Getting to grips with Pillar 3

Tackling the key strategic and implementation issues emanating from the Solvency II reporting and disclosure requirements.

January 2013
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With so much attention devoted to the Pillar 1 capital evaluation and Pillar 2 risk management requirements, Pillar 3 can sometimes become the forgotten pillar within many organisations. Yet the quantitative and qualitative disclosures could have a significant impact on how your business is judged by policyholders, analysts, investors and supervisors. The tight turnaround times and level of data and analysis that will need to be reported and disclosed also present a significant operational hurdle over and above what is required for the other two pillars.

The implementation date for Solvency II looks set to be postponed to allow more time for assessment and agreement on a number of key issues. But the reporting and disclosure are unlikely to see material changes and it will be important not to lose momentum on the preparations for Pillar 3, especially as some local supervisors are set to require a demonstration of reporting capabilities and significant interim disclosures ahead of the EU-wide launch (as an example, the ACP in France are potentially introducing QRT reporting in XBRL format for 2014.) Furthermore, EIOPA are currently looking to see what aspects of Solvency II (particularly Pillars 2 and 3) they can introduce in the interim phase within the supervisory process.

The extra time also offers a valuable opportunity to use resources in the most cost-effective way. This includes developing sustainable reporting capabilities and building them into business as usual. This would help avoid the quick fix spreadsheet options that many were envisaging to get over the line in time for the earlier deadline. Some national supervisors may allow you to use advanced Solvency II templates in place of current regulatory standards, and this could include reporting and disclosure.

A further consideration is that the postponement would open up the potential to bring the timetables for Pillar 3 and the planned new IFRS insurance contracts standard (IFRS Phase II) closer into line if your company chooses the possible option for early adoption of IFRS Phase II. This would help to avoid digging up the road more than once. (See our publication ‘Laying the foundations for the future of insurance reporting’.). The added benefit would be to bring a relatively early end to a period of substantial financial reporting change and allow you to fully focus on business priorities.

As you think about how to prepare in the most effective way, the strategic section of this publication, ‘How are you going to be judged?’, looks at what areas of the business are going to come under the spotlight, how the numbers might influence decisions and how they are going to be viewed by the financial markets. The consistent market value approach could provide greater comparability of risk and capital disclosures across the EU. But it could also introduce greater balance sheet volatility and there will still be inconsistencies with business written outside the EU. The market focus on the numbers is going to be heightened by the fact that the solvency evaluations will have a crucial impact on how much money you can pay in dividends. You will also need to decide how much independent review will be required to ensure market confidence in the disclosures.

The implementation section, ‘Bringing reporting up to scratch’, examines the practical considerations for complying with the demands of Pillar 3. Pillar 3 will require your business to report more information (in a structured, electronic format) more quickly and with much greater scrutiny than ever before. But there will also be opportunities to use the required investment to improve the quality, reliability and timeliness of management information. Many businesses will be looking to realise these benefits ahead of the compliance deadline.

To help illustrate the scale and nature of the task, the section opens with a programme director’s view from the coalface of implementation. We then look at the different elements that will need to be put in place, including getting down to the right level of detail; bringing asset managers on board and what is appropriate for different types and sizes of company; along with how to develop the systems infrastructure needed to keep it all running.

There is no single right answer for any of these issues. What works best is going to depend on a range of coalescing factors including what kind of business you write, where and the structure of your company. What this paper does seek to do is to outline the issues you will need to consider and the next steps towards implementation.

I hope that you find this paper informative and useful. If you have any queries or would like to discuss any of the issues in more detail, please speak to your usual PwC contact or one of the authors listed on page 36.

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Overview

Given the lack of focus on Pillar 3 in comparison to Pillars 1 and 2 within many insurance companies, it is easy to misjudge or under-estimate some of the key strategic and implementation challenges. Some of the main misconceptions and their implications are set out here.

Possible misconception one
“Pillar 3 reporting and disclosure does not matter as we primarily focus on a different basis of disclosure.”

In fact, your business will need to take full account of Pillar 3 reporting and disclosure in line with the requirement to build the risk and solvency evaluations into decision making. The binding capital constraints imposed by Solvency II will also have a decisive impact on how much money is available for dividends and investment, which are a key focus for analysts and investors.

See ‘Moving to a new regime: Judging the business through the lens of Pillar 3’

More broadly, Pillar 3 could provide a useful catalyst for a review and rethink of reporting and disclosure aimed at communicating the strength and potential of the business in a more understandable, accessible and, ultimately, value-enhancing way.

See ‘Vision for the future’

Possible misconception two
“Pillar 3 disclosure will provide a more useful and comparable market-consistent approach to insurance disclosure.”

Pillar 3 introduces a prescribed and hence consistent EU-wide basis for evaluating and communicating a market value balance sheet. But while some firms may thus want to use Pillar 3 as a key basis for judging and communicating performance, translating regulatory measures into performance reporting can be difficult in practice. For one, Pillar 3 could introduce short-term fluctuations in the evaluation of assets and liabilities, which may not reflect how they are viewed, managed and matched within the business. The regulatory capital calculations for many non-EU operations would also be based on the existing local rules, not on the prescribed Solvency II format.

See ‘Moving to a new regime: Judging the business through the lens of Pillar 3’

Possible misconception three
“Reconciling Pillar 3 disclosures with financial reporting should be relatively straightforward.”

There are conceptual similarities between IFRS and Solvency II and it will be important to make the most of these synergies when designing and developing models. But there are also a number of key differences in areas ranging from contract boundaries to the basis for discounting. So it will be important to identify any divergence and be able to explain the reasons for it. If you don’t, you could face awkward questions from analysts and investors.
Possible misconception four  
“A single group SFCR would be easier and cheaper than preparing separate reports for what may be many different legal entities.”

A single group report would allow both the group and the reader to view the business as a single entity. But it may not necessarily be more straightforward and understandable than separate solo entity reports once factors such as language, stakeholder expectations and differences between business lines are taken into consideration.

See ‘Setting the scope’

Possible misconception five  
“The simplifications used in Pillar 1 capital evaluation will also make Pillar 3 more straightforward.”

In fact, simplifications in Pillar 1 could actually add to the Pillar 3 demands by requiring the inclusion of a full explanation to justify the use of these simplifications.

See ‘Applying proportionality to your reporting demands’

Possible misconception six  
“Fund administrators will easily be able to take care of all the third party information demands.”

In fact, your business will be responsible for making sure the required information on assets is delivered on time and that it is subjected to appropriate governance and verification. Particular challenges include the ‘look-through’ approach, under which your fund administrator would have to provide details on each of the assets within a fund or fund-of-funds.

See ‘Developing an effective partnership with your asset managers’

Possible misconception seven  
“The detail and timelines will be tough, but existing solvency evaluation and financial reporting systems can be adapted to cope.”

In fact, the level of detail required and the turnaround times are unprecedented. People, processes and technology are all going to have to be reviewed and rethought as part of the ‘industrial’ approach needed to build Pillar 3 reporting into business as usual. Without it, the process is going to be unsustainably labour intensive.

See ‘Getting down to the right level of detail’ and ‘Delivering on time, every time’

Moreover, Pillar 3 will require actuarial evaluations that are at present only used internally to be brought up to the standards of verification and review needed for external reporting.

See ‘Gauging the need for external evaluation’

Possible misconception eight  
“The postponement of the implementation date for Solvency II is a chance to put Pillar 3 preparations to one side.”

In fact, some local supervisors are set to require a demonstration of reporting capabilities and significant interim disclosures ahead of the EU-wide launch. EIOPA chairman Gabriel Bernardino said in his speech of 21 November 2012 that an interim phase could introduce elements of Pillars 2 and 3 before the implementation date. Sustaining the momentum of implementation would also help to build Pillar 3 into business as usual and avoid the potentially costly and error-prone quick fixes that many might have felt necessary to comply with the previous deadline.

Simplifications in Pillar 1 could actually add to the Pillar 3 demands by requiring the inclusion of a full explanation to justify the use of these simplifications.
Section one
How are you going to be judged?
Moving to a new regime: Judging the business through the lens of Pillar 3

Solvency II will change how companies within the insurance sector think about their businesses. This might include how performance, risk and capital are evaluated and communicated. But using regulatory-driven data for performance analysis brings with it many challenges. Quite a few companies, particularly in the life sector, may also not view Solvency II data as the ideal basis for allocating capital or judging the performance of the business.

These companies may look to augment Solvency II data with additional metrics, both internally and externally, but this introduces a new set of issues. And whether management thinks Solvency II is a good approach or not, the Directive could introduce greater volatility into capital metrics and new complications into determining the amount of cash available to pay dividends, which are key areas of analyst and investor focus. So with no ‘one size fits all’ view, how your business addresses these challenges will vary considerably.

Greater consistency
The introduction of greater harmonisation and better alignment of capital requirements and risk is a welcome step for the European insurance sector. Solvency II may help iron out some of the inconsistencies in current solvency reporting, and the outputs should be more useful as a tool to help evaluate the business than is the case with existing requirements.

Pillar 3 is also going to put new and potentially more detailed information about your risk profile and the way it is managed into the public domain. Even countries such as the UK, where regulatory returns are already made public, will see new disclosures that the markets will be keen to scrutinise.

In an industry that currently lacks a consistent approach to calculating an ‘economic’ view of the business, some insurers believe that Solvency II could help to fill the void and allow them to link performance, capital and risk metrics. They may see Pillar 3 reporting as an opportunity to bring market disclosure closer into line with the measures they use to run their businesses and possibly provide a new basis for how they judge performance. This is more likely to be the case for non-life companies, as the ways risk and capital are evaluated under Solvency II are conceptually not far away from how most internal models work. Many will thus want to focus analyst and investor attention on the Pillar 3 numbers and use them as one of the bases for steering the business.

Using Pillar 3 as one of the bases for performance management may be difficult to achieve in practice, however. A particular challenge will be how to use a framework designed for regulatory reporting to provide information that is useful to management (let alone investors).
The focus to date has been on ensuring that insurers can explain the movements in solvency capital in a Solvency II world in the form of ‘variation analysis’ and ‘P&L attribution analysis’. However, this may not generate the type of information that is actually needed to run the business or communicate with investors – essentially, a clear view of operating and non-operating elements, and an ability to determine what is really driving movements in capital available at a group level.

In particular, ‘variation analysis’ may not prove particularly useful as a management tool. It will be prepared on a solo basis only. It will not be mandatory until the second year following Solvency II implementation, and the degree of detail around life results (with separation only between ‘life’ and ‘health’) may not provide the granular level insight that will be needed to understand what is happening in the business.

And while the industry has looked for more user-friendly information from P&L attribution analysis, the main aim of this information is to act as a cross check against whether internal models are focusing on the key risks, not on providing insight into profit drivers to management or investors. With a lack of clarity as to how this information should be presented combined with considerable flexibility as to the approach adopted, there is a great deal of uncertainty as to whether this will be a step forward.

Those insurers that are looking to use Solvency II to help bridge the information void both internally and with investors will need to be able to build from solo level to group-level analysis and to help provide clarity on the different sources of earnings that drive results on a Solvency II basis, as well as how group capital structures work in practice.

A further consideration is to reflect the views of investors. Fund managers are keen to ‘join the dots’ with measures that are comparable to other industries. Given the ‘economic’ starting point for Solvency II reporting, this will create new challenges. In particular, simply providing analysts with a new raft of data on a basis that is unique to insurers is unlikely to be a successful strategy.

What this means for your business is that it will need to be able to reconcile Pillar 3 disclosures with other aspects of financial reporting and to be able to explain the main differences, whether they relate to contract boundaries, the basis for discounting or the myriad of other variables. From a practical perspective it will be important to prepare the Solvency and Financial Condition Report (SFCR) in parallel with annual reports to allow your business to identify any divergence and be able to explain the reasons to analysts. Failure to do this risks sending out mixed messages and incompatible numbers.

**When Solvency II may not be the right answer**

For large and complex insurance groups with significant operations outside the EU, particularly life insurance operations, Solvency II may not be fully consistent with what management view as the main drivers of value and risk.

First, under the proposed equivalence rules, regulatory capital calculations for many non-EU operations could be based on the existing local rules, not on the prescribed Solvency II format. This may be particularly significant if your business has large US operations, given the conceptual differences between the US statutory and EU Solvency II frameworks (discussions between EU and US supervisors on equivalence are ongoing).

While not relevant to solo level reporting, the consolidated data that emerges from the Solvency II reports would include two different bases of evaluation, rendering it far less useful either internally or externally as a way to judge performance or to allocate capital. In such cases, it is hard to see how Solvency II information for insurers operating outside the EU could be viewed as a substitute for embedded value data, for example.

**From a practical perspective it will be important to prepare the SFCR in parallel with annual reports to allow your business to identify any divergence and be able to explain the reasons to analysts.**
Secondly, Solvency II is built on a market-consistent approach that does not have universal appeal. Many insurers view a market-consistent approach as the most appropriate benchmark of economic value in their businesses. However, there are some who believe that it can portray an overly generous view of some businesses (for example, mortality and other risks within protection business, as well as unit-linked business), while taking a highly punitive view of the risks within certain guaranteed savings business. A market-consistent approach also introduces much greater volatility into both capital available and capital requirements, which even with ‘dampeners’ in place may exacerbate pro-cyclical pressures.

Tackling these challenges will require careful thought. On the one hand, management teams will need to demonstrate that Solvency II-style information is at the heart of decision making. On the other, management may not want to adopt bases for internal or external reporting that do not reflect its own view of risk and value. You could look to adopt a consistent group-wide ‘Solvency II’ view, but this may not be easy to do, and would be resisted by those who believe that a market-consistent approach is inappropriate. An option is to focus group-wide capital allocation decisions and external markets on the outputs from internal economic capital models, and to use Solvency II data at a local solo level, as well as a means of testing compliance with binding regulatory constraints.

The advantage of this approach is that it can be applied on a consistent basis across the business and may better reflect management’s own perspectives and objectives, as well as what is viewed as most important in creating value in the business. However, this approach also brings numerous challenges. A key one is ensuring that it does not jeopardise internal model approval. In addition, experience shows that embedding an approach for group-wide decision making that is not fully aligned with local regulatory approaches, or with how local competitors set capital requirements or price products, is far from straightforward. It is also debatable how useful this approach is to analysts and investors, since local regulatory demands are the ones that may determine dividends and other questions around capital deployment.

In respect of the needs of analysts and investors it is not possible simply to dismiss Solvency II information. Your business would still need to find ways to tie these binding regulatory constraints to group level economic capital evaluations, along with those used in IFRS and rating agency capital models. We set out in Figure 1 some of the considerations that companies will need to address.
Break on capital flexibility

Whether or not Solvency II or alternative versions such as internal economic capital models are viewed as the best proxy for economic value in the business, it will be local solvency rules and rating requirements that are likely to be the decisive factor in calculating how much cash is available to be reinvested in the business, or is legally available to pay dividends or fund possible share buybacks.

Market movements come into play here, as there will be more volatility in available capital than under the relatively static existing regimes. Today’s point estimates are therefore likely to be redundant and will need to give way to dynamic analysis under a comprehensive range of scenarios.

A further consideration is the impact that Solvency II will have on capital flexibility, particularly for life companies. At present, Solvency I rules and the legal requirements for what counts as distributable earnings tend to operate in a broadly consistent way (and in some jurisdictions are in fact the same). But Solvency II could create a high degree of divergence between what may be ‘free capital’ from a regulatory view, and what may in fact be legally distributable. This is because Solvency II takes an ‘economic’ view, as opposed to the traditional cost-based view, which tends to drive legal considerations around dividend distributions. A further complication is that the difference between an economic and ‘distributable’ perspective may vary greatly by product. This will have consequences for different legal entities within a business as to whether the real binding constraint will be regulatory capital (guaranteed savings products) or what is legally distributable (protection).

What this means is that even if Solvency II may be viewed as broadly neutral to an insurer at a group level, there may be consequences in the ability to move capital internally from what is the current practice. A key question for CFOs is whether today’s cash cow becomes tomorrow’s dividend block?

Identifying the implications of these considerations for your own operations will be hard enough, but clearly analysts and investors will be looking for ‘winners and losers’. In other words, they will want to know what Solvency II data means in terms of sufficiency of capital and ability to withstand shocks, the quality of capital, and the impact that this will have on the financial flexibility of the business. To be prepared, it will be important to have thought through your positioning relative to key competitors and the consequences this may have for the business – and to do so early enough to be able to take any necessary actions well in advance of Solvency II coming into effect. Here, delays to implementation may actually work to the industry’s advantage, but there is no room for complacency.

Strategic response

While the latest delay to Solvency II may be viewed as an opportunity to focus on remaining technical challenges, it’s important to bear in mind that shareholders reward good performance and potential rather than good models. Assessing the investor relations implications of these reporting changes and how to address them is therefore vital. Getting this right is going to take time and a considerable amount of high level input. The postponement will allow more time to address these challenges in a well-planned strategic way.
The first key step is to determine whether the Solvency II numbers are going to be an important performance driver in allocating capital across the group or will be viewed more from a compliance perspective. If Solvency II numbers will be the core basis for decision making and performance management, then your Pillar 3 disclosures are clearly going to be a vital part of how management and investors will assess your strategy and track progress against objectives. But you will need to think through how to make information intended to be used for regulatory reporting genuinely insightful for you in performance reporting, and how to tie this together with other perspectives of your business (bearing in mind that there is resolutely no ‘one view’ that can tell you everything you need to know). While not a direct factor in Pillar 3, it will be important to look at how to make P&L attribution analysis useful within your financial reporting function.

Companies with less appetite for using Solvency II as a basis for valuation, capital allocation and performance management at a group level will need to determine how to build and embed a more coherent approach without this leading to regulators questioning whether the Solvency II evaluations have enough influence on decision making. Alternatively, these insurers may decide to manage the group to local bases.

Whichever approach is adopted, there will be a raft of additional challenges. For example, if you are looking to design an alternative to Solvency II, there is the challenge of how to embed a metric in your business that may not actually be a binding constraint – as well as to have clear links to what will actually drive your ‘real-world’ capital flexibility.

Clarity on the final direction of Solvency II will be helpful but not essential before you can fully engage with this issue. There are steps that are relevant now. For example, it is important to think through the possible consequences of Solvency II for your business, and to start to plan ahead for future reporting – for example, where will embedded value data fit in?

You will need to ask how financially stable the business will look under the SFCR. How will the new regime affect distributable earnings? How does this compare to your competitors? How does it square with the measures used by analysts and investors to rate performance?

It is also important to look at how the changes to reporting support your ‘equity story’. This includes explaining to analysts and investors the extent to which Solvency II is likely to change the key performance indicators used to run the business and how strategic objectives accord with your regulatory requirements.

Next steps

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Vision for the future

The previous section, ‘Moving to a new regime: Judging the business through the lens of Pillar 3’ explores some of the immediate investor relations challenges created by the move to Solvency II. We think it is also useful to examine how the Directive might influence longer term changes in insurance reporting and how we believe these will take shape.

In particular, given investors’ continued frustrations about how insurers communicate on value, performance and risk, the combination of Pillar 3 reporting and the planned new IFRS for insurance contracts (IFRS Phase II) presents the opportunity for a broader rethink of insurance reporting and disclosure. The results of this rethink would aim to communicate the strength and potential of the business in a more understandable, accessible and, ultimately, value-enhancing way. Further opportunities to cut through the complexity of reporting are going to come from the market push for more straightforward and comprehensible products.

Closing the information gap

The gap between what analysts and investors want from reporting and what they actually receive from many insurers has long been a cause for concern.

The markets want a clear indication both of how insurers make money now and how they intend to in the future (underwriting, fees or investment returns) as well as how these funds would translate into ‘real’ distributable cash. To be credible and informative, these metrics need to be consistently prepared (across years and between companies) and actually be used within the enterprise itself.

In most analysts’ view, what they currently get, particularly with respect to the life industry, is far less useful. There are essentially two main issues to overcome, comprehensibility and comparability. Our research has consistently highlighted market concerns over what analysts and investors believe are disjointed and opaque insurance financial statements, creating a jumble of numbers that are difficult to comprehend and compare against other sectors and which often fail to tell them what is actually happening within the company. Comparability is compromised by material inconsistencies in approach in relation to almost all aspects of reporting. The numbers are produced on a different basis from insurer to insurer and might not even correspond with the measures that are being used to run the business.

At a time when competition for capital has rarely been more intense, the difficulties in understanding the strategic direction and value potential within insurance businesses mean that they may lose investment to industries that offer seemingly more transparent and easily discernible opportunities.

Equally, policyholders want products that are easy to understand and compare. We’ve already seen the rapid rise of price comparison sites for many forms of insurance. The drive towards greater product simplicity, transparency and comparability is also gaining ground on the life side through the emergence of online access life policies and easy to manage pension products such as target date funds.
As a lot of the complexity is stripped out of product design, it should be possible to cut out some of the corresponding complexity in reporting to create financial statements that all stakeholders can understand. For example, simpler products are likely to require less sophisticated investments, which will make risk evaluation more straightforward and the resulting reports and disclosures more concise and comprehensible.

**A new framework**

As the previous section highlighted, the way insurers approach Solvency II is going to vary. Some will be looking at it as a binding capital constraint, while others will want to place greater emphasis on the evaluations within management information and external reporting. Equivalence could act as a further constraint on comparability, as quite a lot of the non-EU operations of European groups could be measured on a different basis. Given these factors, the view that Solvency II could represent a fresh start for the industry from a reporting perspective may be rather naive.

However, when put in the context of the far-reaching changes to financial reporting likely to come in as part of IFRS Phase II, the insurance industry is going to have to rethink how it judges all aspects of performance over the next decade. It would clearly be a wasted opportunity if this was not used to address some of the problems highlighted earlier.

From this perspective, as well as focusing on the technical challenges of these new standards, companies need to think about how they use Solvency II and IFRS Phase II data to answer the key questions that are relevant to management of the business and to what investors need to know.

In our investor survey earlier this year, fund managers told us that insurance reporting consistently failed to answer some of the following points:

- **How do life insurers make money?**
  Here, existing reporting often provides only the most tangential clues as to what drives profits, whether on an IFRS or embedded value basis.

- **How do we know that the reinvestment in the business is of good quality?**
  Investors are increasingly sceptical as to whether new business profits are really achieved, and whether published internal rate of returns (IRRs) or payback periods really match reality.

- **How do insurance earnings turn into distributable cash?**
  While there have been attempts by several insurers to try and answer this question, the outputs are often not robust or linked to the ‘real world’.

- **Does the company have sufficient capital?**
  This may seem like a straightforward question, but the myriad of different capital lenses and frequent company confusion mean that a clear answer can often be lacking.

We’re not suggesting that these are the only issues, and clearly there are numerous other considerations that are of equal importance to management and investors. However, it is not a stretch to understand how Solvency II and IFRS could be used to try and address these questions, and to deliver a far more coherent approach to internal and external analysis than the patchwork of disjointed metrics that tend to represent the reporting dashboard of many insurers in today’s environment.

For example, using scenario analysis built around Pillar 3 data would go a long way towards giving analysts the prospective information on cash generation they are looking for and help them to track the most important risk and value drivers that influence this. As a result, financial statements would provide a more balanced evaluation of risk and reward and the strategies that underpin this.

Industry investment in new technology will support these developments by speeding up the supply of key information. To manage their businesses, management will have online access to value creation and risk information through dashboards. Once the link between Solvency II and statutory accounting is bedded down, we may also see the emergence of a core suite of metrics to manage and communicate the performance of the business on a consistent basis.

Of course, there remain unanswered questions as to how far the US and other non-EU markets will go along with approaches often built from a market-consistent approach; in this respect, multinational insurers are likely to have to continue to grapple with multiple reporting approaches for many years to come. A further consideration is the complexity of the Solvency II and IFRS Phase II reporting, which could just as easily make current confusion even worse if not handled properly. However, there is a clear prize here for the insurers that get this right – and focus beyond technical considerations to make the outputs of the significant investment in reporting useful and insightful.

Presenting a clearer, more concise and more compelling approach to reporting would remove much of the ‘mystery’ from insurance disclosure and help companies to compete for investment on a more favourable basis with other sectors, while being more transparent to shareholders, policyholders and other external stakeholders.
Pillar 3 disclosure could have a significant influence on investors’ decisions. How much independent review will be required to ensure market confidence in the disclosures?

We would expect that key elements of the quantitative reporting such as the technical provisions and own funds are likely to require mandatory external review under Solvency II. Preliminary consultations are underway.

As market pressure to disclose aspects of Solvency II increases, your business may eventually want to consider whether external review may need to go further than the mandatory areas. Possible areas include parts of the own risk and solvency assessment (ORSA), such as the assessment of the future solvency position. External review would enhance the credibility of the reporting within the markets. This will in turn require a more forward-looking approach than is typical within today’s audit-type evaluations.

However, it is important to note that external review is intended to be a complement to internal governance rather than a replacement for it. Reviewers are expected to place considerable reliance on your company’s own framework of oversight and controls.

So what role may external reviews play in Solvency II reporting and how would this work?

Broad scope of review

Investors and other stakeholders may come to expect both a retrospective and prospective focus for external review under Solvency II. On a retrospective basis, reviewers will be called upon to provide stakeholders with reasonable assurance that key elements of Pillar 3 disclosure are materially correct. On a prospective basis, it is our view that some analysts and investors might want to see a review of the assumptions made to assess the future continuity of the business. These perspectives would draw on reviews of the risk assessment and control framework to judge whether the business is properly controlled.

Therefore, we envisage that the external review will focus not only on a selection of the publicly available elements of Pillar 3, but also on a limited number of additional disclosures as a result of market pressure (Figure 2 sets out the possible scope of external review).

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**Figure 2: PwC’s view on the potential scope of external review**

- A selection of the publicly disclosed Quantitive reporting templates (e.g. Solvency II balance sheet)
- Tiering and eligibility of the own funds
- Solvency capital requirement (SCR) and minimum capital requirement (MCR) calculation and thus the solvency position
- Management’s assessment of the prospective risk and solvency position based on the ORSA and a statement on the quality of the internal control framework to the extent that the information can be objectively measured and made subject to a clear framework for review

Source: PwC
Changing role for auditors
Some countries already require auditing of certain elements of regulatory returns. But Solvency II may take such evaluations into uncharted waters. In particular, if stakeholders would require a statement on management's prospective risk assessment, this would lead to a more forward-looking focus for auditors than at present.

The review body would be required to provide a letter detailing any matters arising from the evaluation, such as internal control issues. This would be shared with the supervisor, but not publicly available.

Reviewers might be allowed to place a certain amount of reliance on your internal control framework and the independent validation of the cash flow and (in the case of internal models) the risk models in judging the accuracy of the numbers and rigour of the surrounding governance and oversight. Their main role will be to test controls and 'review' the procedures in place rather than primary verification, though how much testing of their own they are likely to carry out remains to be seen.

Emerging requirements
In addition to the mandatory areas for review, there may eventually be peer and market pressure to disclose some additional elements of Solvency II evaluation and management. This could include scenario analysis within the ORSA. The credibility of this information would benefit from external review and verification.

Strengthening assurance
The details of the (mandatory) external review requirements are still to be finalised. What is certain is that such reviews would play a significant role in assuring stakeholders over the accuracy of disclosure and the quality of the controls that underpins it. We expect that the market may also be looking for an additional voluntary review of managements' forward-looking statements not covered by the mandatory review. This will be a new departure for companies used to a traditional audit of financial reports, and therefore the information and evidence they will seek to assure themselves will be extensive.

External review is intended to be a complement rather than a replacement for internal governance.

Next steps
EIOPA has embarked on a programme of consultations which will look at what should be covered by an external review, how it will work (including how much reviewers can rely on internal controls) and the cost/benefit of the proposed approach. Subject to this cost/benefit analysis, further areas that could fall into the scope of the review include the SCR and MCR. Further questions are likely to centre on clarification of how much reliance can be placed on internal controls.
Section two
Bringing reporting up to scratch
The challenges of getting ready for Pillar 3 disclosure should not be underestimated. However, the systems and operational upgrades that will be required open up opportunities to create a more efficient, organisationally integrated and ultimately useful framework for company-wide reporting. We asked the programme director from a leading international insurer to share his company’s expectations, practical experiences and perspectives on the hurdles ahead.

"We knew from the outset that meeting the Pillar 3 requirements would be challenging, requiring us to disclose more information, more frequently than ever before and with much less time available to do so. But the challenge is not compliance in itself – we would always find a way to get over the line, even if that meant bringing in more people from other areas of the business. The real issue is how to meet the demands of Pillar 3 in a sustainable way that minimises the implementation costs and ongoing compliance burden in the future.

Having carried out some initial work in 2008 and 2009, mainly focusing on the Pillar 1 quantitative requirements, the programme began in earnest in 2010. The first step was to bring together key stakeholders from across the organisation (actuarial, finance, risk, internal audit etc.) to evaluate what would be required for all three pillars, carry out a high level gap analysis and set up work streams to address the gaps. This was accomplished during a project initiation workshop where the programme structure, vision and training requirements were determined.

It is very important to develop a good organisation-wide understanding of what is required for Pillar 3 at an early stage to help to mobilise the business. As people become aware of the implications, they can begin to lobby their supervisors for a workable approach. Many local companies had been primarily focusing on Pillar 1 at the beginning and therefore there was less awareness of how long the Pillar 3 implementation will take and how much it is likely to cost.

We were among the first few organisations to be lobbying our supervisor for better recognition of the challenges and this has resulted in greater awareness across the industry.

Setting your ambitions

Drawing on our high-level evaluation, a core team developed the programme vision for the new solvency regime and for Pillar 3 specifically, before we sought views from key stakeholders at all levels of the business.

This vision is going to vary from organisation to organisation depending on their ambition and what other issues they want to address as part of the programme. But an agreed vision is the key to getting everyone mobilised and working towards common goals.
Our overall vision not only focuses on the practical compliance demands (for example, how to clear the compliance hurdle at the lowest possible costs), but also how to use the necessary changes as an opportunity to develop a more risk-aware culture and optimise risk-adjusted value. Our Pillar 3 vision reflects these overall objectives by looking at how we can use the new management information and reporting requirements as a foundation to add value for customers, investors and other key stakeholders. It also recognises that the right processes, controls, technology, data and governance have to be in place.

Pillar 3 is a journey and some elements of what we want to achieve will not be in place before the implementation deadline. But as long as you have a clear and agreed vision, the direction and momentum can be maintained to ensure you will get there eventually. Similarly, you are bound to need some workarounds to get over the line during the transition. But you can't afford to institutionalise these fixes, as this will only prolong the costs and disruption.

From a practical perspective, we have come to realise that integration with financial reporting is vital, especially as many of the same people are going to be closely involved in both. The worst thing to do would be to create a whole new set of reports on top of what is already produced.

In turn, efficient implementation demands close integration between risk, finance, actuarial and assurance (internal audit) teams. These teams tend to work quite independently, so getting them to work together posed a possible challenge. However, the earlier you can get these teams to engage and collaborate, the better.

**Steps along the journey**

All this preliminary work paved the way for the development of a target operating model. We carried out a more detailed gap analysis that looked at the potential data gaps and hold-ups and what organisational changes and systems investment would be needed to tackle these (The ‘Delivering on time, every time’ section on pages 32–35 explores some of the key considerations). A very important part of this was to look at the reporting calendar and then determine who needs to do what and when and how all the reporting activities are going to come together. Among the potential bottlenecks we identified were systems and process inefficiencies, technology not deployed as efficiently as it could be and actuarial, risk and finance teams working in silos. Other key bottleneck areas included reliance on asset managers and other third party data providers for more frequent and detailed data feeds (the ‘Developing an effective partnership with your asset managers’ section on pages 20–31 looks at the additional requirements and how to overcome them).

We’re upgrading our systems to make sure that we can meet the new reporting deadlines. While we currently have several months to submit our returns, in future these will need to be ready in a matter of weeks. Our investment includes a combination of off-the-shelf Pillar 3 reporting systems and the development of a new data warehouse. It’s important to stress that you can’t just buy a solution, as the really hard part is making sure the right data is fed into the system at the right time, which requires a substantial amount of data sourcing and data flow work across the organisation.

Looking at where we are now, I think we are probably slightly ahead of the curve, but there is still some way to go. The key challenge ahead is embedding the changes, though I believe that if you develop capabilities that the business will use and see the benefit of, embedding will just be the by-product of this rather than an exercise in itself. Starting ‘with the end in mind’, i.e. what you are going to report on, brings significant clarity on what the business needs to do after the programme.

**Key lessons**

When asked what we’ve learned, I think the first key point is that all the people who are going to have the most important roles in making this work – including the IT, risk, finance, actuarial and internal audit teams – need to be pulling together from the outset. In turn, you need senior buy-in or progress will be significantly delayed. Given the amount of dependencies and oversight involved in Pillar 3 reporting, allowing time for a dry run and any subsequent fixing is also essential. The final message is the importance of being pragmatic and realistic and developing an iterative solution approach. An overly complicated programme and approach can all too easily come unstuck, destroying value rather than creating it.

We would like to thank the contributor for his time and thoughtful insight.
Setting the scope

One of the key implementation considerations is how to present the solvency and financial condition report (SFCR) in a way that works best for your company and the users of your reports.

At first glance, bringing all your various entities into a single (group-wide) SFCR would appear to be easier and cheaper than preparing separate reports for what may be many different legal entities. It would also allow both the group and the reader to view the business as a single economic entity. But a single group report may not necessarily be more straightforward and understandable than separate solo entity reports once factors such as language, stakeholder expectations and differences between business lines are taken into consideration.

Meeting stakeholder demands

Pillar 3 reporting and disclosure requirements under Solvency II include both private reporting to supervisors in the form of the Regular Supervisory Report (RSR) and annual public disclosure in the SFCR.

Overall, the SFCR and RSR provide integrated quantitative and qualitative analysis, bringing together a view of how business activities affect your risk profile and related capital adequacy.

The QRTs capture information on the balance sheet, assets, SCR, MCR, technical provisions, variation analysis and reinsurance. Your business can use the QRTs to support the preparation of the RSR and the SFCR.

It is worth noting that EIOPA leaves scope for EU member states to define national specific templates, covering products and conditions with particular relevance to local markets and national legal requirements. National specific templates would not replace the QRTs, but would have to be submitted in addition.

A single SFCR should include an overview of the position at group level with the specific details of individual entities being easily identifiable. Figure 3 outlines the contents of an SFCR.

The publicly available SFCR is designed to bring out the internal operational structures/procedures underlying capital management (Pillar 1) and the system of governance (Pillar 2) so that it can be scrutinised by external stakeholders. Although it has close parallels with the RSR presented to supervisors, the SFCR will be more descriptive in detail and will not contain commercially sensitive information. Key elements include:

- Nature of the business and external environment, objectives, strategies, underwriting and investment performance
- Governance structures, responsibilities of the board/administrative bodies, senior management and key committees, reflecting elements of the ORSA
- Risk profile and risk management approach for each category of risk
- Valuation bases for assets and liabilities including technical provisions, with explanation of any major differences to the bases used in the financial statements
- Capital management including SCR, MCR, Own Funds (tiers and classification) and quality/structure of solvency reserves

Figure 3: Content of SFCR

So what are the key factors that would help your business to judge whether to opt for a single group-wide SFCR for all operations or separate group and solo entity reports?
If your company has significant market share in a particular country, the local supervisor may well press for a translation into their local language of subsets of the SFCR, even if the operation is not materially significant within the group overall.

The options
Subject to approval from your group supervisor, you then have three possible options for how to submit your group SFCR:

Option one: Single (group-wide) SFCR
You can submit a single SFCR, which not only includes the aggregate group position, but also the information for each applicable solo entity. It should be easy to identify which undertaking the solo entity information relates to.

Option two: Separate SFCRs
You can submit an SFCR covering the group on its own. Each solo entity would then generally submit a separate SFCR in local language to the solo supervisor, along with others as determined by the college of supervisors according to the level of interdependency and whether sub-group supervision is applied.

Option three: Combination
You can submit separate SFCRs for selected entities (e.g. a national subsidiary or operation with a significant local market share). The group SFCR would include the aggregate group position and information for smaller entities not producing their own SFCRs.

Weighing up the options
A single (group-wide) SFCR would appear to cut out a lot of work, especially as there would only (in theory) be one supervisor to engage with. It could also make the monitoring of consistency of application and evaluation around the group slightly easier. But the same level of detail that would go in a solo SFCR would need to be included in the group report if there is no solo version. The result would simply be a longer group report, which may end up being very difficult to put together and comprehend in a group where there are multiple business lines in many different territories.

If your company has significant market share in a particular country, the local supervisor may well press for a translation into their local language of subsets of the SFCR, even if the operation is not materially significant within the group overall. Stakeholders of a local subsidiary are also likely to expect an entity-specific report in their own language rather than trying to extract the information they need from a group report. This underlines the importance of liaising with stakeholders about their expectations.

Either way, the level of work will in most cases be the same as the data gathering, risk analysis and other key elements of an entity report, and would in any event need to be produced for the RSR whatever the chosen option for the SFCR.

Nonetheless, a single SFCR would be more straightforward and acceptable to stakeholders if your group is operationally centralised and has a limited number of business lines. If you plan to ask your supervisor for permission to submit a single (group-wide) SFCR, your request should explain how the single group SFCR will meet the requirements set out in the Level 2 delegated acts (‘implementation measures’).

The explanation should cover both the group and the individual subsidiaries included within the single group SFCR. Your request letter and subsequent single SFCR would need to set out which subsidiaries you intend to include within the single SFCR, which you do not (because they are not material) and how the requirements will be met for those you don’t propose to include (e.g. by separate solo SFCRs). It is important to bear in mind that one of the main purposes of the group SFCR (whether...
solo entities are included or separate) is to present a view of the group and interconnectedness throughout.

For subsidiaries outside the EU, it won’t matter whether they are in an ‘equivalent’ jurisdiction or not, as they could be required to contribute quantitative and qualitative data to the group report. Whether they need to be included as a distinct section depends on how material they are to the group overall.

It’s important not to underestimate the work involved and the time it will take to prepare your SFCR(s) – single reports could be very lengthy and it will be a challenge to present this in a way that is representative of the group overall.

The first step is to work out what is the best choice for your company and its stakeholders. At the same time, it’s important to open a dialogue with your group and solo entity supervisors to understand and manage their expectations about your disclosure.

You should ideally allow enough time for a dry run ahead of initial disclosures. Working back from that timetable you should think about choosing your preferred option and ideally seeking affirmation from your supervisors in advance. That will allow you enough time to carry out an assessment of the status of your Pillar 3 programme and then begin to develop and implement your reporting procedures and calendars, technology changes and Pillar 3 governance.

Next steps

A single SFCR would be more straightforward and acceptable to stakeholders if your group is operationally centralised and has a limited number of business lines.
Applying proportionality to your reporting demands

If your business is relatively small or not especially complex, your reporting and disclosure demands will in some respects be less extensive than a larger or more complex counterpart. This ‘proportionality’ will mostly be evident when reporting on your Pillar 2 systems and processes. Some of the QRTs also include materiality aspects (e.g. on lines of business reporting).

Proportionality is one of the core tenets of Solvency II. It seeks to ensure that the regulatory demands on your business reflect its nature, scale and complexity.

In principle, your business won’t be expected to report or disclose information that is not material or relevant. As outlined in the previous section, ‘Setting the scope’, the general rule of thumb is that reporting or disclosure is material if a user might come to a different decision if it was left out. In practice, you will need to be prepared to report all the QRTs where you have relevant data regardless of the size of your business.

Based on the nature of the business and its investment strategies (e.g. smaller insurers may not have structured products on their balance sheet), some QRTs might not be applicable. If you only write a few business lines or there is little complexity in your investment strategy, the required level of detail in your asset and liability QRTs might be relatively straightforward.

To take account of proportionality, some insurers will be exempted from the quarterly reporting requirement on assets look-through. According to the available draft delegated acts, such an exemption would apply when the ratio of investment funds to total investments is less than 30%. These exemptions can be made by supervisors, based on the scale, nature and complexity of the risk profile of undertakings and their investment funds. Nonetheless, this information may still be required for Pillar 1 evaluations.

In March 2012 the ECON Committee in the European Parliament voted on and approved a series of compromises which included some areas of proportionality in Pillar 3. In particular, a concept was put forward whereby if an insurance entity represented less than 20% of the market share of the country it operated in, the national supervisor has the ability to release that company from certain reporting obligations during the year, so long as the supervisor believes it can carry on its duty without the information and the company reports the data at least annually.

These concepts could clearly result in some inconsistency across Europe and so there remains some uncertainty around whether they will ultimately be part of the Directive. Furthermore, they still need to be voted on and approved by the European Parliament.

If you have approval to use an internal model or partial internal model, you will have to complete a slightly different set of QRTs from those that use the standard formula. Technically, reporting the templates for internal model users only apply if your model is approved. However, your supervisor may require that you complete both sets of QRTs depending on your status within the internal application/pre-application process. Ring-fenced funds may also have to report certain templates themselves, including the balance sheet, own funds, SCR and overview of technical provisions. If you are a large and complex insurer with many ring-fenced funds, this will be an additional burden.
The simplifications used in Pillar 1 capital requirement calculations should be reflected in the Pillar 3 QRTs. But as Figure 4 highlights, these simplifications may create their own additional reporting requirements, including the need to explain why they have been applied.

For example, simplifications in the standard formula might allow you to evaluate fewer scenarios for lapse risk or a simplification of the spread risk for structured products. But you may have to include a detailed explanation in Pillar 3 to justify the use of these simplifications and validate that they are proportionate.

As regards Pillar 2, the governance and risk management framework is based on the risk profile and complexity of an undertaking, and therefore proportionality within Pillar 2 will have a direct and high impact on your reporting (see Figure 5 overleaf).

As the ORSA includes elements of both Pillars 1 and 2, the simplifications used will also have a high impact on the reporting demands (quantitative and qualitative), especially if using all possible synergies between the ORSA report and the RSR. Thinking about the synergies between the ORSA report and the RSR and setting up the ORSA to take advantage of these is therefore crucial in reducing reporting demands. As before, however, you will need to justify why you are operating with a relatively simple governance and risk management framework.

### Figure 4: Extra reporting requirements generated by simplification

<table>
<thead>
<tr>
<th>Simplification</th>
<th>Ref</th>
<th>Description of proportional treatment</th>
<th>Ref</th>
<th>Description of reporting requirement depending on simplification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplified calculation of SCR</td>
<td>109 SII D</td>
<td>Simplified calculation for a specific sub-module or risk module and where it would be disproportionate to require the standardised calculation.</td>
<td>G20 CP09/11</td>
<td>Information on the justifications that simplifications used for calculation of the solvency capital requirement are proportionate.</td>
</tr>
<tr>
<td>Simplified calculation of technical provisions</td>
<td>47 TPS1 Draft L2</td>
<td>Methods to calculate technical provisions shall be proportionate to the nature, scale and complexity of the risks. In determining whether a method is proportionate, undertakings shall carry out an assessment.</td>
<td>G37 CP09/11</td>
<td>Details of any simplification used in the calculation of the technical provision and including a justification that the method chosen is proportionate.</td>
</tr>
</tbody>
</table>

Source: PwC analysis

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**Simplification**

The simplifications used in Pillar 1 capital requirement calculations should be reflected in the Pillar 3 QRTs. But as Figure 4 highlights, these simplifications may create their own additional reporting requirements, including the need to explain why they have been applied.

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As regards Pillar 2, the governance and risk management framework is based on the risk profile and complexity of an undertaking, and therefore proportionality within Pillar 2 will have a direct and high impact on your reporting (see Figure 5 overleaf).

As the ORSA includes elements of both Pillars 1 and 2, the simplifications used will also have a high impact on the reporting demands (quantitative and qualitative), especially if using all possible synergies between the ORSA report and the RSR. Thinking about the synergies between the ORSA report and the RSR and setting up the ORSA to take advantage of these is therefore crucial in reducing reporting demands. As before, however, you will need to justify why you are operating with a relatively simple governance and risk management framework.

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**To take account of proportionality, some insurers will be exempted from the quarterly reporting requirement on assets look-through.**
It's important to look at proportionality in the round across Pillars 1, 2 and 3. Key considerations include assessing what aspects of Pillar 1 and Pillar 2 proportionality could be applied to Pillar 3 and to think about the consequences for Pillar 3. The extra reporting needed to justify simplifications is one of the areas that will need to be weighed up. This is one of the areas where it will be important to liaise with your supervisor to find out what they are likely to expect from your company.

It is quite likely that over the coming years harmonised standards for the level and focus of reporting across the EU will emerge. The benchmarks are likely to be set by analysts and investors as much as supervisors and many may well go beyond the statutory minimum.
The required level of detail in the data needed to prepare the Pillar 3 reporting and disclosure requirements is going to be a significant challenge for companies. How far down will you need to go?

While some of the information may already be collated for other reporting demands, much of the Solvency II reporting and disclosure will be required for the first time. When obtaining data from existing sources, it is important to consider whether this is the right level of granularity or classification to support Pillar 3 requirements. Pillar 3 is going to demand considerable changes to data management, both in terms of existing financial reporting processes, and linking these to Solvency II valuation and calculation processes. In this section, we primarily focus on the data granularity issues in respect to the asset and liability QRT templates, as many of the other QRTs will draw on this information or from Pillar 1 or Pillar 2 results.

Data as the cornerstone

Good data has always been the lifeblood of a successful insurance business.

Effective risk management requires a close watch on risk exposures across the enterprise and this monitoring is only as good as the data that feeds it. Solvency II recognises the vital importance of data in the safe running of the business by making proper governance and quality controls over data processes a cornerstone of the Directive. If companies are not confident about their own data, how can they assure their supervisor?

Although the full reporting requirements have yet to be finalised, we already have a good idea of what is likely to be required, and little change is expected. The last consultation rounds were quite stable, other than perhaps some additions that may ease the demands on smaller companies (The ‘Applying proportionality to your reporting demands’ section on pages 20–22 looks at how application for different companies may vary).

Under the Solvency II Directive, data must be:

- Accurate – the degree of confidence that can be placed in data
- Complete – is the information sufficiently comprehensive for the task?
- Appropriate – the data must not be skewed towards a particular viewpoint; it needs to be appropriate to the specific risks that are being assessed and to the calculation of the capital requirements to cover these risks.

These would appear to be straightforward common sense expectations, but the detail of the Pillar 3 reporting requirements belies this seeming simplicity. The quarterly round of data sourcing and updating is going to stretch existing reporting systems (as well as the modelling systems used for Pillar 1 calculations).
There could be considerable difficulties in collating the right level of detail on liabilities within the tight timelines. Significant challenges also exist on the asset side, especially since much of the information will have to come from third parties and the third party will need to demonstrate that the data still passes the accurate, complete and appropriate test (the ‘Developing an effective partnership with your asset managers’ section on pages 28–31 looks at the third party considerations in more detail).

Most of the data is likely to be available already, but preparation is required to report and disclose the right data at the right level of detail, within a tight timeframe, while ensuring data quality and consistency at all times.

While there is significant resistance from the insurance industry, policymakers have made clear that this level of granularity is key and is unlikely to be watered down for carriers of more complex business. It is therefore important to prepare on the assumption that the level of granularity in existing guidance will be required.

Asset data
Current guidance requires insurers to disclose asset data by individual security for quarterly reporting to the supervisor. Detailed information on each asset is required, including, for example:
- ID code, ID code type
- Duration
- Maturity date
- External rating, rating agency
- Quantity
- Acquisition price
- Issuer name, sector, group (code) and country of custody
- Complementary information code

While most QRTs present information at a point in time, some transactional information over the period will be required (see Figure 6). This is clearly going to add to the reporting and data burden.

The overall reporting package will require information on asset exposures to different categories of risk; these requirements could necessitate additional system applications. This type of data may not typically be held directly by insurers in their current general ledger systems or data systems.

In addition, the so-called ‘look-through’ principle means that for collective investment vehicles you may have to work with your asset managers to drill down into the fund-of-funds or other pooled vehicle and identify information on the underlying assets (a key area covered in the ‘Developing an effective partnership with your asset managers’ section on pages 28–31).

The logistical challenges are evident. Insurers may have an array of service providers helping them to execute different parts of their asset strategy. There may be multiple asset administrators, fund managers, custodians and other service providers. Identifying where in the range of providers the necessary information resides is the first major complication. Ensuring that information being provided from each is in a consistent format is another challenge, and doing so within the timeframe just adds to the complexity. Even in the case of a single asset manager or administrator they may not have timely access to all of the information required by the Directive, nor will they have all the information on a single platform or system. Existing licence agreements, non-disclosure and service level agreements may need to be renegotiated to accommodate these new requirements.

Liability data
Although the challenges around data preparation and reporting on the asset side have received reasonable coverage in the industry press, less attention has been focused on the data hurdles on the liability side. It might be assumed that insurers should have access to sufficient information on underwriting risk, as this is central to their business. However, the detail required by the QRTs means that the challenges are still extensive.
The QRTs package includes 13 annual templates for life and non-life business including: a full breakdown of technical provisions, projection of future cash flows and two quarterly templates covering the gross best estimate and risk margin (see Figure 7). Line of business reporting is an important feature of these templates, and depending on how many lines of business the company underwrites, as many as 5,000 separate data entries could be required for these templates, though this will vary widely depending on the nature and type of the business.

The data granularity required in the QRT for underwriting risks (E7A/B) poses a particular challenge as sufficient policy records may not be maintained on systems. Examples might include business written under a delegated authority. Many such third parties tend to send summarised information, so your business may have to renegotiate existing contracts to obtain the required level of information.

For life and health SLT technical provisions, the QRT TP(L) – F1 requires a split of the guarantees and the risk margin by line of business. Non-life insurers will also have to provide a split of the risk margin by line of business. Depending on the simplifications that have been applied to split out the technical provisions from Pillar 1 into this level of granularity, this may pose challenges. It is important to consider the data requirements of Pillar 3 in the Pillar 1 results or work on allocation rules for reporting purposes to map local business to the lines of business as defined in Solvency II.
For the technical provisions QRTs, TP(L) – F2 (Best Estimate - Life) and TP(NL) – F2 (Best Estimate – Non-Life), your business will need to include a projection of all future cash flows split by future premiums, claims and expenses by line of business each year for the next 50 years. The aim is to give an overall idea of the duration of liabilities used in the calculation of the best estimate. You will need to allow for this within your Pillar 1 projections. This can be particularly difficult for contracts with options and guarantees and split into homogeneous risk groups.

The life obligations analysis template TP (L) – F3 is designed to break down the information by product. While the required level of information should be available on IT systems, the detail needed required may require upgrades. Life insurers will also be required to give a description of the guarantees on their variable annuities by product and the hedging techniques used in QRTs TP (L) – F3A and F3B.

Under the technical provisions template for variable annuities, TP (L) – F3A and F3B, if policies are split between two companies, for instance a life company and a non-life company for the guarantee, the company with the guarantee is required to fill this template. This proposed reporting template introduces higher reporting standards for undertakings selling variable annuities compared with other product types. Companies are required to include a description of the guarantees and the hedging strategy used for variable annuity business.

For the movements of reported but not settled (RBNS) claims TP (NL) – E4, the required level of detail could be especially difficult. For example, the holistic view on calendar claims year does not allow for a distinction between outstanding claims at the end of the year which were carried forward from the start of the year, those reported through the year and those which have been reopened during the year. The reporting of reopened claims during the year and closed at the end of the period may be a particular challenge.

Collecting the required information on catastrophe exposures could be a tough call for many non-life insurers. Particular issues relate to the age of data, as there are potentially long lags between the production of useable datasets (exacerbated for reinsurers), and a lack of granularity about geographical location for all the risks. The reliability of data on building types and other descriptor fields, which is also required, is often questionable at best.

**Assessing the impact**

The high level of detail is an intrinsic feature of Solvency II’s quarterly and annual reports. Both asset managers and insurers will need to provide a range of information which isn’t disclosed in the current returns. The SFCR will heighten the market scrutiny on investment strategies, asset-liability management and the underlying risks.

Your business is likely to have been accumulating historical data on most policy types for many decades. However, data has usually been collected for daily operations and financial reporting, rather than for the calculation of risk-based capital and risk monitoring. In turn IT legacy systems may be outdated and organised in multiple silos across different departments; this causes duplication of data and inconsistency of values.

Your business will eventually have no more than five weeks at each quarter end to complete your quarterly returns, giving you and your asset managers a very brief operational window to assure quality and deliver data to support these cycles.
The need for more robust, more detailed and more frequent regulatory and public reporting is likely to place immense pressure on your internal processes, systems and architectures. Approaching the three Solvency II pillars in a holistic manner and integrating your Pillar 3 disclosure requirements into your overall financial and risk reporting and governance plans will help lay firm foundations for building them into business as usual. Finance functions may need to re-think their target operating model to enable faster reporting and enhanced integration with actuarial, risk and other departments.

A key step in addressing the granularity challenges is to develop an appropriate level of open and practicable communication between your business and your fund administrators. The insurance industry, in collaboration with the fund administrators, should ideally seek to define a core/standardised set of data designed to meet the needs of the three Solvency II pillars. Fund administrators need to define the data points that are currently available and identify the gaps and any associated development efforts. In addition, both asset managers and administrators need to recognise that reporting data represents only part of the insurer’s overall data needs, as a more detailed breakdown will be required for the calculations themselves under Pillar 1.

Next steps

The reporting of reopened claims during the year and closed at the end of the period may be a particular challenge.
Developing an effective partnership with your asset managers

The breadth, detail and timelines for the Pillar 3 data needed from your asset managers (either operating within your group or outsourced) are going to require more than just a straightforward request for information.

Managing this critical element of your quarterly and annual regulatory reporting demands is likely to require a review of the choice, contract terms and working relationship with your asset managers. Particular challenges include the look-through approach, timings, confidentiality and data governance. Any slip-ups could potentially lead to capital add-on by the regulator.

So what are the key considerations for developing an effective partnership with your asset manager?

**Huge extra demands**

The evaluation and preparation of Pillar 3 disclosures will require far more information about the value, make-up and risks relating to your asset portfolio than current regulatory returns in many European countries.

Figure 8 provides a breakdown of the quantitative reporting templates (QRT set) for assets. The QRTs will be shared with your supervisor but do not need to be made public.

The first key challenge to overcome is the scope and level of detail. This includes breakdowns by currency, geography and type of asset. Some of the information, such as identification of the (underlying) assets, data on counterparties and geographical breakdown per zone of issues will also be required for Pillar 1 capital evaluation, and it will be important to co-ordinate requests to your asset managers.

Figure 9 outlines how assets will be categorised according to a Complementary Identification Code (CIC) provided by EIOPA. The main reason for introducing the CIC is to create a standardised set of codes to help insurers determine where to assign particular assets. Each of the categories in Figure 9 must be brought into line with the Pillar 1 calculations.

**Look-through approach**

The required granularity is going to be especially taxing in relation to the 'look-through' approach, under which you would have to provide details on each of the assets within a fund or fund-of-funds.

EIOPA believes that the level of detail called for under the look-through approach is needed to assess application of the 'prudent person' principle towards investment strategy. The principle gives complete freedom to insurers over their investment strategy provided that they make sure they can properly identify, measure, monitor, manage and control their investment risks.
In theory, your company might choose to stop the look-through at a certain level. But the draft delegated acts also require a look-through as part of the Pillar 1 SCR market risk module calculation. In practice, supervisors may argue that if the look-through is not carried out to at least this level, you cannot substantiate that your company applied the prudent person principle.

Following consultations, the look-through approach applies to unit-linked assets in line with EIOPA’s interpretation of the prudent person principle.

Tracking down the precise asset allocation in alternative investments or funds-of-funds could be especially challenging. Some portfolios are likely to be spread out across many lines, with certain types of assets making up a very small proportion of the overall portfolio (1% or less in many cases). Dealing with all these small allocations will add to the time and effort. Your business could ask your asset manager to collate and supply the information at the required level of aggregation, though they would need the capabilities and may charge a premium to do so. Alternatively, you might opt to develop systems capable of taking in all this multiplicity of data, but that will naturally incur a cost.

The look-through approach is going to be especially taxing for asset managers who deal with third parties on behalf of their insurance clients. They need to ensure the right level of detail in the information coming from their data providers. This could affect both the fees and the choice of asset manager.

A further consideration is data storage. You need to make sure that you can store all the data or ask your asset manager to do it for you. Either way, the costs will need to be taken into account.

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**Figure 8: Asset reporting templates**

<table>
<thead>
<tr>
<th>Form</th>
<th>Description</th>
<th>Frequency (at least)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>D1 Investments Data – Portfolio list + D1Q</td>
<td>Detailed inventory of all assets (including investments funds but excluding derivatives) disclosing a wide range of statistical information on each asset.</td>
<td>Quarterly</td>
</tr>
<tr>
<td>D1S Structured products Data – portfolio list</td>
<td>Detailed information on structured products.</td>
<td>Annually</td>
</tr>
<tr>
<td>D20, D2T Derivatives data</td>
<td>A detailed list of all derivatives traded in the reporting period.</td>
<td>Quarterly</td>
</tr>
<tr>
<td>D3 Return on investments assets</td>
<td>Detailed information about assets profitability (including derivatives).</td>
<td>Quarterly and annually</td>
</tr>
<tr>
<td>D4 Investment funds (look-through approach)</td>
<td>'Look-through’ approach for investment funds demands additional information on underlying instruments within funds.</td>
<td>Quarterly and annually</td>
</tr>
<tr>
<td>D5 Securities lending and repos</td>
<td>A detailed list of securities lending and Repo operations needs to be reported for all contracts in the reporting period (including closed ones).</td>
<td>Quarterly and annually</td>
</tr>
<tr>
<td>D6 Assets held as collateral</td>
<td>Detailed information on assets held as collateral is required for all type of investments.</td>
<td>Annually</td>
</tr>
</tbody>
</table>

Source: EIOPA

*Supervisor may require additional submission in certain cases
<table>
<thead>
<tr>
<th>Category</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Government bonds</td>
<td>Bonds issued by public authorities, whether by central governments, supranational government institutions, regional governments or municipal governments</td>
</tr>
<tr>
<td>2 Corporate bonds</td>
<td>Bonds issued by corporations</td>
</tr>
<tr>
<td>3 Equity</td>
<td>Shares representing corporations' capital, i.e., representing ownership in a corporation</td>
</tr>
<tr>
<td>4 Investment funds</td>
<td>Undertakings the sole purpose of which is the collective investment in transferrable securities and/or in other financial assets</td>
</tr>
<tr>
<td>5 Structured notes</td>
<td>Hybrid securities, combining a fixed income instrument with a series of derivative components. Excluded from this category are fixed income securities that are issued by sovereign governments. Concerns to securities that have embedded all categories of derivatives, including credit default swaps (CDS), constant maturity swaps (CMS), credit default options (CDO). Assets under this category are not subject to unbundling</td>
</tr>
<tr>
<td>6 Collateralised securities</td>
<td>Securities whose value and payments are derived from a portfolio of underlying assets. Includes asset backed securities (ABS), mortgage backed securities (MBS), commercial mortgage backed securities (CMBS), collateralised debt obligations (CDO), collateralised loan obligations (CLO), collateralised mortgage obligations (CMO). Assets under this category are not subject to unbundling</td>
</tr>
<tr>
<td>7 Cash and deposits</td>
<td>Money in the physical form, bank deposits and other money deposits</td>
</tr>
<tr>
<td>8 Mortgages and loans</td>
<td>Financial assets created when creditors lend funds to debtors, with collateral or not, including cash pools. Doesn't include loans on policies</td>
</tr>
<tr>
<td>9 Property</td>
<td>Buildings, land, other constructions that are immovable and equipment</td>
</tr>
<tr>
<td>A Futures</td>
<td>Standardised contract between two parties to buy or sell a specified asset of standardised quantity and quality at a specified future date at a price agreed today</td>
</tr>
<tr>
<td>B Call options</td>
<td>Contract between two parties concerning the buying of an asset at a reference price during a specified time frame, where the buyer of the call option gains the right, but not the obligation, to buy the underlying asset</td>
</tr>
<tr>
<td>C Put options</td>
<td>Contract between two parties concerning the selling of an asset at a reference price during a specified time frame, where the buyer of the put option gains the right, but not the obligation, to sell the underlying asset</td>
</tr>
<tr>
<td>D Swaps</td>
<td>Contract in which counterparties exchange certain benefits of one party's financial instrument for those of the other party's financial instrument, and the benefits in question depend on the type of financial instruments involved</td>
</tr>
<tr>
<td>E Forwards</td>
<td>Non-standardised contract between two parties to buy or sell an asset at a specified future time at a price agreed today</td>
</tr>
<tr>
<td>F Credit derivatives</td>
<td>Derivative whose value is derived from the credit risk on an underlying bond, loan or any other financial asset</td>
</tr>
</tbody>
</table>

Source: EIOPA
The look-through requirement might seem needlessly onerous, but the information is of importance for understanding the individual investment portfolio and to capture all material risks. For supervisory purposes this gives the European Systemic Risk Board the necessary granularity to assess and monitor allocation and build-ups in concentration among countries and insurers across Europe.

Your business should consider all these various issues before finalising your quantitative reporting requirements with your asset or fund manager.

**Data governance**

Data from an external source will need to pass the same complete, accurate and appropriate standards built into Solvency II. You will need to demonstrate that the fund managers and asset service companies that you use have appropriate controls in place. Monitoring and verifying governance in funds or fund-of-funds may be especially challenging, as you may not deal directly with the source of the information.

To demonstrate compliance to the satisfaction of your board and your supervisor, you are likely to need documented assurances from your asset managers that the quality, consistency and reliability of the risk information they supply, and the governance and control procedures that underpin this, are up to scratch. It is possible that some stakeholders may press for ISAE 3402 (former SAS 70) type validation, and that this is updated at least quarterly.

**Tighter turnaround**

Asset managers will need to provide more data in less time for insurers to meet the Solvency II deadlines. The required aggregations, sensitivity analysis, cash flow projections and other evaluation criteria are going to place considerable strain on the reporting systems and processes of even the largest and best-resourced firms. It isn’t just the scale of the required work, but the transparency and validation that will need to underpin it that will create huge challenges.

Meeting these tight timelines will have a considerable impact on the operating models of asset managers and their third party administrators, as the information currently available at this date may not meet the rigorous granularity and quality standards demanded under Solvency II. It is also important to recognise that management as well as regulators are pressing for faster turnaround of key data and analysis, especially in today’s volatile and uncertain market environment.

A key consideration is how the format of the data and procedures for its delivery might vary from asset manager to asset manager. It is also important to bear in mind that these issues could apply even if the asset manager is part of your group, as their approach may not necessarily reflect those used at group level.

**Confidentiality and equal treatment**

A further complication is confidentiality. Some service providers may place limitations on sharing information with third parties (such as EIOPA, group/solo supervisor) or charge for the services.

In the US, the Securities and Exchange Commission restricts how quickly certain information can be released in case an investor in fund with multiple investors derives an unfair advantage. Meeting this equal access principle could prove disruptive for asset managers as they try to deal with varying information requests and preferences from different insurance clients engaged within the same fund.

EIOPA insists that if you can’t access the required data in time, you should not be investing in that fund (in line with prudent person principle).

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**Next steps**

Asset managers already have their work cut out dealing with a wave of regulatory change in their own industry, including the Alternative Investment Fund Managers Directive (AIFMD) and updates to the Undertakings for Collective Investment in Transferable Securities (UCITS). The timeline, control and governance requirements for Solvency II are going to compound these already pressing challenges.

It’s therefore vital that you sit down with them as soon as possible to go through your expectations, check if they can comply and, if not, what steps you or they will have to put in place before Solvency II goes live. The benefit for them of setting out your requirements early would be in helping to make the most of any synergies in the various regulations they face and avoid digging up the road more than once. It would also be useful to use any additional time before Solvency II goes live to discuss matters with asset managers, as switching a mandate can be a lengthy and potentially costly process.

Furthermore, asset managers may want to charge more for the additional service. It will therefore be important to look closely at the overall cost-benefits. The complexity of your holdings may be making it difficult to evaluate your assets and hence lead to higher service fees. Does the benefit justify the cost, or would simpler structures be more appropriate? While many insurers have diversified their asset management relationships, could the complications and potential costs thrown up by Solvency II encourage businesses to reduce the number of partners they deal with?

Finally, it is important to remember that the ultimate responsibility for the delivery and quality of the required asset information rests with the insurer, not the asset manager. Specific oversight procedures must be put in place for functions or activities that are critical or important. Outsourced functions and activities may also be inspected by the supervisory authority or a third party representing the supervisory authority, and it is important to discuss these topics in full with any third party.
Without greater automation, moving from today’s 80-12 day reporting cycles to the 5 week Pillar 3 quarterly deadline is going to be unsustainably labour intensive. Firms should consider their approach to meeting these accelerated deadlines and how to roll these out across their organisation.

Even the most sophisticated systems won’t get you over the line every time. People, processes and technology are all going to have to be reviewed, rethought and brought into one single framework as part of the ‘industrial’ approach needed to build Pillar 3 reporting into business as usual. So what systems, governance and organisation will be needed to get your Pillar 3 delivery up to speed and how can you make the reporting process as smooth and repeatable as possible?

Real test
If your company has tried to generate the Solvency II numbers against ‘real’ deadlines, either as part of a dry run or an earlier quantitative impact study, you will know how demanding this is.

Bringing ‘all hands to the pump’ can get you over the line first time, but in the long run it will take too many key people away from their jobs within the business. This includes claims teams, senior executives and other frontline personnel as well as finance, actuarial and risk management teams. At the very least, their time needs to be used more productively. Moreover, the demands of Solvency II will create an even greater proliferation of spreadsheets. These will be harder to monitor and verify than at present due to the much shorter turnaround times, heightening the risk of error, misstatement and resulting regulatory sanction and reputational damage.

The first key step is therefore to look along the critical path of data supply, evaluation, verification and eventual reporting sign-off to see how long each stage will take with your current reporting infrastructure and identify the gaps and hold-ups that will need to be tackled to get down to the 25-day quarterly and 70-day annual turnaround. The key considerations are: in what format is the data needed, who supplies and validates it, what is done with it at each stage, what is the required format for the output and who is the user? The expected reporting format for Solvency II is the eXtensible Business Reporting Language (XBRL), which can either be embedded in your systems or can be bolted-on at the end of processes to convert the data to the required format. There is evidence to suggest that embedding XBRL could help to streamline existing reporting processes, as well as improve the quality of reports.

The internal timescale will vary according to the complexity, organisation and investment in technology within the business. But there are some common sources of delay, many of which could add crucial extra days and even weeks to the turnaround.

Readily available data
Solvency II requires a greater granularity of data for reporting than ever before (See ‘Getting down to the right level of detail’ section on pages 23–27). The absence of central data governance and the resulting need for multiple validations is one of the most needlessly time-consuming areas of the reporting process.

Data is often cleaned and checked at each stage in the reporting chain. When you think about how many sources of data are required to evaluate an area like the technical provisions and how many hands they will go through, then the time taken...
The absence of central data governance and the resulting need for multiple validations is one of the most needlessly time-consuming areas of the reporting process.

<table>
<thead>
<tr>
<th>Financial systems</th>
<th>Fraud systems</th>
<th>Policy administration</th>
<th>Customer relationship management systems</th>
<th>Underwriting systems</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workflow &amp; document management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consolidation</td>
<td>Calculation engines</td>
<td>Risk management</td>
<td>Management reporting</td>
<td>Solvency II</td>
<td></td>
</tr>
<tr>
<td>Staging area</td>
<td>One version of the truth/details area</td>
<td>Results area</td>
<td>Extract, transform and load testing</td>
<td>Reporting data warehouse</td>
<td></td>
</tr>
<tr>
<td>Data integration</td>
<td>Data storage</td>
<td>Data integration</td>
<td>Applications</td>
<td>Reporting tools</td>
<td>Reporting</td>
</tr>
<tr>
<td>Metadata management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 10: Technology architecture for Solvency II

Source: PwC

*Mainly Pillar 1

Weighing up the systems options

With the data foundations in place, it's possible to think about what systems would be right for your business and how best to deploy them. Figure 10 outlines a typical technology architecture for Solvency II. The core components feeding Pillar 3 reporting are the calculation engine (internal model or standard formula). Solvency central data repository and finance brought together into the reporting data mart. These components need to be supported by a technology platform providing data management, workflow, management information, document management and analytics capabilities.

Weighing up the systems options

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Pillar 3 reporting is the convergence of all Solvency II elements, enabling firms to provide a consistent, accurate, complete, appropriate and timely reporting for internal and external stakeholders. As such, Solvency II reporting is dependent on the entire accuracy, completeness and appropriateness of the Solvency II technology framework.

Software vendors have, or are developing, Pillar 3 systems. However, the best fit for your organisation will clearly depend on your budget and what systems you have in place already, along with the nature of your financial reporting demands and the size and complexity of your business. The main choice is between dedicated Solvency II Pillar 3 software (top-down) and building on existing capabilities (bottom-up) – see box. If your business has multiple reporting demands and is part of a wider global group, the bottom-up approach is likely to be more serviceable. If you’re a smaller or specialist insurer, the top-down approach would allow you to bring your management information capabilities into line with your larger competitors, without having to develop an extensive systems infrastructure. Whatever choice you decide to make, it does not change or take away any of the principles from Solvency II or the fact that an end-to-end process needs to be completed.

Choosing the right systems: Bottom-up or top-down

**Bottom-up: Building on existing foundations**
A number of major vendors have developed bottom-up Solvency II ‘packages’, which would allow your business to capitalise on data warehouse infrastructure, while creating a dedicated workspace for Solvency II. This is especially true if you’re using packages such as enterprise resource planning (ERP) or business intelligence software, which include advanced reporting capabilities. The important factor here is that these vendors have gone through a considerable product development for the last 3-5 years. The aim is to establish a Solvency II technology-enabling framework providing an integrated platform, which builds on existing systems and, where required, provides specific Solvency II capabilities across three pillars. Some of these vendors already provide customers with multi-GAAP management and group financial consolidation capabilities. The latter group of vendors will enable firms to have a robust bottom-up approach utilising financial management systems to support and facilitate a Pillar 3 end-to-end process.

**Top-down: Opting for point solution capabilities**
Another set of vendors have developed point solution software for automating Pillar 3 reporting, drawing on their experience of developing dedicated software for Basel II. These applications are designed to be integrated into your existing IT infrastructure, using dedicated plug-ins for the most common data warehouse systems. Some of these vendors are also planning to offer a data warehouse component, together with a multi-business line data model. This is primarily aimed at medium-size and specialist insurers, allowing them to take advantage of a state-of-the-art reporting infrastructure, delivering regulatory spreadsheet and other business reporting needs.
Although the various applications have the Pillar 3 templates in place ready to be populated, our work with both suppliers and insurers suggests that a significant amount of adaptation and refinement will be needed to fit the technology to your specific circumstances.

Once the technology is in place, you will need to think about how to bring people, processes, data models and technology into sync. Key considerations include what can be done from the beginning of the period-end or even prior to it, possibly in parallel with other activities, and what will need to wait until source evaluations are ready (e.g. the solvency capital requirement will need to draw on various ‘building blocks’ including the technical provisions and own funds). You can then look along the critical path once again to check for duplication, areas that could be rationalised and how to make more effective use of data processes, IT systems and resources.

A reporting dry run to see how the various elements knit together and identify any snags that will need to be ironed out will help your business to prepare before the live date of Solvency II. When you come to the dry run, it will be important to make sure the conditions are as real as possible. That means conducting it alongside current annual or period-end reporting so that the demands on key personnel and systems can be properly evaluated.

It is vital to develop a robust system and data architecture to facilitate core processes and deliver the more insightful risk, capital and financial management information needed to support effective decision making.

Cutting one or even two months off your reporting cycle times is bound to be tough. There is a real danger in thinking that once you’re over the line first time, it’s going to get easier. Relying on bringing in people or redeploying those that you already have is going to be unsustainably costly, disruptive and distracting.

The key steps in delivering on time, every time are to identify areas that could be speeded up or run in parallel and then assess what systems will be needed to facilitate and support this faster turnaround. You can then look at how to industrialise the process by seeking to minimise manual intervention, duplication and error on the one side and assigning clear evaluation and governance responsibilities on the other.

In order to meet the accelerated Solvency II reporting timeline, organisations should:

- Continue with their Pillar 3 programme and ensure effective governance throughout the journey to Solvency II go live
- Clearly define and execute the scope of enhancements required along the critical path to implementation
- Look at Pillar 3 as an integral part of the risk and finance roadmap from current to target state between now and the go live date
- Streamline and standardise (i.e. embed as business as usual) processes where possible.

For a long time, insurance financial and regulatory reporting has been a challenging and complex process. Companies can thus seize this opportunity to make the process as smooth and repeatable as possible.
PwC is helping a range of insurers and reinsurers to get to grips with the practicalities of Pillar 3 reporting and disclosure. If you would like to know more about how to tackle the strategic and implementation implications, please call:

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We would like to thank all the contributors from within the industry and within the PwC network for their contributions to this publication. From within PwC, these include Geraldine Ahern, Micael Cervin, Martin Eibl, Nick Foster, Marie-Christine Jetil, Manina Kunz, Gezim Llanaj, David Mbatha, Emir Mujkic, Ronan Mulligan, Niall Naughton, Rebecca Pratley, Christoph Schellhas, Deepa Seshadri, Mike Vickery, Stephen Walsh, Jeroen Willemstein and Mara van Willigen.
Acronyms

EIOPA  European Insurance and Occupational Pensions Authority
MCR  Minimum capital requirement
ORSA  Own risk and solvency assessment
QRT  Quantitative reporting template
RSR  Regular supervisory report
SFCR  Solvency and financial condition report
SCR  Solvency capital requirement