it is very likely that the QIS5 specifications will be closely aligned to the final proposal put out by the Commission at the end of this year.

**Gould:** For those looking not to do anything until the last minute (under economic pressure, it is always an option), what are the options for it being derailed still or being watered down, or pumped up, based on the current economic background?

**Carr:** The Level 1 text is agreed by the European Parliament and the European Council, so Solvency II is going to happen: that is clear.

**Gould:** Ben, from your perspective, or your co-regulator's perspective, where do you think, especially on the reinsurance side, the industry is in terms of preparedness?

**Carr:** I think it is a mixed picture. We have a hundred or so firms that are looking to use the internal model, then we have several hundred more that will be subject to Solvency II that



David Russell (l)  
and Ben Carr

will have to implement as well. I think some firms are taking it very seriously; they have project plans in place, they have a budget in place, they have resources in place; they have a clear plan and a strategy to get to where they need to be in time to implement the directive.

There are probably other companies that are probably not fully engaged yet in Solvency II. They need to. I think they need to get up to speed very quickly and they need to develop their project plans. We issued a DP, DP08/4.

We would expect all firms to have done the things that are set out in that DP already. Some of the firms are still not as far up the curve as they should be.

**Gould:** Is everybody here on track?

**David Russell:** I think, speaking to firms in the Lloyd's market, Lloyd's has been pretty good actually exercising a degree of due discipline and making sure that people do keep on track.

**Carr:** Lloyd's has set out a very clear timetable for implementation. That gives people a very clear target to aim for.

**Gary Wells:** I get the impression that Lloyd's is making good strides as a market. It should be on target. I am not so convinced that the small and medium enterprises outside the Lloyd's market are as advanced as Lloyd's and that could create some issues.

**Rob Jones:** The UK is much better prepared than most of the continent, I would say.

**Peter Tavner:** Actually, I think the picture is pretty mixed and not necessarily related to jurisdiction. Some of the big companies across Europe are very advanced but I still think there is some potential for complacency in the UK, purely because we have been regulated under the ICAS regime for a number of years.

**Wells:** I know that my French colleagues are extremely busy. Somebody is taking it seriously in France.

**Eric Paire:** Well, I think there is quite a large degree of polarisation on this issue. What we are seeing is that the very large firms on the continent are tending to invest heavily in preparing for Solvency II. However, these firms also tend to have their own internal models. So perhaps one of the main questions they must tackle is whether or not their internal models have a similar structure to the Solvency II model that is eventually approved.

The second question that they will have to tackle is how to manage the volume of data. One of the key differences between a Lloyd's syndicate, for instance, and a multinational

group is the amount of data that they both generate and all the practical issues that this creates. This will be a major headache.

At the other end of the spectrum, we have the smaller companies, many of which on the continent are mutuals. I think that, for a number of these smaller organisations, they have simply been crossing their fingers for the last few years, hoping that it wouldn't happen. However, now they realise that it is happening. I would add that some of these companies are quite advanced in terms of their preparations. In particular, those companies focusing predominantly on one particular area, such as professional mutuals, because their narrower focus means that they often have a better understanding of their businesses, finding it easier to get their houses in order as a result. All in all, we are seeing two pretty different pictures depending on the size of company you are looking at.

**Gould:** Do those firms that are quite advanced see a change in the actual shape of their businesses?

**Russell:** The answer should be yes, shouldn't it? The whole point of Solvency II is to identify those risks that attach a high capital loading to them. So businesses should think about it, absolutely. Whether or not that means a wholesale exit from lines of business, I very much doubt it actually. I just think it means repricing.

I think that the more likely structural issue could be the extent to which it varies between size and diversification. If that is the case then I think we will see a bit of consolidation somewhere in the market. You might find the smaller firms having to band together a bit; you might find larger entities just having a bit more surplus resource available and being able to make some acquisitions, particularly in a market that is a little depressed.

I think it probably will drive some change. The bigger companies are actively considering it, looking for advantages coming into the market.

**Gould:** Are there any concerns about the touch across different countries in terms of the regulations and supervision and the monitoring, whether that is going to create an imbalance?

**Russell:** A little earlier, you made the comment that the Financial Services Authority is gold-plating the regulations and I am not sure that this is actually valid. It is likely, as Ben said, that a lot of the Level 2 stuff is going

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(Foreground left to back right) David Russell, Ben Carr, Eric Paire, Peter Tavner, Nick Lowe, Jason Doughty, Ant Gould and Rob Jones

to come out in these regulations. Therefore, there is going to be quite a lot of commonality across the piece. I haven't seen any evidence that the FSA is pushing additional regulation. The evidence of the last year or two is that it has been regulators, perhaps in other member states, that have had a much more conservative view on the advisability of reliance on internal models, so they have maybe added some additional bits of regulation to counterbalance that.

I don't see the UK coming out of this in a worse place. I think actually we will probably maintain an approach as much as possible consistent with a Europeanised regulation, which is kind of close to where we are at the moment, actually. The drive will probably be, I think, elsewhere in Europe and not so much our close neighbours but perhaps the ones towards the east and the south that are having to adapt to a completely different way of regulation. I think it is probably quite a challenge for them and it may end up with their applying extra levels of prudence.

**Carr:** We want to implement the directive properly but we do not want to gold plate. We are very concerned about making sure we follow the proportionality principle of

ing Solvency II in a consistent fashion. That aspect of the crisis we have been through is actually going to make sure, I think, that there will be a higher level of harmonisation than there would have been just with CEIOPS in place.

**Paire:** One of the main practical challenges will be the process of approving the internal models. The speed at which these models are approved will vary from country to country depending on the amount of resources that the regulators in that state are able to contribute to the task. As a consequence, some insurers will be able to use internal models and others will not, which has a knock-on effect on other things such as its impact on reinsurance. This is because different forms of reinsurance are not treated in the same way as the formula of the internal model, in particular for non-proportional reinsurance.

It may take up to three years before all of the countries have gone through the process of approving the various internal models.

**Wells:** Is that likely to lead to problems? The standard formula does appear to be quite onerous to put it mildly. The internal model route is not an easy option either; it does offer the ability to better reflect your risk profile and therefore optimise your capital position. If a company is not in a position to optimise its capital through an internal model, I think regulatory capital could be a major problem. This may actually be to the benefit of the reinsurers.

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the directives. We don't want to place undue burden on smaller companies, I think that is key for us. I would very much hope that Solvency II results in more harmonised regulation across the EU because that is one of its main objectives. The idea is that you have a common view about how supervision should be conducted.

It is about more than just the rules: there is an embedded principle and idea within the directive that there should be convergence in the way that those rules are implemented. So supervisory practice as well. I hope that we will see much greater commonality across Europe.

**Jones:** To pick up on Ben's point, the CEIOPS is going to be transformed into EIOPA during the course of the next year or so. That will have more teeth than CEIOPS, which was merely a committee. EIOPA is going to have its own legal identity and a lot more staff and it will be charged with policing and making sure that the regulators around Europe are operat-

**Tavner:** Absolutely. The Solvency II requirements for group supervision and group solvency capital will also lead to greater dialogue between different supervisors and this should lead to a convergence of regulatory standards.

**Russell:** One of the questions I am very unclear about is the extent to which there will be a degree of relationship expected between the standard model calibration, whatever that is going to turn out to be, and the internal model output. It is not so much how it is approved in the internal model but, in a sense, what expectation will there be in the internal model to produce an answer not too dissimilar from the standard model. From my point of view, that is one of the key uncertainties and one of the issues about going down the internal model route, if we have a choice in any case anyway. But I don't know if you have any thoughts on that?

**Carr:** Well I can say this from an FSA perspective: there is, if you like, a calibration standard of a 99.5%, one -year VaR measure in the directive and we will be assessing internal models on that basis. We will not go in saying to firms 'you would have had a charge of x under the standard formula and therefore we would expect the internal model to deliver the same number'. We will be reviewing companies' models and seeing how they demonstrate to us that their models meet the calibration standards set out within the directive. We will be using the standard formula as a direct benchmark.

**Carr:** I think, with the ICAS regime, firms in the UK have already done quite a lot of work. That is why we are seeing a lot of firms are wanting to use the internal model to develop economic models that are similar to those required under Solvency II. More than 100 firms have indicated to us that they would like to go the internal model route: I think that just reflects the headstart that the UK has, compared with some other jurisdictions. We want to make sure that those firms are resourced sufficiently well, for those firms with a realistic chance of getting an internal model approved by 2012, we will be able to follow those firms' plans for the development of their internal models.

In some member states, both on the firm side and on the regulatory side, there is less experience of the use of capital models. Many countries are keen to explore this and to work with their firms to implement the internal models. regime under Solvency II We are working closely with our European colleagues on this, setting standards with them on approval, thinking about how we can make sure that we do this in a consistent way and, in particular, thinking about how we are going to deal with the groups' challenge, which is big.

It is clear that the standard formula will not be appropriate for all firms and will not properly measure the impact of sophisticated risk-migration techniques. So there is no reason to believe that, just because the internal model numbers coming out of a firm are lower than the standard formula, that it is not a problem. I think that it should be a better reflection of the risk, a more assessment than 99.5% view of risk.

Going down the internal model approval route is a choice for firms. The regime is designed to encourage all firms actually to improve gradually their assessments over time, their capital assessments, their risk assessment processes. As those processes improve that the regime is designed to enable, assuming that the regulator is comfortable with the risk management framework, those numbers can be used to drive the regulatory capital requirement. That makes perfect sense from the regulatory perspective. If we are comfortable with the risk management and the capital assessment framework of a firm and we believe it is delivering an accurate assessment of their risk then why wouldn't you want to place reliance on those numbers rather than those produced by a standard formula?



Eric Paire

**Nick Lowe:** Conceptually, it just seems wrong that you should have a huge variance between one company and another. The internal model may be extremely well designed but, if a company is doing similar business to another but has much lower capital requirements then it doesn't seem appropriate to me. Or I suppose you could, if your system will force companies towards adopting the internal model, which could be very good. Is that the intention? Everyone should be applying for the internal model in the long term.

**Carr:** I don't know if it is the intention is to provide incentives for firms to improve their risk management and capital assessment. I think that the idea of the framework is that everybody should be using an internal model in the end. I think that the idea of a blanket application of the standard formula would necessarily deliver a fairer and more level playing field is wrong. Given that the standard formula has been designed to work with 5,000 insurance companies operating across Europe that are very different, if that was the only option then there would be massive distortions and an uneven playing field because it would unfairly penalise some insurance companies over others.

**Paire:** Also, the calibration of the standard formula for underwriting risk has been done based mainly on one particular country, while the calibration for reserve risk has been based mainly on another country. So, from a European

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perspective, there is very little likelihood, if you are in France and have a UK-calibrated model for, say, motor business, that you will end up with something that makes economic sense.

**Jones:** Would you say, Ben, that on average at least, the capital saving achieved by using internal models across Europe wouldn't be expected to be much more than 10%, possibly 20%?

**Carr:** I haven't got a figure in my mind about what the right answer is, I don't know if the Commission or others do have a figure in mind about what they think the average should be. What is clear to me, though, is you would; that in order to provide incentives for companies to improve their risk management, there has to be some capital saving on average. Exactly what the size of that will be, we will have to see.

It will vary from company to company because it will depend so much on the extent to which the standard formula is appropriate for a particular firm's business. The standard formula is not trying to capture all risks; it is not necessarily picking up all the types of risk mitigation. So the extent to which the standard formula it will be appropriate will depend from firm to firm.

**Jason Doughty:** The standard formula results from QIS4, for non-life companies, typically gave results that were higher than what would be expected under an internal model. Since QIS4, CEIOPS advice has changed a number of the parameters within the standard formula such that they give a significantly higher result (which I now know is around 60% higher – if I can rewrite history). The increasing gap between the standard formula results and the internal model results only makes this problem worse. I, too, am concerned about being benchmarked against the standard formula.

**Tavner:** We should not be under any illusion that the latest calibration of the standard formula has huge capital consequences, especially for international commercial insurers. Most firms that do not get internal model approval will find themselves at a massive competitive disadvantage. Similarly, those that do get approval will view this as a competitive advantage.

**Paire:** The other issue that we face is not just the difference that may exist between the standard formula and the internal model, but also trying to compare the internal model to Standard & Poor's or other ratings agencies. In many cases, this is going to be a secondary issue. We have seen that the latest capital charges are relatively higher, though. This, we think, is changing the dynamic of some classes of business and in particular the reinsurance classes. For a reinsurer, this is not a new story but, for insurance companies with a reinsurance division or reinsurance activity, it may create problems for them in different regions.

**Jones:** Some of the capital requirements doubled over QIS4, didn't they, for some reinsurance classes of business? The overall impact is at least 35% across the (re)insurance market. So this is a big impact. Certainly for companies that are smaller and less diversified, then yes, the capital constraint may be a supervisory requirement rather than one for a ratings agency.

**Russell:** Yet surely I would be disappointed if there is a reinsurer anywhere that is going to rely on the standard model. Isn't it almost axiomatic that it should adopt the internal model because of the nature of its business.

**Paire:** In Europe, we have some small insurance companies that have a reinsurance division. These companies may not yet realise the relative weight of capital allocation that this is going to create.

**Tavner:** It is also worth saying that the onus is on the company to demonstrate that its internal model is fit for purpose and that it understands

it. It is a two-way education process; it helps the FSA understand that those processes could be better.

**Gould:** One thing concerning me is that there is a lot of emphasis on the FSA and the other regulators to have the right skills base. In terms of your operation, the FSA, is it fully geared up to recruit the right level of people to be able to have the right dialogue?

**Carr:** Yes. I think we have a history that is very beneficial in terms of this discussion. We also have experience of internal model approval in other areas as well from other aspects. So I think that we have the right experience and mix of skills to run the internal model approval process with firms and have that dialogue with them. We are recruiting at the moment as well in order to deal, with the scale of the task more than the complexity of it. We are looking to recruit new people to help us with the work that we are going to see with the internal model approvals as we run up to Solvency II but we are confident that we can meet the challenge.

**Tavner:** It is also worth saying that the onus is on the company to demonstrate that its internal model is fit for purpose, that it is embed-

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Gary Wells

ded within the operation and fully understood at all levels. The resulting two-way dialogue between each company and its supervisor is a valuable opportunity to increase understanding of each company's business.

**Gould:** There is going to be a squeeze somewhere and it will be felt everywhere, I am sure. Even on the regulatory side, once it drops out of the political arena. Now is a good time to ask for money, though. Politics is politics.

In terms of skills levels, in terms of the other regulatory bodies, are you aware whether or not they are able to skill up at the moment?

**Carr:** There is the internal model expert group in CEIOPS that is responsible for developing policy and standards as well as developing the process for internal model approval. The FSA chairs that group and we are working very closely with other European supervisors in that group to set the standards. We are also starting to engage actively now with other regulators, thinking about the implementation generally. We are trying to flush out any issues that may arise with international groups: people are starting to come to us to say 'this is how we propose to proceed'. For international groups, we need to make sure that all the regulators are comfortable with the approach that is being adopted. All our supervisory colleagues are aware that this is a challenge for all of us as well as the industry.

We have some advantages in the FSA because we have more flexibility than some

of our colleagues with respect to the recruitment of additional staff to support the internal model approval activity as a result of the way in which we are funded. That said, I think they are committed to doing it and they certainly have; the French and German regulators both have a lot of specialist resources, expertise and experience for internal model approval as well.

**Tavner:** I think it is true to say that, even though the Level 2 text is very detailed, it is still open to interpretation. So you can get two people who form a slightly different view of what it means in practice. It will take a few years for these issues to be worked through and for the industry to reach consensus as to what the standard is. This is why it is crucial for firms to start engaging with Solvency II sooner rather than later.

**Gould:** Is Solvency II fit for purpose?

**Doughty:** I think, as far as its measurement of capital and embedding risk management and getting firms to understand their risks, yes, it is. I think a lot of the reporting standards both to the regulator and externals appear onerous at this time and may be a little bit heavy. I guess that would be my comment as to where it may deviate from its original aim.

**Tavner:** The Solvency II principles are fine and very few people can object them. However, it's all in the application.

**Paire:** Well yes, though I think again I would come back on the asset side. I think the industry has not perhaps been fighting hard enough against the banking view in particular, forgetting about the value of asset liability management and focusing too much on market value. I think the latter is still a big issue that needs to be tackled if Solvency II is to be considered fit for purpose.

**Wells:** I think if Solvency II is carried out effectively, it should deliver a level playing field. We should get better risk metrics, we should have better risk management. So in terms of its principles, yes, it should deliver good things for the reinsurance and the insurance industries. How it is implemented at the end of the day will actually define how effective it will be. The flippant answer on Solvency III is, if we add Solvency I to Solvency II then you might get a form of Solvency III.

**Jones:** In terms of Solvency III, it would be global rather than European. That might not be too far away in regulatory terms, maybe a decade away, which is relatively close. In terms of Solvency II being fit for purpose: Solvency I isn't. It was established getting on for 30 or 40 years ago, so Solvency II is long overdue and a welcome, positive step. 