Bridging risk and capital*
Countdown to Solvency II

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In this issue...

01 Call for action: UK and German regulators point the way
02 Smart implementation for multinational insurers
03 Engineered for success: Developing effective data and systems capabilities
04 No surprises: An opportunity to reinforce governance
05 Contacts

Foreword

Welcome to the fourth edition of Countdown to Solvency II, PricewaterhouseCoopers' newsletter examining the latest developments in the planned reform of prudential regulation for European insurers.

A year of market instability has intensified the focus on the effectiveness of risk and capital management within the insurance industry. Boards, investors and regulators want assurance that all potential threats are being identified and addressed (‘no surprises’).

Some commentators have questioned whether Basel II provided sufficient protection from the recent market turmoil and therefore whether the comparable approach under Solvency II is relevant. The key difference is that Solvency II is likely to be much more exacting than Basel II. This includes placing greater emphasis on embedding risk awareness into strategic management, an attribute that has been shown to be critical by the financial crisis. Indeed, by requiring insurers to put risk understanding, transparency and control at the forefront of their governance and decision making, Solvency II could provide an important contribution to the development of effective risk management.

However, insurers need to get moving now if they are to meet the tough demands of the directive. For UK and German insurers, the urgency of action has been reinforced by recent regulatory initiatives. In the case of the UK FSA, this includes appointing a senior management sponsor for Solvency II implementation by March 2009, if firms wish to be considered for the first wave of model dry runs and approvals. The Supervisory Minimum Requirements for Risk Management, which are about to be introduced in Germany to pave the way for Solvency II, also emphasise the essential importance of robust executive oversight.

We hope that this and future editions provide insights that can help insurers to assess the implications of the directive and assist them in preparing for the changes ahead. The subjects covered are based on feedback from our clients. If you have any comments or if there are any issues you would like to see covered in future editions, please let me know.

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1 ‘PricewaterhouseCoopers’ refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.
As the development of Solvency II moves from legislation to the practicalities of implementation, initiatives being put in place by the UK FSA and German BaFin provide important insights into how the directive is likely to be applied. Martin Eibl and James Tuley look at what these initiatives reveal about the scale and urgency of the tasks ahead.
The ink is not yet dry on the guiding legislation for Solvency II. Inevitably, there are still a number of details to be ironed out ahead of finalisation late this year or early in 2009. However, the broad foundations for the move to a risk-based supervisory framework are now in place and the directive remains on course for its planned introduction in 2012. The focus is thus moving to the pressing challenges of the Level 2 implementation measures.

Banks’ gruelling experience of applying the comparable Basel II suggests that insurers need to get moving now, if they have not already, in order to meet the 2012 deadline. Waiting for the implementation measures to be finalised could leave companies at risk of needless extra cost and disruption as they struggle to catch up. ‘Companies need to prepare for Solvency II in good time – and not wait until it comes into effect in 2012,’ said Dr Thomas Steffen, Chief Executive Director for Insurance Supervision at the German Federal Financial Supervisory Authority, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), earlier in the year.

Good guide

So how should companies frame their implementation plans and seek to discern the most effective allocation of resources? Dr Steffen is likely to provide a good guide as to how the directive might be applied in practice, as he is Chairman of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), the key adviser to the European Commission on the implementation measures for Solvency II. Under his direction, BaFin is about to introduce a new set of Supervisory Minimum Requirements for Risk Management by Insurance Undertakings (Aufsichtsrechtliche Mindestanforderungen an das Risikomanagement – MaRisk VA). Following public consultations earlier in the year, the finalised MaRisk VA circular is expected to be put in place at the end of 2008. MaRisk VA is designed to lay the foundations for Solvency II in Germany and to help the country’s insurers make early preparations.

What is perhaps most significant about MaRisk VA is that it concentrates on the Pillar 2 principles of governance and risk management rather than the technicalities of Pillar 1 solvency capital evaluation, despite the latter being the predominant focus of many insurers’ current implementation plans. ‘The basic idea behind Solvency II is to increase managements’ responsibility for their business,’ said Dr Steffen.

At present, German insurers are subject to general cross-industry provisions for the early identification of risks threatening the existence of the business, which are based on the country’s Stock Corporation Act (Aktiengesetz). The specific regulatory risk management requirements for insurers are mainly confined to investment strategies, asset management and asset liability management. MaRisk VA therefore presents an important change for the process of identification, evaluation, management and control of risks. This includes a formalised evaluation of the company’s particular risk-bearing capacity, which is based on the individual profile of all its material risks (above and beyond those threatening its existence as would be covered by existing legislation). The firm’s risk-bearing capacity needs to be underpinned by a clearly defined risk appetite, consistent risk monitoring, systematic control, maintenance of appropriate skills, internal audit review and, crucially, a comprehensive framework of executive oversight and accountability.

To meet supervisory guidelines, German insurers will also need to set out a risk strategy that reflects their business strategy and demonstrate how risk considerations are built into new product development, resource allocation, compensation, incentives and other key business decisions.

‘...although the detail of the European requirements is not finalised, the aim is now clear and the risks of waiting before starting to plan for implementation are considerable in terms of non-compliance in 2012 and/or being forced into costly high-risk programmes of work at short notice.’

From ‘The path to Solvency II: FSA discussion paper’, September 2008

1 For information about the “levels” of development please see “Making it happen: The political process” in Edition 2 of Countdown to Solvency II (www.pwc.com/SolvencyII).
2 BaFin Quarterly Q2/08.
3 BaFin Quarterly Q1/07.
In practice, MaRisk VA could have significant implications for the culture, behaviour and mindset of the business.

The process of supervision under MaRisk VA could be equally telling. BaFin intends to create an assessment system for the risk classification of insurers, in which quantitative as well as qualitative aspects will be considered. The classification will determine the frequency of on-site audits. Executives will also be subject to extensive questioning and challenge about their understanding of and justification for the firm’s risk profile, risk-bearing capacity, risk management processes and risk reports.

Executive engagement

In September 2008, the UK Financial Services Authority (FSA) published ‘Insurance Risk Management: The Path to Solvency II (DP 08/4)’. The discussion paper ‘highlights and explains the key requirements of the directive and identifies the actions that insurers should presently be undertaking’. In keeping with BaFin, the FSA’s key message is the need for urgent action—‘firms should be making effective plans now for the implementation of Solvency II’. It is also notable that the FSA leads its detailed examination of the directive’s implications and suggested response with a chapter on risk management and executive responsibility, echoing the priorities of its German counterpart. ‘Under Solvency II, senior management is clearly responsible for the risk management system and ensuring that it is used in managing the business, including how it influences business decisions,’ says the discussion paper. It also suggests that the nature and extent of their responsibilities, as outlined in DP 08/4, ‘be tabled for discussion at an early board meeting’. In preparation for Solvency II, MaRisk VA asks for comparable documentation of appropriate responsibilities and segregation of duties.

The Path to Solvency II further underlines the importance of executive engagement by asking firms to nominate a senior individual to be responsible for Solvency II delivery. This person should ideally be in place by March 2009, by which time the FSA plans to ask each UK firm to identify their executive sponsor.

The FSA also suggests that insurers should be undertaking detailed gap analysis to help identify any shortcomings and provide the basis for their implementation plans. The analysis should at least cover the areas addressed in the discussion paper, namely governance, reporting, demonstrating adequate financial resources and use and approval of internal models.

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4 FSA DP 08/4 newsletter, September 2008.
5,6,7 ‘Insurance Risk Management: The Path to Solvency II’ (DP 08/4).
‘However, it is important to note that neither the FSA nor BaFin is seeking to curb risk-taking or dictate strategy.’

‘Our own work with the industry suggests that even the best-prepared firms are still some way short of Solvency II standards,’ says the discussion paper.8

**Dry run for models**

Recognising the work ahead in preparing for internal model approval, DP 08/4 outlines plans for working with companies on a series of ‘dry runs’. These will provide a valuable opportunity to engage with the FSA in the development and validation of appropriate data quality, model governance, application within the business and other key aspects of approval. Ensuring appropriate quality of data within the individual risk evaluation is also a crucial requirement of MaRisk VA.

To qualify, companies will at the very least be required to carry out their gap analysis and appoint an executive sponsor before putting in an application to take part in the engagement programme in June 2009. They will also be expected to have carried out the spreadsheet analysis covered in Quantitative Impact Study 4 (QIS 4) and to have made substantial progress in developing governance procedures and supporting documentation for their model.

The FSA’s perspectives on the use and approval of internal models should not just be used to generate a regulatory assessment. It needs to be integrated within the firm’s overall risk management and decision-making activities, as well as being used to quantify risks and assess economic capital. In line with MaRisk VA, this requires attention to the culture and mindset of the business rather than just the mathematical models.

‘To embed the model into the business, it is first necessary to embed the business into the model,’ says the discussion paper.

In keeping with MaRisk VA, the Path to Solvency II also highlights the importance of developing executive understanding of the model analysis, including its inherent limitations. ‘Board members and senior managers are sometimes unaware of the limits of the remit of their risk management functions and may therefore place inappropriate reliance on outputs,’ says the discussion paper. A model output can help boards to come to a more informed business judgement, but cannot provide a judgement in itself – in short, risk management cannot be automated.

**Nature of intervention**

The Path to Solvency II goes on to offer some useful pointers as to how the FSA will supervise the new regime. This includes stating that the ‘capital add-on, plus the firm-calculated Solvency Capital Requirement (SCR), will replace the original SCR to become the new capital requirement that firms must meet’. Situations where additional capital may be applied include instances where the ‘standard formula might not sufficiently match a firm’s risk profile’ or where the Own Risk and Solvency Assessment (ORSA) indicates that the SCR is ‘lower than its risk profile should merit’.9

However, it is important to note that neither the FSA nor BaFin is seeking to curb risk-taking or dictate strategy. Risk is an inherent part of ‘normal’ insurance business, says the FSA.10 According to Dr Steffen, BaFin has no intention of interfering in insurers’ business strategies; this is something for the companies alone.11

**Quick off the starting block**

The circulars issued by BaFin and the FSA highlight their determination to ensure that their country’s insurers recognise the importance of timely preparation and adopting what they see as the most appropriate priorities. They are also likely to set the running ahead of CEIOPS’ publication of the draft Level 2 implementation measures for Solvency II in the spring of 2009.

The underlying messages are to understand the scale and interdependencies of what is required, ensure that direction for the project comes from the top and, above all, don’t delay. They also stress the critical importance of effective governance and risk management, both from a compliance perspective and in ensuring that companies realise the competitive prize of more secure and well-informed strategic planning and execution.

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8-10 ‘Insurance Risk Management: The Path to Solvency II’ (DP 08/4).
11 BaFin Quarterly Q2/08.
Smart implementation for multinational insurers

For large multinational insurers, the already daunting task of preparing for Solvency II is likely to be heightened by the diverse nature of their operations and extended lines of command. However, the directive also offers valuable opportunities to enhance the quality and consistency of management information and streamline the operational infrastructure of the group. Drawing on their experience of the comparable move to Basel II, Rob Field, Karin Hjalmers, Jan-Huug Logbregt and Douglas McNaught offer some expert insights into how multinational groups can prepare for effective implementation.
Insurance is an increasingly international business. The pace of cross-border consolidation continues to accelerate, while “passporting” has helped to lower the barriers to new market entry. Allianz, the EU’s largest insurer, describes all of Europe as its “home market” and has adopted a single Societas Europaea (SE) legal structure. One of the key aims of Solvency II is to provide further impetus for the development of a single market for insurance by harmonising the current patchwork of prudential regulations.

Multinational groups are often seen as the chief beneficiaries of the directive. In particular, they will be well placed to take advantage of the capital benefits of risk diversification across borders and between business classes.

However, Solvency II could prove to be a double-edged sword for multinational groups. Each of their numerous national subsidiaries may be a separate legal entity in its own right, with its own culture, way of working and regulatory obligations. Even where common group supervision applies, capital evaluation and the underlying systems of governance and risk management will need to be co-ordinated across borders and between the group and the individual entities.

It is likely that many larger insurers will seek approval for use of an internal model, which for some may reduce their capital requirements. However, any capital savings need to be built around more effective understanding and control of exposures or the company could face the same risk of capital erosion experienced by some banks in recent months.

Companies that have already developed economic capital systems may assume that gaining supervisory accreditation should be relatively straightforward. However, meeting the stringent statistical quality tests is likely to require the streamlining of systems, standardisation of data and verification of assumptions across a multitude of diverse operations. Groups will also need to develop rigorous standards of model control, validation and organisational integration.

Direction

In our view, the additional challenges faced by large multinational insurers underlie the need for high-level direction of Solvency II implementation. If it has not been made already, the most important step is therefore appointing a member of the board to take charge (normally someone within risk or finance).

Early appointment of an executive sponsor can help to ensure that Solvency II becomes a group-wide business priority and that the project has access to the right people and resources. With Basel II costing many large banks upwards of €50 million to implement, ensuring the effective targeting of investment demands high-level support and oversight. Active direction from the board can also help to foster collaboration and resolve any roadblocks on the way, which is likely to be a key priority for diffuse international groups. The result is not only more efficient implementation, but also a greater chance of realising the potential benefits.

While larger institutions were able to pull out the stops to ensure eventual implementation, the lack of initial focus and subsequent rush heightened the organisational disruption and management distraction. Many banks were also forced to rely on outside technical contractors to get them over the finishing line, which added to the costs and has made subsequent compliance harder to sustain.

Ultimately, lack of forethought and co-ordination meant that the results were often poorly understood and integrated within the business. Some would argue that failure to sufficiently embed risk management into the organisation left some large banks more vulnerable to the recent financial turmoil.

Some insurance board members may be equally reluctant to take the helm for Solvency II. However, recent market events have underlined the importance of the governance and risk management standards being promoted by Solvency II and therefore the project may prove to be more of a compelling executive priority. Some supervisors including the UK Financial Services Authority (FSA) have recognised this and are looking into how companies are addressing these issues.

Ambition

The first key question for the sponsor and the wider board is defining the group’s business case (“ambition”) for Solvency II. The key consideration is deciding whether this is primarily a compliance project or an opportunity to strengthen the business, for example by enhancing management information or embedding risk management more closely into the fabric of the organisation. They may also wish to realise the potential synergies with IFRS Phase II in areas such as data and systems.

1 Allianz media release announcing plans for restructuring and acquiring remaining RAS shares, 13.09.05.
Objectives clearly need to be realistic and work within the constraints of cost, organisational structure and ever more pressing implementation deadlines. The UK FSA’s tight timeline for the first wave of internal model approval could mean that late starters have already missed the boat (see previous article). However, there is still ample time to develop more reliable data and systems, which could not only prove beneficial in its own right, but also lay the foundations for later model accreditation.

Thorough gap and cost-benefit analyses covering such areas as data supply, systems capacity and the availability of key personnel can help to identify what investments are necessary to ensure compliance, while establishing what additional capabilities would be beneficial and realisable. The resulting implementation plans should balance management expectations and regulatory requirements, while articulating how the business will be managed in the interim to minimise potential disruption.

Co-ordination

Implementation of Solvency II is likely to be a complicated task and therefore careful co-ordination across a large multinational group is critical. The various legal entities in different countries can create additional cultural and linguistic challenges. If the group culture and structure gives these entities considerable autonomy, it can be especially difficult to end up with a single approach. Addressing these issues demands clear communication from project management and strong engagement on a local level. Our experience of Basel II highlights the importance of having local champions to help nurture buy-in to the initiative and to ensure that it is seen as relevant and beneficial to subsidiary operations rather than just being a central priority.

The foundation for efficient co-operation and collaboration is a solid project structure. Figure 1 sets out a possible structure. This includes a steering committee, ideally headed by the executive sponsor, which is responsible for making high-level decisions. Day-to-day direction and co-ordination can be provided by a project management team, ideally headed by an experienced programme manager.

To avoid miring the steering committee in excessive detail, a sounding board can be established to examine and make recommendations about conceptual issues of policy. It can also be useful to bring together a dedicated technical panel to determine how particular aspects of the directive are likely to affect the company, analyse the strategic implications, address cross-border issues and to lobby for any necessary changes. This can help to avoid differing interpretations of the directive across the group.

It is important to establish a ‘critical path’. For example, the quality of data and validity of assumptions are essential in ensuring the accuracy of models and would therefore need to be addressed before bringing any newly developed or upgraded models on line. Project teams should also formulate ‘migration plans’ for what will need to be achieved year-by-year.

Ensuring data consistency is likely to be a particular challenge across groups with different regulatory regimes and ways of working. Starting now can allow time to develop a more systematic and future-proof approach to data management. For example, this approach can avoid the expensive post-implementation data cleaning exercises that many banks had to carry out under Basel II. It can also help to ensure that the need to address the Pillar 2 priorities of governance and organisational integration is not forgotten amid the technicalities of Pillar 1.

The development of a group-wide data dictionary setting out common standards for data interpretation and delivery will be crucial. Applying Solvency II within a large and diverse organisation is also likely to require a more industrialised approach to data and systems management. Ideally, this would include replacing manual entry with electronic transfer and phasing out spreadsheets in favour of greater automation – without this step change, data management, analysis and reconciliation within a multinational organisation could simply buckle under the demands of the directive. Solvency II may also accelerate moves towards centralised data warehousing and service centres within many groups. Clearly, these are all expensive investments. Companies therefore need to be certain about their objectives and plan ahead to be sure of the payback in terms of faster close, greater efficiency and more useful management information.

Engagement

Banks’ experience of implementing Basel II highlights a failure to appreciate the scale of the task within many institutions – not only in developing appropriate systems, but also in ensuring that they were integrated into governance and decision-making structures. An especially common pitfall was underestimating the amount of documentation needed to demonstrate proper oversight and understanding across a large multinational institution. In some cases, firms set out with ambitious plans for internal model approval, but because of delays in embedding their systems could not meet the requirements in time and had to revert to a standardised approach. Moreover, systems were often designed and developed by technical teams in isolation from the wider organisation – the systems drove the solutions. Business units need to be involved in planning from the outset.
to help win their buy-in and ensure that the resulting capabilities provide useful information that can help enhance their decisions and deliver competitive value.

The early involvement of actuaries, underwriters, finance and risk management will be critical in ensuring timely and reliable data and fostering greater commitment and understanding. Engagement with finance is especially important in increasing their understanding of the implications of the demanding Pillar 3 disclosure and regulatory reporting frameworks. Greater alignment between risk and finance will also be important in realising the synergies between IFRS and Solvency II and in using these developments as a platform for developing a more informed ‘economic’ approach to management.

The business case defines the ambition of the project and is therefore an important guide for actuaries as they embark on model building. A common mistake is to start modelling before the business case is defined, which may result in the model being unsuitable for management’s business purposes. In the worst case, the actuarial department may even need to start the model-building phase again.

Early engagement with supervisors will also be useful. While the implementation measures are yet to be finalised, dialogue can help companies to understand their broad expectations and the implications for the group. An issues paper published by CEIOPS in August 2008, ‘Supervisory review process and undertakings’ reporting requirements’, provides some useful indications of what regulators are likely to expect. In addition to working with the group supervisor (possibly operating as part of a college), it will be important to build relationships with local regulators. It seems likely that local supervisors will continue to hold considerable sway over subsidiaries within their national jurisdiction. Although the European Commission is keen to ensure consistent application of the directive across the various EU states, there are still likely to be differences in interpretation and approach. Moreover, while a particular national operation may not necessarily be highly significant to the group, it could have a prominent impact on the local market and may therefore attract considerable regulatory attention.

Step in the right direction

To date, many insurers have focused most closely on the technical challenges of risk-based capital evaluation and assigned the project to back office technical teams. However, experience of Basel II suggests that concentrating on the technicalities may leave the equally fundamental and demanding strategic issues of governance, communication and organisational integration until last, by which time it may be too late to address them appropriately.

A carefully structured multidisciplinary approach to implementation that aligns the work of the different departments is essential within large multinational groups. Effective implementation also requires local understanding and buy-in – it cannot be imposed from the centre particularly where the group is comprised of different autonomous entities.

Developing a solid platform for implementation is likely to require:

- Executive sponsor;
- Understanding of the scale and nature of the task;
- Gap analysis;
- A proper business case;
- Clear operational objectives;
- Realisable implementation plans and associated timelines and accountabilities;
- Effective structuring and delegation;
- Close co-ordination;
- Early organisation-wide awareness and involvement; and
- Dialogue with group and subsidiary supervisors.

Figure 1 Possible Solvency II project structure

Sub-committees co-ordinate the work between the different work streams (Pillar 1, Pillar 2, Pillar 3 and QIS), where necessary.

Source: PricewaterhouseCoopers
Solvency II is likely to require a substantial increase in data gathering and computational capacity within many European insurers. The good news is that by leveraging enterprise risk management (ERM) capabilities and aligning the implementation of new information systems with developments in financial reporting, firms could not only reduce costs, but also deliver more of the benefits. Robert van der Eijk and Isabelle Jenkins look at how to ensure your data and systems are engineered for success.
Solvency II calls for a full evaluation of all the risks faced by the business and the capital needed to support them. As experience of Basel II underlines, dealing with the terabytes of risk data and carrying out the huge volume of required stress and scenario analysis are likely to demand vast systems capabilities. At a time when many insurers are already forced to run less taxing versions of this analysis over the weekend as they need to draw on the capacity of just about every computer within their network, the scale of the systems challenge becomes clear.

Yet Solvency II is far more than simply an IT issue, not least as even the most sophisticated risk models are only as useful as the quality of the data, the validity of the underlying assumptions and the ability of management to correctly interpret the results. One of the key lessons of Basel II is that while effective systems are important, they cannot be developed in isolation from the operational and reporting demands of the business. Data needs to be comprehensive and consistent. The model outputs need to be sufficiently credible and intelligible to be trusted, understood and used within the business. To ensure consistency, insurers need to develop a firm-wide data dictionary comprising a standardised taxonomy and set of assumptions. Some companies may wish to go further by developing service level agreements (internal or external) for data sourcing and transfer.

Building data management under Solvency II into the overall ERM programme can help firms to break down risk silos and create a standardised approach to risk identification, monitoring and evaluation. This can not only ensure greater consistency, but also help to leverage the risk management capabilities that already exist within the business. From a business perspective, this streamlined approach will improve companies’ ability to develop a portfolio view of risk.

Nonetheless, much of the data being fed into the Solvency II and broader ERM/ economic capital models will still require verification and cleaning. Quite a lot of the required data may also need to come from outside sources. Firms should take account of the inherent strengths and weaknesses of using external information. For example, they will need to look at how to apply the industry-wide benchmark information that is often used in areas such as operational risk to their own

Data

Consistency is critical and therefore needs to be addressed from the outset. At present, risk is often managed within separate silos. Moreover, variations in regulation and legacy systems mean that particular operating arms may often collate and evaluate comparable sets of data in markedly different ways. To ensure consistency, insurers need to develop a firm-wide data dictionary comprising a standardised taxonomy and set of assumptions. Some companies may wish to go further by developing service level agreements (internal or external) for data sourcing and transfer.

In this article, we look at how to overcome some of the practical hurdles to compliance and how effective implementation can help to strengthen the business.

The recently published results of QIS 4 show that most insurers see opportunity to improve risk management rather than specifically targeting a lower capital requirement. However, a global study of ERM in the insurance industry, which was published by PricewaterhouseCoopers earlier in the year, provides a telling indication of the scale of the challenge for European firms in developing the necessary systems capabilities and integrating the resulting analysis into the business. Less than 30% of European respondents believed that their risk data and systems were good or excellent. Less than half reported that consistent criteria were in place to assess identified risks and less than 10% believed that the communication and escalation of risk information across the organisation was very effective.

Although challenging, the development and integration of more effective information systems under Solvency II can strengthen risk management and provide a more insightful and assured risk-adjusted basis for decision making. For example, insurers are better able to judge which policies are delivering the most favourable return on investment. They are also in a better position to evaluate acquisitions, new market entry and other key strategic options.

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1 “Does ERM matter? Enterprise risk management in the insurance industry”, a study published by PricewaterhouseCoopers on 24.06.08. To download or order a free copy, please visit www.pwc.com/insurance.
particular circumstances. They may also need to validate credit ratings with additional internal evaluation.

**Systems**

The sheer scale of Solvency II evaluation is likely to require a more industrialised approach to risk and capital analysis, in which data entry and use of spreadsheets are replaced by automated systems wherever possible. The clear benefit will be improved statistical quality and reliability.

With Solvency II valuation moving in the same direction as the latest developments in IFRS Phase II for insurance contracts, companies should be able to realise valuable synergies in data, modelling and reconciliation. This would improve the consistency of both internal and external reporting, while avoiding the needless duplication and disruption of ‘digging up the road more than once’.

Operationally, the key to realising these synergies is greater alignment between the risk, actuarial and finance functions. In particular, dovetailing Solvency II implementation with IFRS could provide an opportunity to rationalise disparate models and valuation systems onto one platform. Firms might also consider developing a common data warehouse and consolidating back office reporting processes into centralised hubs. Building these developments around the ERM programme could help to bridge risk and finance.

From a business perspective, bringing together risk and financial analysis could provide a more balanced view of risk and reward within the budgeting and strategic planning process. Greater harmonisation could also facilitate a faster close for both accounting and capital results, which should in turn enhance credibility with external stakeholders. The common ground between IFRS and Solvency II is likely to include disclosure of the risk profile, risk management approach and valuation bases for assets and liabilities, including technical provisions.

Alignment can be demonstrated in a number of ways, but one of the key barometers is the consistency of the metrics between risk and finance. It is therefore notable that our ERM survey found that only around a quarter of respondents are confident that they have an efficient basis to link risk with other financial information. Greater alignment does appear to be moving up the agenda, however. Most European respondents expect to realise synergies between financial and regulatory reporting as part of the move to Solvency II and IFRS Phase II. Nonetheless, most are only just beginning to realise these anticipated synergies (see Figure 1).

**Governance and integration**

Effective control is not only important in meeting the compliance demands of Solvency II, but also in building confidence in the model outputs and hence their usefulness within the business. Boards and business teams also need to understand the analysis, however complex and unfamiliar it may be, and use it as a key part of their decision-making toolkit. Experience of Basel II confirms that developing the necessary understanding and buy-in can be a considerable challenge.

Many insurers may be some way short of the mark. More than 60% of European respondents in our ERM survey believed that the control environment surrounding
data input and the use of their models were no more than moderate or weak. Only a quarter felt that the outputs from their capital models were trusted by business units or influenced their day-to-day decisions. More effective control and buy-in will not only be critical in gaining approval for the use of internal models under Solvency II, but also in bringing ‘black box’ actuarial analysis up to an auditable standard for external disclosure.

Experience of Basel II suggests that developing effective governance and operational integration can take two to three years, with many underestimating the demands to their cost. Key requirements include training, documentation and dry runs. Boards and business teams also need to become comfortable with the outputs and may therefore need to allow enough time to back test and if necessary re-calibrate model outputs against actual experience. Companies also need to look at what kind of impression the solvency evaluations will convey externally to probably unfamiliar and possibly sceptical analysts and investors. Naturally there will need to be a trade off between meeting stakeholder expectations and information that may be commercially or otherwise sensitive. However, effective Solvency II disclosure will provide a valuable opportunity to convey the strength and potential of the enterprise.

**Next steps**

To meet the demands of Solvency II, insurers should verify that all relevant risks are being reflected in their capital models, gauge the quality of the data and assumptions used to quantify these risks and confirm that all model processes work as intended. They will also need to ensure that these evaluations are trusted and used within the organisation as part of a more risk-aware approach to running the business.

The first milestone will be an assessment of the impact of Solvency II on data management, systems and valuation processes. Firms can then decide on the scale of re-engineering of finance and risk functions that will be required and how this can be realised. This includes identifying potential benefits for the business and possible synergies with IFRS and other financial reporting developments.

Bringing systems up to speed and meeting the broader demands of governance and integrations will take time, care and commitment. It is therefore important to identify and communicate the benefits to the wider organisation to ensure that this is seen as a valuable business investment rather than a remote compliance distraction.
Solvency II is set to impose extensive governance requirements for insurers of all sizes. Although some insurers may opt for straight compliance, this may miss a valuable opportunity to strengthen stakeholder confidence and provide greater assurance for the board. Åsa Malmström Rognes, Garvan O’Neill and Wendy Reed look at the competitive benefits of building the latest concepts in risk and compliance management into a tailored framework for governance.
These are nervous times for insurance executives. For an industry already grappling with challenges ranging from climate change to geopolitical instability, the recent shockwaves in the financial markets offer the starkest possible warning of what can happen when risk governance is not up to scratch.

Even before Solvency II comes into force, many insurers are likely to face tougher legislation and heightened regulatory scrutiny in the wake of the financial turmoil. However, far from being simply a regulatory imperative, the ability to effectively identify, measure and manage business and compliance risks now needs to be integral to the way insurers run their companies. One of the most important benefits at any time is greater transparency and comfort for the board and wider senior management (‘no surprises’), especially in uncertain and unstable markets.

Solvency II seeks to ensure that insurers are suitably equipped to deal with a rapidly evolving risk landscape by fortifying their Pillar 1 capital reserves with tough governance standards under Pillar 2. Justifying this approach, the European Commission noted that ‘poor management and inappropriate risk decisions rather than inadequate capitalisation per se’ are the primary causes of insurance company failures. As a result, Solvency II places primary responsibility for risk management and compliance on the board and senior management and requires insurers to demonstrate that both are integral to business decision making. Under Pillar 2, companies will be required to develop a systematic and comprehensive framework of risk control and oversight, founded on the clear definition and allocation of firm-wide governance roles and responsibilities and underpinned by independent actuarial, risk management, compliance and internal audit functions.

In essence, the governance system should ensure that:
- A clear and tangible definition of the risk appetite is in place and consistently communicated and applied throughout the organisation;
- All aspects of business planning and management take relevant risks into account;
- All key personnel meet ‘fit and proper’ requirements; and
- Management retains oversight of all outsourced activities or functions.

Clearly, the governance provisions of Solvency II, including what for many will be the establishment of new functions and management structures, are likely to prove taxing. There may also be some potential tension between rigorous risk management and an entrepreneurial approach. It is therefore important to ensure an appropriate balance between controls and business aspirations. This includes building risk considerations into performance objectives and incentives.

One size does not fit all

The principle of ‘proportionality’ requires companies to design their governance structures according to the scale, nature and complexity of their specific business. This can mean less onerous demands for

Solvency II: Governance requirements

Article 41 of the proposed directive requires insurers to put ‘in place an effective system of governance which provides for sound and prudent management’, including an ‘adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities’. This system should be in keeping with the nature, scale and complexity of the business and include board-approved written policies on risk management, internal control, internal audit and, where appropriate, outsourcing. It should also be subject to regular reviews.

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3 Amended draft framework directive published by the EC in February 2008.
No surprises: An opportunity to reinforce governance

Some. To enable firms to flex their governance framework appropriately, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) envisages that some governance functions may be outsourced or combined within smaller or less risky organisations. This should be good news for many insurers, as our experience indicates that only larger organisations tend to see significant benefits in, for example, separate risk management and compliance functions.

However, proportionality cuts both ways, as size is not the determining factor. Small firms with risky portfolios will face stricter supervisory demands, while larger, less risky, firms and mono-line companies should have lower governance benchmarks to meet. CEIOPS is currently refining its approach to proportionality and we can expect more details in its advice to the European Commission on the Level 2 implementing measures. Firms of all configurations and sizes would be well-advised to provide input into this process.

Solvency II presents insurers with a central challenge in defining and implementing a governance system that appropriately reflects their individual risk profile. The governance structures and procedures need to be based on a regularly reviewed, organisation-specific risk assessment. This should be aligned with the overall strategy and direction of the firm, in order to convince supervisors that governance structures and procedures are fit for purpose. Defining and allocating roles and responsibilities appropriately across functions (including risk management and compliance) requires a sound appreciation of the relative importance of each within a particular organisation. In turn, the suitability and efficiency of the governance framework will need to be constantly reappraised as part of the Solvency II Own Risk and Solvency Assessment (ORSA). The key challenge is determining an appropriate structure, which is able to adapt smoothly to evolving risks and changing strategic objectives.

Risk management

In the lead up to Solvency II, further impetus for more effective governance has been coming from the rating agencies, which in recent years have been looking more closely at the quality of insurers’ risk management systems as part of their financial strength evaluations. Standard and Poor’s believes that ‘all insurers, independent of their size and complexity, need to have capabilities to limit their risk exposure and losses to within appropriate tolerances’. In line with Solvency II, the keys to this are ensuring that an appreciation of how to manage risk permeates through the organisation and, building on this understanding, that risk considerations are fully embedded into governance and decision making.

The development of enterprise risk management (ERM) capabilities could help to underpin this more structured approach to governance and related compliance and risk management. However, it is notable that few insurers have earned high marks from the ratings agencies for their ERM. For example, less than 15% of insurers were rated as ‘strong’ or ‘excellent’ in the latest Standard and Poor’s assessment. Some have even received a rating downgrade as a result.

PricewaterhouseCoopers 2008 study of ERM in the insurance industry further emphasised the need for greater integration between risk and business management, particularly at ground level. Using Solvency II as an opportunity to strengthen integration across different aspects of risk management and between risk, business and compliance management could therefore help to create a more secure and efficient framework of governance. A foundation for this is a clear understanding of who is responsible for risk management within each link of the decision-making and risk-taking chain. This enables companies to allocate resources more effectively and ensures that risk is evaluated and communicated on a clear, timely and consistent firm-wide basis. In most cases, business units should assume primary responsibility for identifying, monitoring and managing the risks they take (first line of defence). Risk management and control functions can then concentrate on providing oversight and advice (second line of defence) and internal audit can provide independent assurance that the risk management programme is operating effectively (third line of defence).

Competent governance depends on the culture of the organisation, which in turn stems from the ‘tone from the top’. Boards should therefore underline the need for business judgement to be taken within established risk parameters and lend their authority to ensuring risk is a paramount priority within the minds of frontline teams. Where risk management and control resources are limited, it is even more important that boards promote a culture of risk awareness and responsibility among frontline personnel. Recent experience also demonstrates the importance of both risk teams and senior management being prepared to challenge potentially detrimental risk positions.

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6 ‘Enterprise risk management: ERM development in the insurance sector could gain strength in 2008’, published by Standard and Poor’s on 24.03.08.
Compliance management

The ‘tone at the top’ should encompass all aspects of governance, including compliance.

As policyholders become more informed and regulatory expectations become more exacting, insurers are facing increasing compliance demands in areas ranging from customer protection to outsourcing and anti-money laundering. However, compliance is now as much about safeguarding reputations as assuring compliance with formal regulation.

In turn, compliance functions are seen as an integral part of insurers’ governance structures, augmenting and strengthening other aspects of control and risk management. However, many compliance teams are already straining under the escalating weight of managing both reputation and regulatory risk. There is a particular challenge in determining the scope of the compliance function’s mandate within the overall governance framework and its differentiation from other risk and control functions.

Solvency II sees a permanent compliance function as an important control mechanism, designed to advise the board and management on meeting current and future regulatory and legal requirements. At present, the latter is often allocated to the legal department. However, the directive’s proposals may imply that insurers’ compliance functions should also assume responsibility for ensuring conformance with prudential obligations. Such requirements are not as yet generally included in the remit of their bank and investment firm counterparts, though some supervisors do already expect the compliance function to be their main interlocutor. In effect, the detail of the Solvency II proposals may blur some of the necessary delineation between compliance and risk management. It is therefore crucial that firms clearly define the compliance function’s roles and responsibilities as part of the wider control framework.

The ‘three lines of defence’ approach outlined earlier can ensure that the various aspects of compliance are managed by the most competent and appropriately placed personnel. While retaining overall responsibility for key aspects of compliance, the compliance team can look to draw on the insights, experience and activities of other control and support functions. For example, risk management teams may detect lapses that might indicate a more pervasive pattern of non-compliant behaviour. HR can take the lead, with advice from the compliance function, in communicating expected behaviours, designing appropriate reward structures and, where necessary, determining disciplinary measures in line with the compliance culture established through the ‘tone at the top’.

There are opportunities to align the risk management and compliance activities and sign-off procedures relating to sales practices, product design and strategic planning, along with the risk and compliance frameworks providing oversight of outsourced functions and activities. The benefits not only include more coherent controls through the elimination of separate risk and compliance silos, but also potential cost-savings in areas such as monitoring, documentation and disclosure.

As with risk management, meeting the compliance requirements of Solvency II may demand structural changes within the organisation. In particular, if compliance currently sits within the business legal department (transactions and deals), companies may need to check whether any independence issues are created within such a structure. Moreover, while informal collaboration between different control functions may work in smaller organisations, larger firms need more formalised arrangements to eliminate potential overlaps, ensure that no risks are missed and maintain sufficient segregation.

A platform for success

The need to maintain prescribed control functions and develop more systematic governance structures could place further demands on many insurers. There is no single approach or simple solution.

Companies need to carefully analyse the nature, scale and complexity of their individual risk profile and ensure that their associated governance framework is appropriate. They should also ensure that they have the formal structures and comprehensive documentation to satisfy supervisors of its appropriateness. At the same time, they need to look at how to leverage the control functions that already exist within the business to ensure that limited resources are targeted in the most efficient way and that the new governance requirements do not create a needless additional layer of corporate bureaucracy.

If effectively designed and applied, these organisational changes could provide a valuable opportunity to ingrain risk awareness into tactical decision making, strategic planning and the wider culture of the business. Clearly, some aspects of the business and its behaviour may need to be changed. However, at a time when any perceived lapses in compliance or control can wipe billions off share values, more systematic governance structures could help safeguard the value, reputation and franchise of the business.

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8 Article 45(2) of the Framework Directive.
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