

# insuranceinsight

## No risk, no reward

How A.M. Best views  
enterprise risk management

## Changing times

Solvency II set to level playing field

## Premium taxes

The perils of crossing borders

# Welcome

Welcome to the first issue of our newsletter for insurers. This issue explores a number of key developments, which we will look at in more detail in subsequent issues. You may also be interested in our newsletter addressed primarily to the insurance broking community, Broking Business, which can be downloaded from our website – [www.clblf.com](http://www.clblf.com).

The pace of change in regulation and reporting for insurers has been dramatic in recent years and is set to continue. To help prepare effectively, it is important for insurers to choose professional advisers who understand the issues and can provide practical and cost effective support.

CLB Littlejohn Frazer is one of very few firms of accountants outside the 'big four' with real expertise in the UK's insurance market. For many years we have had a core expertise as auditors and advisers to the Lloyd's market. We are now finding there is increasing commonality of regulation, reporting and management of different insurers. We also act for a large number of insurance brokers and companies that range from small start ups to large multinationals. We provide a wide variety of services to the insurance industry including external and internal audit, due diligence, investigations, general and taxation advice.

The firm's financial services division provides a solid core of insurance expertise with a team of five partners and some 30 dedicated staff. This team, together with the complementary insurance expertise of our taxation division, is well placed to provide the deep understanding of the insurance market essential to meet the needs of our clients.

I hope you find this issue of interest. If you have any comments or would like copies sent to colleagues, please let me know.

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**Neil Coulson** is a partner in the firm's financial services division and head of the insurer services team. He is a member of the ICAEW insurance committee and a regular commentator on market activity in the insurance press.

## Solvency II:

**The annual regulatory requirements for UK insurers have changed significantly in recent years. What further changes does Solvency II have in store? John Perry reports.**

As a concept, Solvency II has been around for some years and is seen as a framework that will level the playing field across the EU insurance industry. In essence, it replaces the historical rules-based approach with a risk-based system that will focus on principles-based regulation.

The project is complex and has continued to develop in 2007 with the European Commission publishing its proposed Solvency II Framework Directive in July for discussion in the European Parliament and European Council. This set a deadline of October 2012 for implementation of Solvency II – a deadline two years later than previously planned.

Also in 2007 the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) undertook its third Quantitative Impact Study (QIS). This considered the calibration of the models to be used in Solvency II, the findings of which are anticipated by the end of 2007.

Although the final details of Solvency II are still to be resolved, the fundamentals have been established. Solvency II is based on a three-pillar approach, similar to that already put in place for banks under the EU Capital Requirements Directive, but which is more importantly also the framework of the FSA's Individual Capital Assessment (ICA) regime.

# creating a level playing field in Europe

Solvency II will encompass two thresholds: a Minimum Capital Requirement (MCR) and a Solvency Capital Requirement (SCR).

The MCR is likely to be a formula-based calculation below which a firm would be considered technically insolvent. The SCR will be calculated by the firm based upon its assessment of the risk of unplanned losses. The SCR calculation is likely to be based upon a firm's internal model of risks. This will be assessed by the supervisor for suitability who will suggest changes or loadings according to the assessment of the model's appropriateness. If a firm has insufficient capital to meet its agreed SCR, a plan to address this, such as a reduction in the volume of business to be underwritten, will need to be agreed with the supervisor.

It should be noted that once Solvency II is implemented, it will form the basis under which insurers report to the FSA; the current annual regulatory returns will no longer be required.

Pillar 2 will include requirements that address the adequacy of a firm's internal systems and controls. It will require a risk and capital assessment to be produced, an approach that effectively looks for firms to adopt an enterprise-wide risk management approach, aligning their business strategy with the compliance, risk management and internal audit functions. When assessing capital adequacy issues, there will be a need to consider these together with the firm's accounting and actuarial functions so that these qualitative factors are overlaid onto the valuation of assets and liabilities and other quantitative factors that will come together in determining the firm's regulatory capital position.



## Solvency II's three pillars

|   |   |   |
|---|---|---|
| <b>Pillar 1</b>   | <b>Pillar 2</b>   | <b>Pillar 3</b>   |
| Qualitative capital requirements, a market-consistent basis of valuing assets and liabilities | Qualitative supervisory activities including a company's approach to the management of risk | Enhancement of market discipline through reporting and public disclosure of information |

### UK takes the lead

Ahead of Solvency II, in the UK the FSA moved forward with its own risk-based capital approach by implementing its ICA regime in late 2004. UK insurers are already required to consider the risks their businesses face and assess the impact that these will have on capital requirements. Therefore while there are distinct differences between the specific details of the ICA regime and the anticipated shape of Solvency II, the similarities put UK insurers ahead of a number of our EU counterparts in dealing with risk-based capital assessments.

There will be increased scope for firms to reduce their capital requirements. As a result, it will be important for insurers to continue to evolve sophisticated integrated approaches to identification and management of risks linked into capital assessment and operational processes.

We have assisted a number of insurers in identifying, documenting and quantifying risks and controls and developing systems to minimise risks and test the effectiveness of controls, and anticipate that firms will need to continue to develop and refine their systems as 2012 approaches.

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**John Perry** is a senior manager in the insurer services team who joined the firm from the insurance team of a 'big four' practice. He has extensive experience of auditing and advising a range of large insurers.



**ERM is one of the most significant additions to the insurance industry's toolkit in many years. Roger Sellek at A.M. Best gives us the perspectives of the industry's leading information provider.**



# Perspectives on **enterprise risk management**

Risk management tools and practices across the insurance industry have advanced significantly in recent years – and it's a good thing they have. The industry has experienced a number of events and trends since the turn of the millennium that have exposed, and will continue to expose, insurers to increased levels of risk and uncertainty.

- The September 11, 2001 terrorist attacks on the United States, and continuing geopolitical unrest.
- The economic 'perfect storm' that generated sharp declines in the equity markets, a deteriorated credit market and prolonged, record-low interest rates.
- A series of four major hurricanes making landfall in Florida in a six-week period in 2004, followed by the one-two-three punch of hurricanes Katrina, Rita and Wilma in 2005.
- The possible emergence of a global 'bird flu' pandemic.
- Converging regulatory and economic views of capital adequacy, which are evident with the advent of Solvency II in Europe and principles-based capital regulatory requirements in the US.

## ERM's evolution

Enterprise risk management (ERM) has been one of the most significant and widespread additions to the insurance industry's vocabulary in recent memory. While many may see ERM as a completely new process, A.M. Best considers ERM as a natural extension of an insurer's fundamental risk management and capital management practices, with the foundation still rooted in sound traditional controls and policies encompassing the five key categories of risk: credit, market,

underwriting, operational and strategic.

## Corporate DNA

What's new about ERM is the 'E,' which represents the development of an enterprise-wide view of risk where insurers can identify, quantify and manage risk on a more holistic basis. ERM effectively makes risk management part of an organisation's DNA, from the board room to the post room. ERM takes into consideration the individual risks, as well as any correlations and interdependencies of risk across the entire



## ERM's three key areas:

- Culture – establishing an environment throughout an organisation, from board level to senior management to business line management to the employee, that embeds risk awareness and accountability in daily operations.
- Identification and Management – consistently identifying key risks across the entire organisation, and establishing uniform controls and procedures to effectively manage and mitigate the impact of those risks to the organisation.
- Measurement – using sophisticated tools and data collection to quantify risks, including the impact of risk correlations within and among the five categories of risk, considering the impact of general economic conditions, industry-specific events and extreme events, and regularly reporting these risk assessments to senior management.

organisation. By overlaying this 'enterprise' view of risk on top of the traditional silo approach to managing individual risks, insurers are creating a more structured, integrated framework that – if prudently applied – can increase the value of the firm, while at the same time providing financial security to the organisation.

Strong fundamental practices and processes encompassing traditional risk management and capital management within an ERM framework provide a wealth of information and sophisticated tools to senior management. When done right, ERM fosters an operating environment that supports both strong financial controls and risk mitigation, and prudent risk-taking to seize market opportunities. Ultimately, a company's risk profile, and its long-term success or failure, are dictated by the decisions made by senior management as they try to find the optimal risk/reward relationship.

### Risk management rating

The assignment of an interactive Best's Rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile as compared with A.M. Best's quantitative and qualitative standards.

A.M. Best believes that risk management is the common thread that links balance sheet strength, operating performance and business profile. Risk

management fundamentals can be found in the company's strategic decision-making process used to define its business profile, and in the various financial management practices and operating elements of an insurer that dictate the sustainability of its operating performance and, ultimately, its exposure to volatility in its capital. As such, if a company is practising sound risk management and executing its strategy effectively, it will maintain a prudent level of risk-adjusted capital and perform successfully over the long term – common objectives of both A.M. Best ratings and risk management.

A.M. Best believes that assessing an insurer's risk management capabilities – within the context of determining an insurer's financial strength – should be viewed in the light of a company's scope of operations and the complexity of its business. A.M. Best believes that to remain competitive in today's dynamic environment, build sustainable earnings and capital accumulation, and ultimately, maintain high ratings, complex organisations – such as insurers operating in the global reinsurance and retirement savings markets – must develop and constantly refine an ERM framework, including the development of internal economic capital modelling.

### A competitive issue

For organisations with a more limited operating scope focusing on more stable, traditional lines of business, the ERM process may

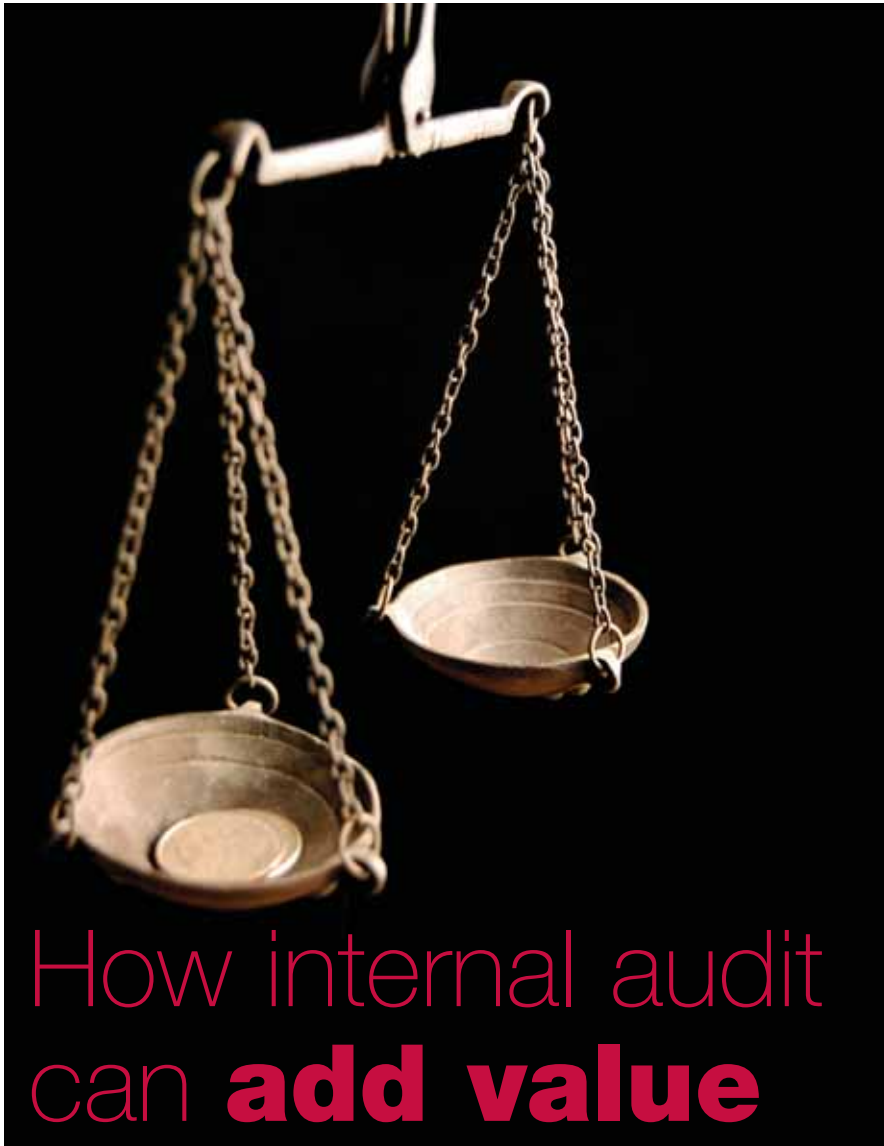
be less comprehensive or complex – at this time. However, the pending implementation of Solvency II in Europe and the significant efforts of sophisticated insurers to raise the bar in risk management, will ultimately become a competitive issue driving continued improvement and integration of ERM concepts for all insurers, regardless of size.

Whether utilising a formalised ERM framework, integrating selected elements of ERM into an insurer's operating practices or relying solely on a traditional risk management process, A.M. Best perceives risk management as paramount to an insurer's long-term success. As such, within the rating process, each company – regardless of size or complexity – is expected to explain how it identifies, measures, monitors and manages risk. An insurer that can demonstrate strong risk management practices that are integrated into its core operating processes, its corporate DNA, and can effectively execute its strategy, will maintain favourable ratings in an increasingly dynamic operating environment.



**Roger Sellek** is Managing Director – Global Financial Services at A.M. Best. He is responsible both for the strategic management of A.M. Best's existing corporate relationships and for developing new relationships with key constituents in the insurance and broader financial services sectors in the UK, Continental Europe, the Middle East, and throughout the Asia-Pacific region. He also provides input on rating criteria, working closely with A.M. Best's senior analytical staff in the United States, London and Hong Kong.

Prior to joining A. M. Best, Roger was commercial director of Lloyd's of London for six years, responsible for the market's strategic business relationships with its investor base, the rating agencies and the financial analyst community.



## How internal audit can **add value**

**No business can prosper without taking risks – but too risky an approach can be fatal. David Roberts argues that internal audit, an often undervalued tool in the past, can help businesses find a happy medium.**

One of the key tasks of management is to define business strategies and operate the business to achieve a favourable risk/return relationship. To do that, management needs an understanding of the risks concerned, knowledge of how those risks can be mitigated, and an assessment of the cost both of mitigating the risks concerned and of not doing so.

Businesses mitigate risks by exercising controls – which of course cost valuable resources. In insurance, the cost of not mitigating risks is not only the

normal business cost, i.e. the expected value of business losses that may be attributable to the risks concerned, but also, in the UK through the FSA's Individual Capital Assessment process, a specific requirement to hold additional capital to protect the insurer's policyholders from the consequences of the losses

attributable to those risks crystallising. That additional capital has a cost, and also affects key performance indicators such as return on capital. This linkage will only strengthen under the Solvency II regime.

### **The risk register**

As Roger Sellek makes clear on the previous page, traditional risk management techniques and tools are a key part of enterprise risk management (ERM). The basis of those techniques and tools is a risk register. This contains all the key risks impacting on the business, an assessment of the potential impact of those risks in terms of frequency and severity, and a record of controls exercised by the business to mitigate those risks.

Assuming that the register embodies sufficient reporting functionality, this should enable management to focus on the most important risks and their net value after recognising the mitigating effect of controls, and to keep a close eye on changes in risks and controls in order to identify any significant trends. That same reporting functionality can also enable non-executive directors to exercise proper oversight of management's analysis and any actions deemed necessary.

Traditionally, many managers regarded internal audit as a low-level activity in which boxes were ticked by people who did not really understand the business. In many businesses, management reasonably took the view that, so long as they had a properly scoped and resourced compliance function, the value added by an internal audit

### Internal audit's key questions:

- Are the recorded risks valid, and have any significant risks been omitted?
- Are the recorded controls effectively designed to mitigate the risks concerned?
- Could more effective controls be exercised?
- Does the assessment of the value of risks make sense?

**“To summarise, internal audit can and should be a highly valued element both in the control processes designed and exercised by management, and in supporting the oversight required of non-executives.”**

function was minimal. The alternative is an internal audit offering that is focused on adding value, and which recognises that this means using experienced staff who really understand the business.

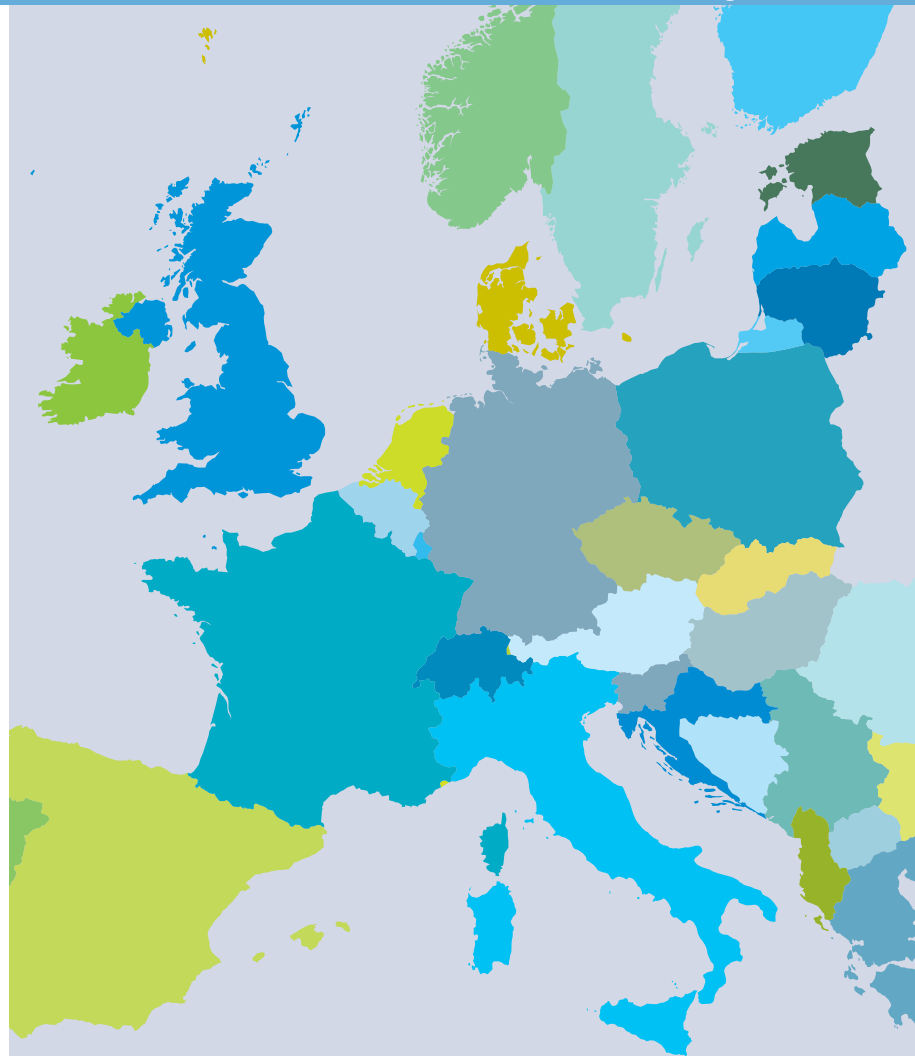
In addition, and effectively as an internal control in its own right, internal audit can answer the Board's question 'Is this business being run the way we think it is, and are the controls actually exercised those which we are assuming are exercised?' The latter is of course more the traditional lot of internal audit, but if set within a value-adding framework, is also valuable in its own right.

To summarise, internal audit can and should be a highly valued element both in the control processes designed and exercised by management, and in supporting the oversight required of non-executives. Internal audit should respond to the concerns of management and the non-executives, and should focus on what really matters.

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Head of the firm's financial services division, **David Roberts** specialises in advising listed insurance vehicles and providing expert advice on internal audit and wider risk management issues



# Taxation: crossing the borders

**The opening of Europe has brought new competitive opportunities for insurers, as well as the need to deal with ever more convoluted fiscal requirements across Europe and worldwide. Bob Jones reports.**

The European Economic Area (EEA) insurance market was rationalised with the introduction of the Third Insurance Directive in 1995, although it took a European Court of Justice decision in 2002 for the premium tax impact to bite. The liberalisation of this market not only encouraged insurance companies to become more active across borders, it also boosted the number of multi-regional contracts.

>> continued on page 8

# Taxation: crossing the borders

>> continued from page 7

The imposition of levies on insurance contracts in Europe is multifaceted. In addition to taxes on insurance premiums, there are often other tax-like fees due. Furthermore, in some countries so-called stamp fees are charged for issuing insurance certificates.

The insurance tax is due upon payment of the insurance premium and is normally collected from the insured, with the insurer having the obligation to report to, and pay, the tax authorities. However, in some countries, e.g. Sweden and a number of non-EEA countries, the insured or the broker has the responsibility of paying direct to the tax authority.

In the EEA, insurance taxes are settled depending on the location of the risk, and therefore non-European insurers, e.g. insurers established in Jersey, Guernsey or Bermuda, also have a legal obligation to register and account for premium taxes collected.

There is a great variance in regulations, tax rates, types of taxes, filing and payment dates, and documentary requirements within the EEA, not to mention language difficulties. There are also stringent penalties in some countries for failing to comply.

In addition, many European countries require the appointment of a fiscal representative, with joint and several liability, to be responsible for reporting and paying premium taxes on behalf of the insurer. The compliance costs often negate the increased competition and efficiency of trans-regional contracts which the rationalisation of the insurance market was intended to foster.

Simplification of premium taxes through a European-wide tax harmonisation is currently not in sight. Conversely, the new EU directive for administrative assistance will strengthen the exchange of information among the European tax authorities, leading to increased monitoring by the tax authorities in the area of insurance and other taxes.

## Worldwide perspective

The complexity of premium taxes in the EEA countries outlined above is reflected worldwide. At present, the 'freedom of services' provisions have focused the attention of insurers on the EEA countries, but the same fundamental requirements apply globally. It is only a matter of time before the tax authorities worldwide follow the lead and focus on this issue.

Many insurers regularly receive amounts of premium tax from brokers collected from insureds all

over the world. Very often these amounts are kept in suspense accounts with the insurer unsure what to do. In many cases the premium tax is incorrectly returned to the insurer by the broker, and should have been paid to the tax authorities directly by the broker or the insured. Simply retaining these monies is not a solution, regardless of how small the amounts might be: there will still be a breach of the regulatory provisions in the country concerned. Insurers and brokers need to ensure any tax collected is paid to the tax authority in question, and put procedures in place to ensure correct accounting in the future.

*For further information, or assistance with accounting for premium taxes, contact Bob Jones on 020 7369 4595 or e-mail [rjones@clbf.com](mailto:rjones@clbf.com)*



Indirect taxes partner **Bob Jones** has more than 30 years' experience of advising insurers and other companies on the complexities of the indirect tax system. He works closely with our international associate Polaris International to provide insurers with cross-border tax solutions.

CLB LITTLEJOHN FRAZER is an independent, top 30 firm of chartered accountants and business advisers. With in-depth expertise in many fields of tax, accountancy and finance, we work for clients ranging from large, listed corporates and SMEs to individuals, their families and their businesses.

Our dedicated financial services division offers extensive experience and expertise. Our particular strength is in the London insurance market, where we have worked for over 100 years. In this time, we have built up a comprehensive business and technical understanding of the workings of the industry, backed by detailed and practical knowledge of the unique challenges and issues faced by the insurance market.

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