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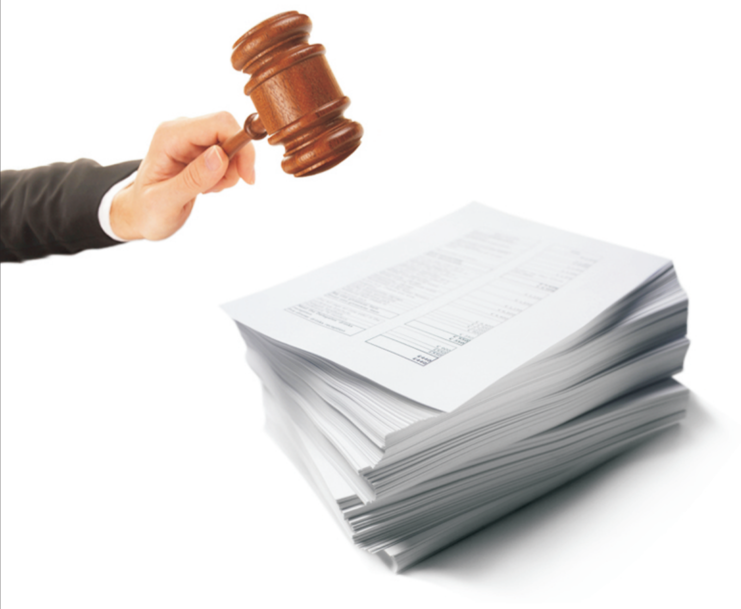

Solvency II: Europe's new charter toward better risk management in insurance

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Insurers in Europe will see the advent of a new regime, come 2012 – Solvency II. Its predecessor and European Union's regulation, Solvency I, which came into effect in the late 1970s, laid out a simple, but robust framework for assessing capital requirements of insurance companies to pay potential claims in the future. Since then, insurance portfolios have undergone changes, and markets have evolved.

This document aims to understand the nuances of the regime and the challenges in the path ahead.

The mandate for Solvency I was to revise and update the EU solvency regime, and had little scope for managing the kinds of risk that the market is exposed to today. Most European countries, thus introduced regulations to prop up Solvency I, so that risks could be covered adequately by the insurers. The result: New sets of rules across Europe that were not necessarily synchronized with each other. This gave rise to an imminent need for a more risk-based solvency regime.

2007 saw the introduction of Solvency II. The European Commission stated that the new regime was meant to improve consumer protection, modernize supervision, deepen market integration and increase the international competitiveness of European insurers. By October 2012, Solvency II will firmly be in place. Companies involved in life and non-life insurance and reinsurance in the EU are preparing themselves for this new regime, which will cover all those insurers with gross premium income exceeding Euro 5 million.

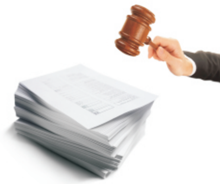
A Comparison Between The Two Regimes

Solvency I lays out how an insurance company should calculate its insurance liabilities, and then apply a solvency margin, which is an industry standard, to arrive at the amount the company should hold so that all the liabilities are covered.

With Solvency II, national regulators will work with each insurance company to arrive at their money requirements based on various risks. Solvency II works on the premise that one-size-does-not-fit-all. The EU solvency requirements today concentrate mainly on the liabilities side (i.e. insurance risks), however, Solvency II will also take into account the asset-side of risks. The new regime will be a 'total balance sheet' type approach wherein all the risks and their interactions will be considered. Solvency I restricts itself to insurance risk, while the new regime would consider market risk (fall in the value of insurers' investments), credit risk (failure on the part of third parties to repay debts) and operational risk (risk of systems breaking down or malpractice). These risks are currently not covered by the EU regime, and experience has shown that they can pose a material threat to insurers' solvency. The new regime will usher in an ecosystem of better risk management, overall.

Understanding Solvency II

Solvency II encourages insurers to engage in a lot more introspection than ever before, and also encourages transparency with the findings. This lays the foundation for Own Risk and Solvency Assessment (ORSA), which requires insurers to assess their overall solvency needs keeping in view their specific risk profile. The ORSA results are to be shared with the supervisory authorities.



Solvency II also introduces the Supervisory Review Process (SRP). The role of SRP is to evaluate the risk profiles of the insurance companies, and the quality of their risk management and governance systems.

To arrive at the capital needed, Solvency II requires insurers to have two capital requirements - Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR), with SCR being the main solvency control tool. There are two ways to arrive at SCR. Companies can follow their own internal models for risk evaluation, provided they are acceptable to the regulatory authorities. In case insurers do not have a model of their own, they can opt for the standard model prescribed under the regime - the European Standard Formula. MCR is a lower capital requirement, the non-adherence to which could lead to withdrawal of authorization of insurers.

Solvency II also prescribes qualitative requirements on undertakings such as risk management as well as supervisory activities, and covers supervisory reporting and disclosure. In general, insurers need to make certain information public and report more information to their supervisors. Solvency II also brings in group supervisors who will be able to streamline the way insurance groups with diversified presence across the EU operate.

Challenges For Insurers

Clarity on the regulations: A new framework is bound to come with its own set of challenges, with new requirements to be met and news ways of conducting day-to-today business. While insurance companies are unanimous in their perception that the new regime will bring in the 'Single Market' in insurance services in Europe, implementing it would be a challenge at various levels - especially with the new directives, guidance notes and consultation papers issued by the European Commission from time-to-time. The path ahead is not clear, and most insurers are uncertain about how they should prepare themselves for the new regime. The pre-application process for internal models is now on, but most insurers are unsure if the work done for this process will hold merit.

Moving beyond compliance: Many insurance companies and their employees consider Solvency II as a new compliance mechanism. Solvency II goes well beyond that, and tries to bring in change in the way business is conducted. It requires a change in thinking, not just at the management level, but all the way to operations. Insurers need to understand that the new regime is not a mere technical requirement, which can be managed by engaging IT resources or by deploying new applications. It is about modeling for risk in day-to-day business, which is a continuous process, and not a one-off project.

Educating employees: Insurers have begun their efforts by training their employees about the new norms under Solvency II. However, adherence to Solvency II requires a different approach from the employees, who might not be too willing to adapt to the impending change. Insurers have to prepare for this change management and figure out ways to get the buy-in from their employees. Solvency II would require various teams in the company to work a lot more in tandem, and the company will have to create a conducive environment to enable this.

Documentation: Though the exact documentation changes are yet to be made clear, the fact that a lot more assessment and information disclosure would be involved implies that documentation needs could go up significantly. Internal assessments imply that all internal data will have to be strictly monitored and controlled, which would bring in new processes and the documentation thereof. New systems and IT applications would come into play as well.

New resources: Resources well-versed in Solvency II stipulations are now being sought out by insurers. Also, with risk modeling being involved, the demand for actuaries is on the rise. The spiraling demand for a specialized talent pool is leading to inflated pay packets, and insurance companies will have to factor the increase into their plans for Solvency II implementation. They could explore outsourcing or offshoring some of these processes to reign-in costs.

While the charter is to mitigate risk, Solvency II can never be hailed as a 'zero-failure' regime. There is no cast-iron guarantee that an insurer will not fail. As its requirements and directives get clearer over the coming months, insurers have to deal with the uncertainties and the challenges up ahead. Rather than viewing the new regime as an obstacle to conducting business, insurers have to convince their teams to consider this as a mechanism that will bring in business flexibility and mitigate risk in a methodical manner.

The 3 Pillars Of Solvency II

Pillar 1 consists of the quantitative requirements (for example, the amount of capital an insurer should hold).

Pillar 2 sets out requirements for governance and risk management and effective supervision of insurers.

Pillar 3 focuses on disclosure and transparency requirements.

What's New about Solvency II?

Solvency II rules will replace old requirements and establish more harmonized requirements across the EU, thus promoting competitive equality as well as high and more uniform levels of consumer protection.

Source: The European Commission

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