

Is a full internal model a step too far?

Countdown to Solvency II

Making the right choice for your company

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Whether to opt for an internal model, the standard formula or one of the options in between is one of the most crucial decisions within Solvency II. It not only affects your firm's capital requirements, but also the way the business is managed and perceived by stakeholders. With the decision not always being clear-cut and also subject to possible change over time, what are the key strategic, capital management and cost-benefit considerations that can help you to make the right choice for your company, both now and in the future?

With the deliberations over the final Solvency II rules and implementation date continuing, firms have a fresh opportunity to consider the approach they use for meeting the Pillar I capital requirements.

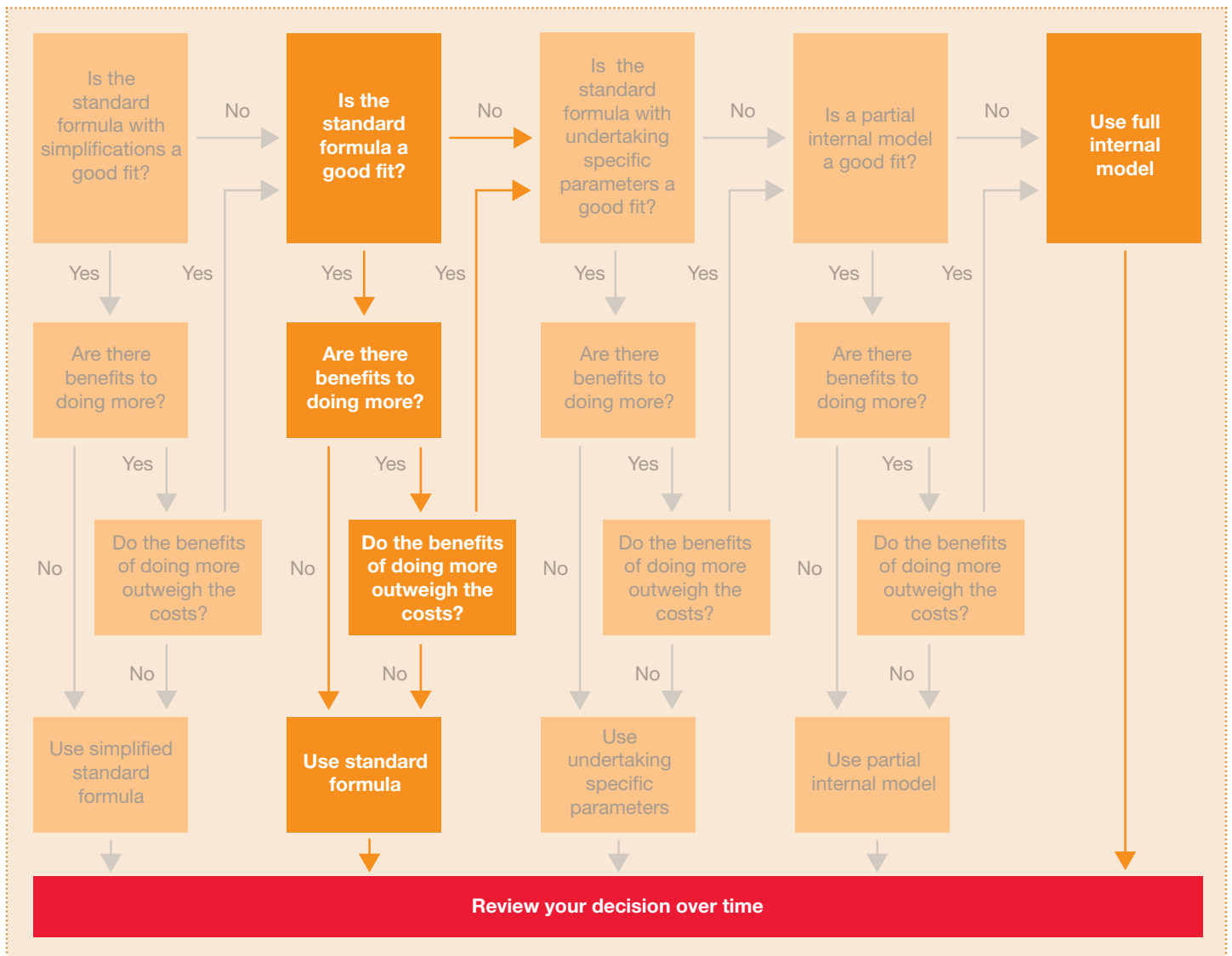
All firms should regularly review their approach to make sure it continues to meet the best interests of their organisation as their business profile and the market landscape evolve. While new

applications to use an internal model for calculating solvency capital may not get approval before Solvency II goes live, choosing whether to opt for an internal model or adopt the standard formula is still an important and relevant consideration. The right choice for a particular firm could also vary over time (e.g. internal model approval may not be essential in the first wave, but it may be a longer term or strategic aim).

For some, the decision is fairly clear-cut. For others, the balance between the advantages and disadvantages is harder to judge, particularly given the various options in between the standard formula and the internal model. In this paper we explore the main pros and cons that will help determine the right choice for your organisation.

Which model is the best fit for your business?

The key considerations are ‘Does this option best fit my risk profile?’; ‘Does it optimise my statutory capital requirement?’; ‘Have I appropriately allowed for the cost, benefit and effort entailed (‘proportionality’)?’



The decision you make can now critically impact the long term outlook of your firm, the cost and resource implications and most importantly the reputation and perception of your organisation.

Typically, firms quickly put themselves into either the standard formula or internal model 'camp'. This decision is often based on existing resources or historical practices rather than a considered long-term view of the costs versus benefits and potential strategic impact. Firms that have selected the simplest approach of using the standard formula should ask themselves if there are benefits to doing more. Equally, firms that have selected the generally more complex approach of applying for internal model approval should ask themselves whether they have gone too far.

The standard formula is a good fit, should I go further?

Standard formula drawbacks

The standard formula may not be quite as straightforward as some might assume. As last year's quantitative impact study (QIS 5) highlighted, the standard formula contains many ambiguous and possibly contradictory requirements. These anomalies may not be resolved until the current deliberations over the rules are complete, or indeed may never be satisfactorily closed off. In addition, there could be further recalibration of the parameters in the standard formula as practical experience evolves.

Variations on a theme

Opting for any of the more risk-sensitive variations of the standard formula could help a company to develop an approach that better reflects its risk profile and help address some of the ambiguity and uncertainty within the standard formula approach. For example, combining the standard formula with either undertaking specific parameters (USPs) or a partial internal model may provide a significantly improved fit to a particular risk profile, while limiting some of the costs associated with full internal model approval.

Internal model advantages

The development of an internal model (full or partial) can provide a solution that not only better reflects the company's risk profile, but again, removes some of the ambiguity and uncertainty related to using the standard formula.

Reputational issues

Beyond the regulatory capital requirement, an internal model could also provide a catalyst for a more informed and organisationally-embedded approach to risk management. The absence of

internal model approval (either through application failure or not applying) could affect the credibility of the business in the eyes of its supervisor, policyholders, shareholders and rating agencies.

Supervisor insists on internal model

In exceptional circumstances, regulators may decide that the standard formula is not an appropriate approach to assessing and managing the unusual nature of a company's risk profile and hence insist on the construction of an internal model for some or all of the risks.

What are the potential pitfalls of going further?

The key consideration is the cost versus the benefit of doing more. The principle of proportionality applies across Solvency II and its application is more important than ever here. We have outlined the potential advantages of going further than the standard formula, but do these benefits outweigh the inevitable costs? Is a full internal model a step too far?

Risk of refusal

There is a very real risk that companies expend a lot of resources and effort developing an internal model over a time-constrained period, only to see their application for use turned down. If day-one approval is not essential, management may consider delaying the application until they can be more certain of getting the right result through better preparation and a better understanding of the requirements as they 'bed down'.

Overestimating the capital benefits

It is important to consider whether the potential improvement in the capital efficiency of the business is worth the cost and calls on human resources. The capital advantages of an internal model may be overstated if the capital actually held is geared to meeting other, typically higher, targets (e.g. economic capital or rating capital).

Uncertainty of partial model application

For some firms, a partial model approach may offer an attractive solution that fits their risk profile while keeping costs down. There is however still considerable uncertainty over how to aggregate the risks from the internal model and the risks from the standard formula calculation. This uncertainty may make it difficult for firms to make this decision, at least for the time being.

Called to account

The considerable analyst interest in the results of QIS 5 suggests that the standard formula could emerge as a market-wide benchmark for assessing capital requirements. So even if an organisation is using an internal model it may still need to evaluate its capital demands under the standard formula. Companies will also need to be able to explain why the results differ from their internal model capital assessment.

Strategic issues

While lack of alignment between a company's standard formula and its risk profile may lead to a higher cost of capital, an internal model is not the only way to resolve this. Scaling back or withdrawing from certain portfolios or locations might be more effective after consideration of the cost versus the benefit of continuing within that line of business.

Conclusion

The choice of approach and the timing for implementation should be subject to ongoing deliberation and review. If directors and management are unsure about whether or not to opt for an internal model, the introduction of the transitional measures means that there is still time to decide and make any necessary preparations before the full weight of the Directive comes into force. There is only a limited amount of time, however. The firms going through the first wave of internal model approval have demonstrated that model development and integration is no small feat.

We encourage firms to make the most of this fresh opportunity and review their approach to calculating their Pillar I capital requirements now. Indeed the decision you make can critically impact the long-term outlook of your firm, the cost and resource implications and most importantly the reputation and perception of your organisation.

Giving you the edge

PwC is helping a range of insurers to get to grips with Solvency II. If you would like help in judging whether an internal model, standard formula or one of the options in between is right for your company, please contact:



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