

Solvency II action required

Solvency II is more than a mathematical calculation and necessitates more than financial modelling. Solvency II requires a business wide assessment of risks, an assessment of the methods by which these risks are managed and consideration of the implications on capital requirements.

Now that the Solvency II directive has been agreed in Brussels there is certainty that Solvency II will happen and it keeps the project on track for the proposed 2012 implementation. As a result there is no longer any excuse for insurers not to prepare for Solvency II.

Whilst there are certain similarities between the current ICAS regime and Solvency II there are significant differences that must be identified and addressed in preparing for Solvency II implementation.

Action is therefore required now or firms will not achieve the EU's implementation deadline or keep pace with the FSA's implementation timetable, particularly if an insurer wishes to use its own model for calculating capital requirements.

Consideration therefore needs to be given now to the following:

- Ensuring that there is Board discussion and approval of the strategy for implementing Solvency II so that preparation can commence.
- Identifying the individuals who will be responsible for implementation of Solvency II.
- Understanding the implications of Solvency II on their capital requirements and risk management framework.
- Identifying the current gaps with Solvency II compliance and preparing a timetabled plan of specific actions and resources that will be necessary to implement Solvency II.

For the implementation of Solvency II to be a success, the following are critical:

- Buy in from all areas of the business and a commitment to pass the use test.
- Models should demonstrate sufficient analysis of the business and the internal/external risks faced. However management should not seek to overcomplicate the process or implement a model that is disproportionate to the size or scale of the business.
- The FSA have indicated that for internal models to be approved, it will be necessary for them to pass six tests:
 - Use test – evidence that capital models are used in the management of the business and play an important role in decision making,
 - Statistical quality standards – evidence that the methodology underpinning the models and the data used are of an appropriate quality,
 - Calibration standards – evidence that the model takes account of the relevant solvency criteria,
 - Profit and loss attribution – evidence that firms have reviewed the sources of profit and loss for each major business unit (on at least an annual basis) and have included an explanation of these sources in the model,
 - Validation standards – evidence of review and validation of the model and its outputs, and
 - Documentation – models should be documented in sufficient detail to allow them to be understood by knowledgeable third parties.
- Management's approach should ensure their implementation of Solvency II is flexible enough to evolve with the business rather than restrict development/opportunities. This should include being able to cope with organisational changes including acquisitions and disposals.

“Action is therefore required now or firms will not achieve the EU's implementation deadline”

We have also outlined on the following pages some of the many ways in which we can help you with Solvency II implementation. For further information or advice, please contact financial services specialist partners:

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Some of the key actions required by management are summarised below:

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Actions for business	What we can do to help you get there
<p>Internal model or standard approach to capital requirements</p> <p>Consider the capital impact of the standard formula by completing QIS 4 quantitative assessment of the new capital requirements (if not done already). This will provide management with an indication of the potential capital requirement under the new regime.</p> <p>Determine whether the firm will apply the standard formula or proceed down the internal model route. Management should consider the costs/benefits of implementing of the two options and if it is determined that the internal model route is to be used the FSA must be notified by June 2009.</p> <p>If an insurer is proposing to use an internal model from the beginning of Solvency II they will need to be able to demonstrate to the FSA by June 2010 that they can meet the requirements to take part in the dry run model approval process. This includes:</p> <ul style="list-style-type: none"> • having completed QIS4 (if not already done) and any subsequent related spreadsheets • having a Solvency II implementation plan that will ensure the model is embedded and compliant • having made substantial progress on documenting the model including a plan to ensure this will meet the Solvency II internal model requirements and • having prepared a plan to enable the model to evolve and regularly recalculate capital requirements. <p><i>For entities that are part of Lloyd's they will be required to ensure they comply with Lloyd's plan for the overall Lloyd's market to obtain model approval.</i></p> <p>The ICAS process only required the FSA to form an opinion as to whether the calculated capital requirement was adequate. Under Solvency II the FSA must approve all aspects of any internal model that is to be used to calculate an insurer's capital requirement. Unless the FSA is satisfied that an insurer has a good overall risk management framework in place, it will not approve the use of an internal model. If an internal model is to be accepted it must meet all of the following six requirements:</p> <ul style="list-style-type: none"> • use test for management of the business • statistical quality • calibration to capital requirements • profit & loss attribution to business units • validation of the model to performance • detailed documentation of the model. <p>The FSA recognises that the use test and documentation tests will be particularly challenging tests to meet.</p>	<ul style="list-style-type: none"> • High level cost benefit analysis of capital and expense changes. • Advice on developing an implementation plan. • Review of model compliance. • Preparation or review of documentation. • Advice on embedding the use of the model in business processes. • Testing of the model for statistical quality, calibration, profit attribution and validation. • Preparation or review of documentation of the model.

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<p>ICAS versus Solvency II</p> <p>Identify the differences between the current ICAS regime and Solvency II including:</p> <ul style="list-style-type: none"> • Identification of the risks faced by the business (including non-financial). There is likely to be an increased focus on operational, systemic and emerging risks. • Assessment of risk the map/register. • Review how the insurer addresses the current ICAS reporting regime and overall consideration of whether all areas of the business have been factored in as appropriate (e.g. technical pricing and human resource management as well as underwriting, reinsurance and investment management). • Review of the risk management process and internal control policy (including frequency of monitoring activity). • Consider differences between the firm's current risk mapping processes and those required under Solvency II. • Ensure the differences in calculating reserves are understood and relevant data for calculating reserves in the required format can be produced, including discounting and risk margins. 	<ul style="list-style-type: none"> • Review of risk registers and provision of suggested improvements. • Design of monitoring programmes <ul style="list-style-type: none"> - Advice on the content, scope and timing of internal audit/compliance/risk management reviews. • Performance of internal audit/ compliance/risk management reviews. • Assistance in the performance of gap analysis. • Advice on the design of controls to close the gap's identified. • Comment on the coverage of ICAS reporting and potential enhancements.

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<p>Implementation plan</p> <p>Establish a timeline for the implementation of Solvency II. This should include the development, testing and embedding of internal models if this is the planned approach. For entities that are part of Lloyd's they will be required to comply with Lloyd's own timelines.</p> <p>For firms electing to adopt internal models the implementation plan will provide management with an assessment of the feasibility of achieving model approval by 31 October 2012.</p> <p>In making this assessment management must be satisfied that they will be able to demonstrate to the FSA by June 2010 that they will be able to satisfy the dry run entry criteria and have documented their implementation plan.</p> <p>This will need to include a consideration of the quality of data, IT capability and resource availability. Resource will be required not only during the implementation of Solvency II, but also going forward to ensure ongoing operations and compliance under the new regime.</p>	<ul style="list-style-type: none"> • Comment on qualitative factors relevant to capital modelling. • Review / testing of quantitative inputs into model. • Comment on qualitative inputs into model. • Comment on operational and other relevant risks. • Comment on key milestones and how these fit into the overall project. • Advice on the current IT infrastructure and enhancements that could be implemented.

Key actions continued

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<p>Operational impacts</p> <p>Consider the changes that will be required to embed Solvency II, including modelling and risk management, into the business and how to demonstrate compliance.</p> <p>This will include ensuring that there is a process to brief the Board members on Solvency II and make them aware of the business's internal model and risk management to enable the Directors to demonstrate knowledge of the company's approach. Directors and senior executives will have greater accountability under the new regime and therefore management information will need to be appropriate and sufficient to provide them with the information that they need.</p> <p>Solvency II has specific requirements regarding internal controls, internal audit, actuarial functions and outsourcing. Insurers will need to ensure that they have effective operations in these areas that will be able to address these requirements.</p>	<ul style="list-style-type: none"> • Management information health check: <ul style="list-style-type: none"> – comment on reporting lines – content of board reporting packs. • Prepare Key Performance Indicators "toolkit". • Comment on management information systems and enhancements that could be made.

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<p>Own Risk and Solvency Assessment (ORSA)</p> <p>Review the ORSA requirements and consider how these can be documented to demonstrate the identification, quantification and management of risks in the determination of the capital requirement. Even where an insurer intends to use the standard formula for calculating capital requirements they will need to have made their own assessment of risks and to quantify the capital that management considers necessary to address those risks.</p> <p>Under Solvency II, where insurers are using their own model for determining capital requirements the FSA will expect the ORSA to be fully integrated in the internal model and used as a decision making tool by Management in order for the model to pass the use test.</p>	<ul style="list-style-type: none"> • Review of risk management processes and assessment of capital needs (even where the standard model is to be used for regulatory capital).

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