

A woman with short brown hair and glasses, wearing a black blazer and a necklace with a square pendant, is smiling and looking to the right. She is standing in a modern office environment with large glass windows in the background. Her hands are clasped in front of her.

# Solvency II – consultation papers provide further guidance

**Ewa Machlarz examines some of the issues raised in these consultation papers and how they may affect the European insurance industry.**

**On 2 July 2009 the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) issued for consultation the second set of draft formal advice on Solvency II Level 2 implementing measures (CP37 to CP62). Twenty-four consultation papers were published covering a range of issues including technical provisions, MCR, SCR, own funds, groups and supervisory reporting and disclosure. This followed the first set of draft formal advice issued on 26 March 2009 by CEIOPS.**

### **Underwriting risk – simpler is better**

For non-life companies, it is clear that although CEIOPS agreed with many of the comments provided by the industry post-QIS4 regarding non-life underwriting risk, they have rejected many of the proposed adjustments to the standard formula and have instead opted to simplify the formula. In addition, CEIOPS urges companies to use internal models, whether partial or full, when the simplified standard formula does not adequately reflect the risks faced by the company.

CEIOPS has now decided to recommend the removal of geographical diversification credits from the standard formula. This means that companies with geographically well-diversified portfolios will most likely find that the standard formula will provide a higher capital requirement than in QIS4.

In addition, the non-life underwriting risk factors to be applied in the standard formula are not yet finalised (CEIOPS suggests that these may be updated in autumn 2009). Many companies are hoping that the standard deviations underlying these risk factors will reduce to reflect, in their view, the actual risk more accurately.

### **Catastrophe risk harmonisation**

CEIOPS has opted to provide standardised catastrophe scenarios for the industry. These scenarios will be developed by a task force set up by CEIOPS, which includes volunteers from across the insurance industry. They hope to have these standardised scenarios in place in time for QIS5 in autumn 2010. This seems to us to be quite an ambitious timescale.

CEIOPS' draft advice has discarded the option for companies to apply personalised catastrophe scenarios for the standard formula as these scenarios were seen not to be sufficiently harmonised across the industry. CEIOPS encourages companies to use internal (partial) models when the standardised scenarios do not accurately reflect the risks of the company. Personalised catastrophe scenarios may be accepted as partial internal models, but the approval criteria for these personalised scenarios may be more onerous than if they were permitted as part of the standard formula.

For many companies (especially Lloyd's syndicates) the catastrophe risk will be substantial. Given that the standardised catastrophe scenarios



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will only be provided towards the end of 2010, companies may not have sufficient time after this to build their own internal models if they find these scenarios are not appropriate for their individual situations.

Given the above points, there is still much uncertainty as to the final details of the standard formula used in calculating the non-life underwriting risk charge, which means there remains a high level of uncertainty regarding the overall level of required capital if a company uses the standard formula.

### Valuation of technical provisions – change is amongst us

This is an area which is particularly uncertain at the moment and further guidance is likely to be required. The Framework Directive suggests that the best estimate shall correspond to the probability-weighted average of future cashflows taking into account the time value of money. For non-life insurance liabilities this was commonly taken as implying that the best estimate should be based on a stochastic calculation of the expected future claims.

In the most recent consultation papers (in particular, CP26) CEIOPS suggests that, under certain circumstances, undertakings will not be required to calculate best estimate liabilities using a stochastic

simulation approach. Deterministic and analytical techniques will also be allowed, such as stress and scenario testing.

Although this is good news for many non-life companies, for whom a change to estimating their best estimate claims reserves using full stochastic reserving techniques would have been a very substantial undertaking, the indication is that further work is still required in the choice of methods used and the final solution will probably be more resource-intensive than the current methods used by insurers.

### Internal model approval – documentation, documentation and more documentation

The consultation papers provide further advice on the six tests for model approval, some of which are discussed below.

#### Validation of model

Whether an insurance undertaking applies for full or partial model approval, they will need to ensure that the validation standards are met for the part of the internal model to be approved. It appears as if, for most companies, the validation standards will require a large amount of work to get the policies into place and done on a regular basis. CEIOPS specifies that the scope of the validation process is not limited to the calculation model that gives rise

to the capital requirements, but to all qualitative and quantitative processes of the model. The implication of these requirements is that this validation process is likely to be onerous for many companies.

Although the proportionality principle is mentioned in respect of frequency of validation and independent review, it is not clear how this principle should be applied and in particular, its scope.

There are indications that, although internal audit and/or external review and systems may be used as part of the validation, responsibility for model validation rests with the Board of the undertaking. Each company will need to implement and document a model validation policy.

In addition, the validation processes need to be performed by an independent person. For some companies with large actuarial and risk management teams this may not be an issue, but for smaller companies with fewer resources, the validation of the internal model is more onerous.

Finally, in CP59, CEIOPS suggests that if a company has made changes to its internal model based on an individual's review, that individual may not be truly independent for future reviews, which will place additional burdens on the company's resources.

## Documentation

Whilst there has been a degree of concern in the industry regarding the documentation requirements for internal models, it is likely that many of those seeking approval will already have a degree of documentation for internal use. The requirements appear to set a high benchmark for acceptable levels of documentation.

## External models

Further validation is required for all external systems being used. Companies will need to consider whether these requirements constrain the benefits of using external models and data when planning for Solvency II. In addition, the level of disclosure provided by vendors may impact the ability of companies to comply with the advice given above. The net effect may be to place internal models beyond the reach of smaller insurers, which would be unfortunate and contrary to the principles of Solvency II.

## Summary

### What does the UK regulator say?

Although the implementation of the ICA process in the UK has provided UK companies and the FSA with invaluable experience with regards to internal modelling, it is clear that Solvency II will require much more from the companies in terms of documentation, risk management and embedding.

Lloyd's has made it clear that they will be applying for internal model approval, and hence require all managing agents to produce internal models which meet the Solvency II standard. Some smaller managing agents may find this difficult, given the level of resources needed to build internal models, embed these in their business processes and to also produce the levels of documentation and validation required.

## Further information

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