Comment

How has Solvency II been affected by the financial crisis and how will it affect risk management among insurers?

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INTRODUCTION

Political agreement was reached on the Solvency II Directive earlier this year and will come into effect in October 2012. The Directive is not just about modernising capital requirements for insurers; it is fundamentally about improving understanding and management of risk. It aims to provide a more transparent means of measuring the promises the insurance industry makes to its customers and requires the industry to establish governance and control structures to improve the management of risk. This paper examines some of the non-financial aspects of the Directive, its impact on risk management for insurers, and how the financial crisis has affected the development of Solvency II. It concludes that Solvency II is a welcome initiative.

With the early focus on all aspects of the 'three pillars' of risk-based regulation, not just the technical capital standards, the Directive has been developed in a collaborative manner by the supervisors, policy makers and industry. It represents cultural change and much has already been learned through the development process over the past seven years.

The insurance industry is in the business of selling promises to customers, which often need to be called upon many years into the future. Solvency II provides a framework for greater transparency as to how this is done. It does not seek to rely on 'hidden buffers'. This increased transparency and focus on risk is already beginning to have an impact on the industry. The financial crisis has even more clearly demonstrated the need for such a risk-based approach. There is no turning back. The insurance industry should embrace these changes if it is to inspire the confidence of its customers and other stakeholders.

HISTORICAL CONTEXT OF SOLVENCY II

The current European insurance regime was first established in the 1970s and 1980s. At that time the key to regulation was 'prudence'. To demonstrate financial strength, insurers were required to undervalue their assets and overvalue their liabilities using prudent margins (often implicit in risk discount rates). The capital requirements were relatively simple and mechanistic. Limits were also placed on what insurers could invest in and even traditional risk mitigation techniques such as reinsurance or derivatives had strict limits.

This system provided stability, but in times of extreme stress it was difficult to see what the true underlying position was from the outside, and the rather blunt capital requirements did not reward good risk management. This had a knock-on impact for the pricing and design of products for customers.

The regime has been modernised slightly since then but still within this prudential paradigm. Solvency II reflects the first fundamental review. It has been under development since 2002 and a number of member states, including the UK, have already introduced their own risk-based regimes to augment existing European rules. This has stood the insurance sector in a relatively better position through the recent banking crisis.

Although Solvency II follows the three-pillar approach adopted by the Basel banking framework, there is more emphasis on pillar 2, which is at the heart of the regime. One of the early studies in Solvency II development was the 'Sharma report' in 2002. EU insurance supervisors from most of the then 15 member states examined more than 100 real supervisory cases, including many near-misses. This work identified many different causes of failure, but the central theme was that failure tended to occur where there was a combination of some underlying external adverse event and a failing in management, in particular, a lack of understanding of how different silos or aspects of risk interact, or how the underlying risk profile changed even if the product itself was unchanged. This early analysis shaped much of the Solvency II design with:

- minimum standards on governance and risk management, placing the onus firmly on senior management to understand and manage risks, supported by strong control functions such as risk, actuarial, compliance and internal audit;
- own risk and solvency assessment (firms required to form their own view of the risks of the impact on capital and solvency) — this supplements the risk-based capital requirements in pillar 1 and will include looking beyond a one-year time horizon as well as picking up risks that are not captured by the capital requirements, such as liquidity;
- enhanced powers for supervisors, with a ladder of intervention enabling them to intervene before the firm hits the minimum capital requirements and the introduction of powers to apply capital 'add-ons' to the minimum requirements where the firm's profile is not adequately covered or if there are concerns over risk management.

RISK AND GOVERNANCE REQUIREMENTS OF SOLVENCY II

The Solvency II Directive recognises that the first step for good risk governance is clarity of roles and responsibilities. For this reason, there is significant detail embodied into the Directive in this regard. Further detailed rules will be prescribed as part of what is known as the 'level 2 implementing measures'. The pan-European group of supervisors (CEIOPS) has issued a number of discussion papers and consultations on aspects of risk management and governance. The most recent is CP 33, which was issued in March 2009.

All firms must have documented risk management strategy and processes, including written policies, which must cover at least:

- underwriting and reserving;
- asset-liability management;
- investments including derivatives;
- liquidity and concentration risk;
- operational risk;
- reinsurance and other risk mitigation techniques.

Further requirements apply where the firm seeks to use an internal model for minimum pillar 1 capital or where activities have been outsourced.

The 'three lines of defence' model is embodied in the Directive. Firms must have transparent organisation structures with clear segregations of responsibilities between risk taking and risk oversight. There must also be an *audit function*, which must be independent from the business and cannot be combined with other functions, although it can be outsourced. This will be a step change for firms where internal audit is currently combined with other control functions such as risk or compliance.

All firms must also have an *actuarial function*, which must provide a formal opinion on adequacy of the technical provisions including the data and methodologies used to calculate them, as well as an overall opinion on the underwriting policy and reinsurance arrangements. It should also contribute to the effective implementation of the risk management system. This differs from the 'responsible actuary' or 'actuarial function holder' which is currently used in a number of member states. For example, the UK actuarial function holder role applies only to life firms, is broader than technical provisions and applies to advising the board on all risks and the impact on the regulatory capital and solvency position.

The Directive also specifies that firms must have a *risk management function* to facilitate the implementation of the risk management system. Supervisory guidance from CEIOPS indicates that they expect firms to designate a member of the executive or board to oversee the risk management function; large or complex organisations are expected to appoint a chief risk officer. Where a firm seeks to use an internal model for pillar 1 capital, the risk management function is required to take on additional tasks in relation to the design, maintenance and monitoring of the internal model. The rationale for this is to distinguish the internal model as part of the risk management toolkit and not just the calculation kernel. There is clearly significant overlap between the risk and actuarial functions and CEIOPS recognises in its draft guidance that in some circumstances they can be combined.

Finally, the Directive requires firms to have a *compliance function* as part of the overall system of internal control. This will advise the executive or board on the 'laws, regulations and administrative provisions pursuant to the Directive'. The scope is therefore broadly relating to prudential regulation, but as part of the wider internal control, the compliance function often includes compliance with other aspects such as business conduct or legal requirements of doing business. This does not necessarily need to be through a single function but can be achieved by a combination of activities, providing the board has access to the right advice.

IMPACT OF THE FINANCIAL CRISIS

The financial crisis occurred as the Solvency II Directive was reaching the final stages of its development. In response, CEIOPS working groups looked at the lessons learned from the crisis. This emphasised the even greater importance of moving to a system that encouraged and enhanced risk management with:

- heightened awareness of understanding credit and liquidity issues in extreme stress scenarios and over different time horizons (for example, CEIOPS guidance states that the anti-money-laundering policy and strategy should look at the short, medium and long-term time horizon over which these risks are assessed);
- enhanced need to understand the underlying risk exposures for complex instruments and to have a means of monitoring changes to those exposures, especially where new concentration risks may not be obvious;
- increased importance of really understanding the key methodology and assumptions behind the valuation basis for both assets and liabilities and how these may change in stressed conditions.

CONCLUSION

The Solvency II Directive has been a long time in the making but is now moving into the final few years of implementation. As part of the development journey, standards across the industry and supervisors' expectations have already evolved. The requirements set out in the Directive of clear accountabilities, written policies, own risk and solvency assessment and regulatory capital incentives for risk management provide a sound framework for building on the lessons learned from the financial crisis. Making it real in practice will be ongoing evolution, and the detailed guidance in the CEIOPS consultation papers gives a strong steer towards minimum accepted emerging practice. The increased transparency brought about by Solvency II and economic risk-based measurement tools will shine a light more clearly on insurers and give greater insight into how companies' financial positions are affected by their promises to customers.