

# Solvency II

**2009**  
**Survey of the UK**  
**non-life insurance market**



# 2009

## Survey of the UK non-life insurance market

### At a glance

**The European Parliament** has now given formal approval on the Solvency II Framework Directive.

**Most respondents** to our survey are starting to plan and implement key tasks in preparation for Solvency II.

**The majority feel** that developing ORSA and integrating the risk management function will pose key challenges.

**Most tests** for internal model approval are seen as difficult.

**The introduction** of an Actuarial Function is prompting insurers to consider how their actuarial teams will be structured and incorporated into the organisation as a whole.

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## Introduction

Following the European Parliament's recent approval of the Solvency II Framework Directive, progress remains well on track for the 31 October 2012 implementation. Meanwhile, companies' preparations for Solvency II continue to gather pace.

Watson Wyatt recently carried out a **survey of practitioners across the non-life insurance market**, to assess current progress and identify the market's views of the key risks and challenges posed by Solvency II.

This report sets out the key messages arising from our survey, and gives an overview of recent developments on the regulatory side of Solvency II.

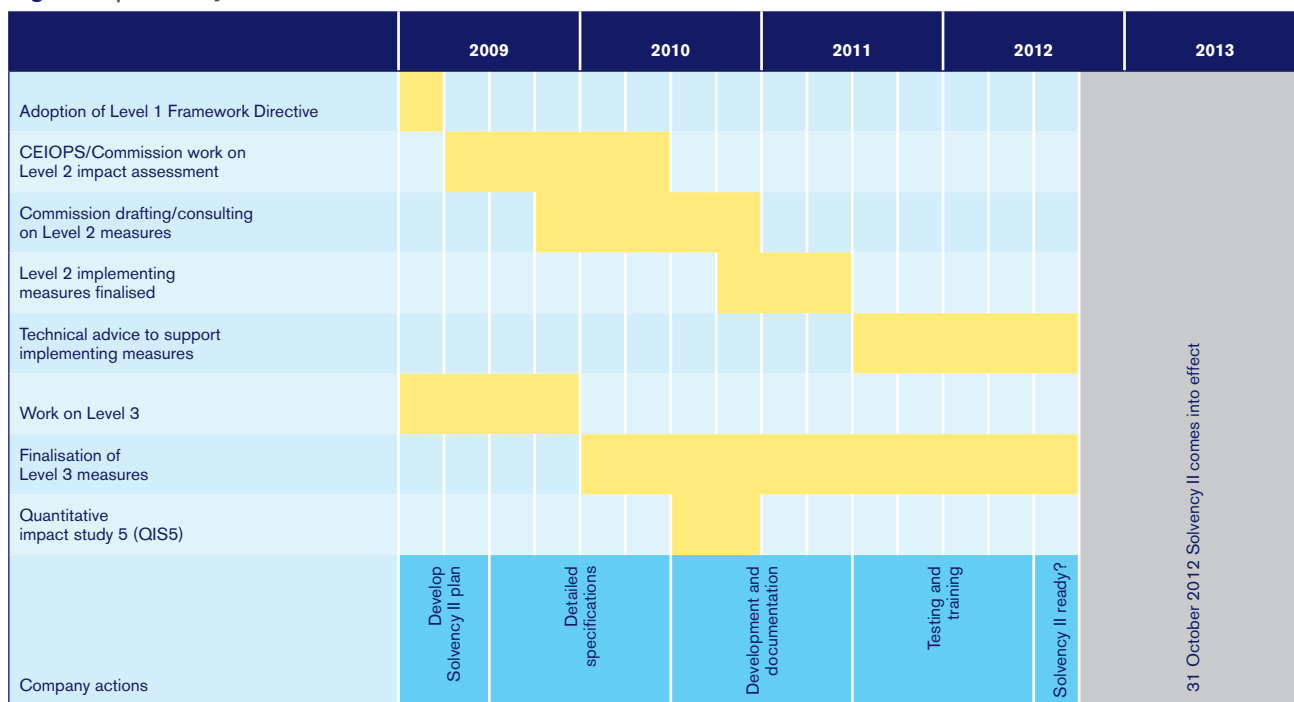
### Timeline

Following informal agreement on the Level 1 compromise Framework Directive on 26 March 2009, the European Parliament gave formal approval of the Directive on 22 April 2009. The Economic and Financial Affairs Council (ECOFIN) adopted the Directive on 5 May 2009, and this means implementation is still on track for the 31 October 2012 start date.

One point of note is that QIS5 is now definite and will take place around June-November 2010, although its scope is not yet fully clear. The key dates and events in the run-up to Solvency II are set out in **Figure 1** overleaf.

Our survey reveals fears that politics may interfere with the setting of standards (as has already been the case, to a certain extent) with almost 90 per cent of respondents believing this is likely to happen. Coupled with this are concerns that the requirements may not be implemented in a consistent way throughout Europe with 80 per cent of respondents saying that they thought the requirements will be applied more stringently in the UK compared to other European countries.

**Figure 1 | Solvency II timeline**



## Recent developments

The compromise Framework Directive had a number of changes compared to the original proposals, including the following:

- The headline announcement is that Group support has been removed from the Directive. Although this came as a disappointment to many in the industry, almost 50 per cent of the respondents to our survey (which took place before this was announced) believed that this might happen. However, the European Commission will prepare a report three years after the launch of Solvency II on the possibility of introducing group support.
- Very small undertakings have been exempted from the requirements. To qualify, undertakings must satisfy certain conditions (for example, less than €5 million of gross premium income). There are also requirements to stop undertakings from falling in and out of the 'very small' bracket from year to year

(such as looking at rolling three year periods and the future expected size of the undertaking). With the recent financial market turmoil in mind, measures have been included to try to avoid potential negative feedback loops between market falls and capital requirements. In particular:

- The equity stress test can be increased or reduced by 10 per cent depending on the movements in an appropriate equity index.
- In the event of an exceptional fall in financial markets, supervisory authorities can extend the period during which coverage of the SCR must be restored, should it be breached.

Our survey showed that over 40 per cent of respondents fear an increase in the level of systematic risk to the insurance industry following the introduction of Solvency II, and these new measures may go some way to alleviating these fears.

- The article relating to the Actuarial Function (discussed in more detail on page 10 of this report) has been weakened; actuarial expertise and knowledge now only has to be “commensurate with the nature, scale and complexity of the risks” faced by a company.
- The Directive now emphasises the importance of the Proportionality Principle, especially for monolines and captives.
- Supervisors will have powers that enable them to change the shape and the parameters of the standard formula SCR if they do not believe that the risk profile of the undertaking is properly reflected. This should add flexibility to the process and produce more appropriate capital requirements for companies not using an internal model, but for whom the SCR is inappropriate.

**“ Our survey showed that over 40 per cent of respondents fear an increase in the level of systematic risk to the insurance industry. ”**

## Level 2 Directive

Work is progressing on the Level 2 Directive, which will describe in more detail the various aspects of how the proposed measures will be implemented. A number of consultation papers are planned throughout the next few months, with final advice then provided to the European Commission in October 2009.

Our survey reveals serious concerns that the public will not understand the new public information disclosures under Pillar 3, with almost 90 per cent of respondents identifying this as very likely or quite likely. It remains to be seen if this will be addressed as the proposals proceed to the next stages.

## Actions intended for Solvency II

Solvency II will introduce a risk-based regulatory framework for all insurers based in the EU with the grand aim of harmonising standards to create a level playing field. With Solvency II just around the corner, it is essential that companies start to consider the implications for their business and start planning and taking action now to achieve compliance with Solvency II.

Generally, our survey reveals that most respondents are starting to plan and implement key tasks with regard to preparation for Solvency II (see Figure 2).

**Figure 2 | Intended actions for Solvency II**

QIS4	93%
Gap analysis	95%
High-level implementation plans	95%
Detailed implementation plans	93%
Prepare for 2010 dry-run	80%
Data warehouse	80%
Set up S2 team	89%
Restructure teams	64%

From the survey, we can see that carrying out a gap analysis on existing systems and resources and doing a high-level implementation plan is already on most respondents' action list. Only 64 per cent of the respondents intend to restructure their actuarial/risk management teams, however, more respondents feel the need to set up a dedicated team responsible for Solvency II implementation.

Approximately 80 per cent of the respondents feel the need to build a data warehouse as part and parcel of preparing for Solvency II. This is in line with the internal model requirement to have credible data to ensure statistical quality standards.

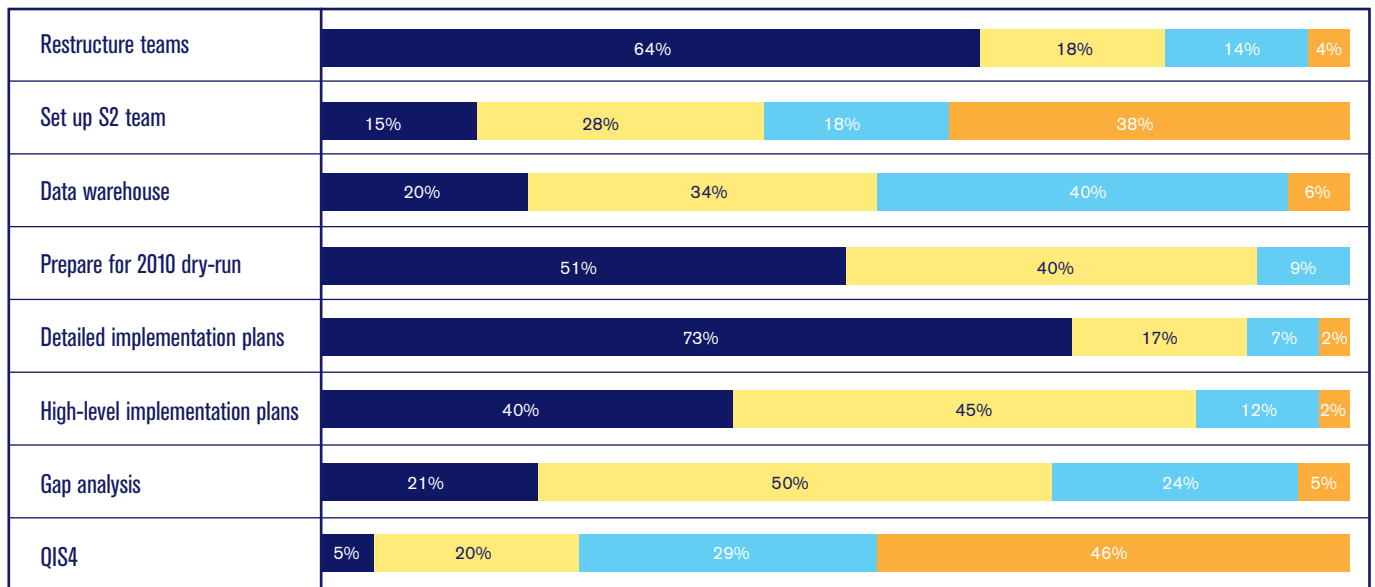
## Preparations for Solvency II

Generally, our survey reveals that the preparations for Solvency II vary quite a lot across the different tasks (see **Figure 3** below).

Our survey indicates that 46 per cent of the respondents who intend to use the QIS4 proposal to estimate the financial impact of Solvency II have already completed the task. The high completion rate may be due to the UK having had the benefit of using internal models to set regulatory capital under the ICAS regime for several years and companies being encouraged by the FSA to complete QIS4.

We can see from **Figure 3** that 93 per cent of the respondents have opted to develop a detailed implementation plan; however, 73 per cent of these plans have not yet commenced.

**Figure 3 |** Preparation progress for Solvency II



■ None ■ Some ■ Significant ■ Completed

This may be due to the fact that most practitioners in the market have so far only developed a high-level implementation plan. However, it will be crucial for both a high-level and detailed implementation plan to be made in preparation for Solvency II as soon as possible.

Only 15 per cent of respondents who indicated interest in setting up a Solvency II team have not yet begun this task, and 38 per cent have a Solvency II team already in place. We expect to see most UK insurers setting up a Solvency II team within their business as we get nearer to the 2010 dry run.

The survey shows that 51 per cent of the respondents intending to participate in the FSA dry-run for internal model approval in 2010 have not yet started preparing. It will be important for companies to start preparations soon to ensure they do not lose out on the first opportunity to adopt an internal model that will reflect the nature of their business better than the standard formula.

## Other key challenges

Looking forward to the Pillar 2 and Pillar 3 requirements, which will be shaped by the next level of Solvency II Directives, our survey identifies the following key challenges for participants:

- Own Risk and Solvency Assessment (ORSA): almost 80 per cent of respondents feel it will be quite difficult or very difficult to develop the ORSA and use it to drive strategic business decisions. Solvency II will require an extension of modelling and reporting to include an assessment of economic capital and risk management requirements.
- Integrating the risk management function: 64 per cent of respondents feel this would be quite difficult or very difficult, which reflects the greater emphasis placed on risk management under Solvency II.
- Public disclosures (the Financial Condition Report): 54 per cent of respondents expressed concerns over the level of disclosures required and how well these will be understood by the public.

**“ Our survey indicates that 46 per cent of the respondents who intend to use the QIS4 proposal to estimate the financial impact of Solvency II have already completed the task. ”**

### Internal model approval

As part of their preparations for Solvency II, many insurers are planning to seek approval of an internal model. In addition to being able to make more informed business and strategic decisions and ensuring that capital requirements are a better reflection of the underlying risks, an approved internal model is likely to be viewed by regulators and rating agencies as an important part of the risk management function.

The Framework Directive sets out six key tests and standards for internal model approval, development and maintenance. These are designed to ensure that the model is widely used within the business and not just a regulatory compliance tool. In addition, methods, assumptions and parameters need to be robust, up-to-date and constantly challenged.

Generally, most tests are viewed as difficult with relatively low proportions feeling that these tests will be easy to satisfy.

In the following sections, we will look into some of these tests in more detail.

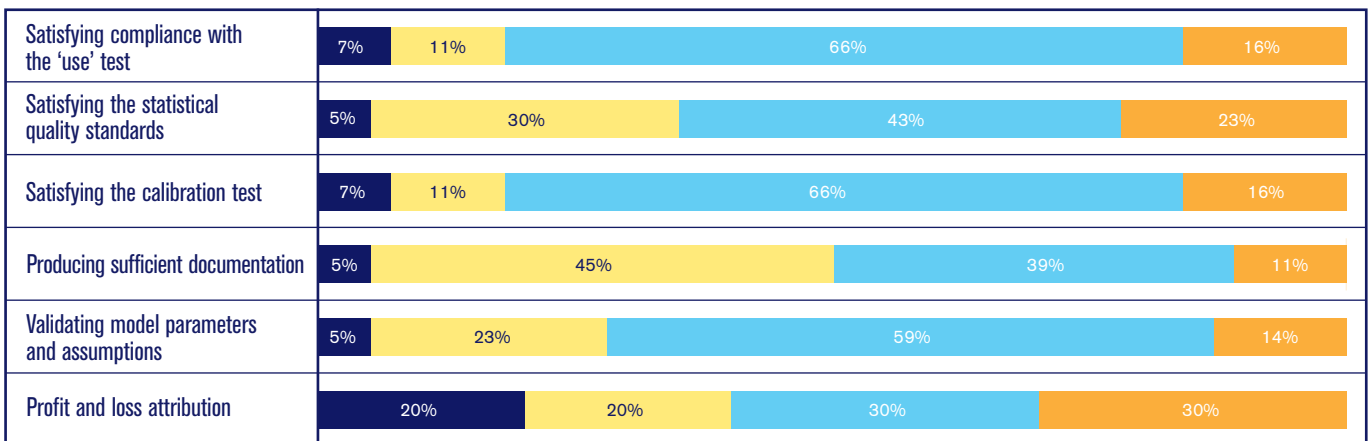
### Use test

The key requirement here is to demonstrate that the internal model is extensively used and plays an important role in the system of governance, in particular in the:

- risk-management system and the decision-making process
- economic and solvency capital assessment and allocation process.

Figure 4 shows that over three-quarters of respondents feel that demonstrating compliance with the use test will be difficult or quite difficult. This is reflective of the much stronger embedding requirements under Solvency II, than under the ICAS regime.

**Figure 4 | Practitioners' current views on difficulty of implementation of areas of Solvency II**



■ Do not know ■ Very difficult ■ Quite difficult ■ Quite easy

## Statistical quality standards

This is the lengthiest of the standards set out in the Directive with a large number of requirements concerning the probability distributions selected for the internal model. In particular, the calculations of this probability distribution function will require:

- methods to be based on adequate actuarial and statistical techniques
- methods to be consistent with the assessment of technical provisions
- methods to be based on current and credible information
- assumptions to be justifiable to supervisors
- data to be accurate, complete, appropriate and updated at least annually

- all material risks to be covered with sufficient ability to rank those risks.

Further, the standard sets criteria around items that would naturally reduce capital:

- any diversification effects taken into account should be adequately measured
- any allowance for risk mitigation techniques should fully allow for the associated credit risk.

Respondents feel that these requirements will be particularly challenging, especially in the London Market where data availability tends to be more limited. Our survey shows that 73 per cent of the respondents believe that it would be quite or very difficult to collate sufficient data to satisfy the statistical quality standards. One possible impact of the standard is a move to more pooling and sharing of data to enable greater benchmarking and testing of assumptions.

**“ Our survey shows that over three-quarters of respondents feel that demonstrating compliance with the use test will be difficult or quite difficult. ”**

## Documentation standards

This standard requires insurers to document their internal models to include:

- design
- operational details
- theory, assumptions, mathematical and empirical bases
- circumstances where the model is inefficient
- major changes to the internal model.

The FSA, in Discussion Paper 08/4, suggested that a suitable test may be that documentation “is detailed enough for a firm to replicate its model in a different platform and in the absence of the original developers”. This represents a huge jump from current ICAS requirements, and will require a substantial effort for nearly all insurers. In their recent feedback on DP 08/4, the FSA commented that the general consensus was that this requirement was excessive. The actual requirement will be in the Level 2 guidance from CEIOPS on implementing measures.

Our survey shows that producing the required level of documentation is one of the most challenging aspects of these tests, with 84 per cent commenting that this is likely to be quite difficult or very difficult.

## Validation standards

This standard requires a regular and statistically effective cycle of validation which includes:

- monitoring the performance of the internal model
- reviewing the ongoing appropriateness of the model against newly emerging information.

Our survey indicates that over 80 per cent of respondents feel that it would be quite or very difficult to validate the model parameters and assumptions to the satisfaction of the regulatory supervisor. For many firms some form of external sign-off may well be the most appropriate and straightforward way to demonstrate compliance with this standard. The initial draft CEIOPS guidance in this area has suggested that validation requires a very strict independence from the initial model development.

## Conclusion

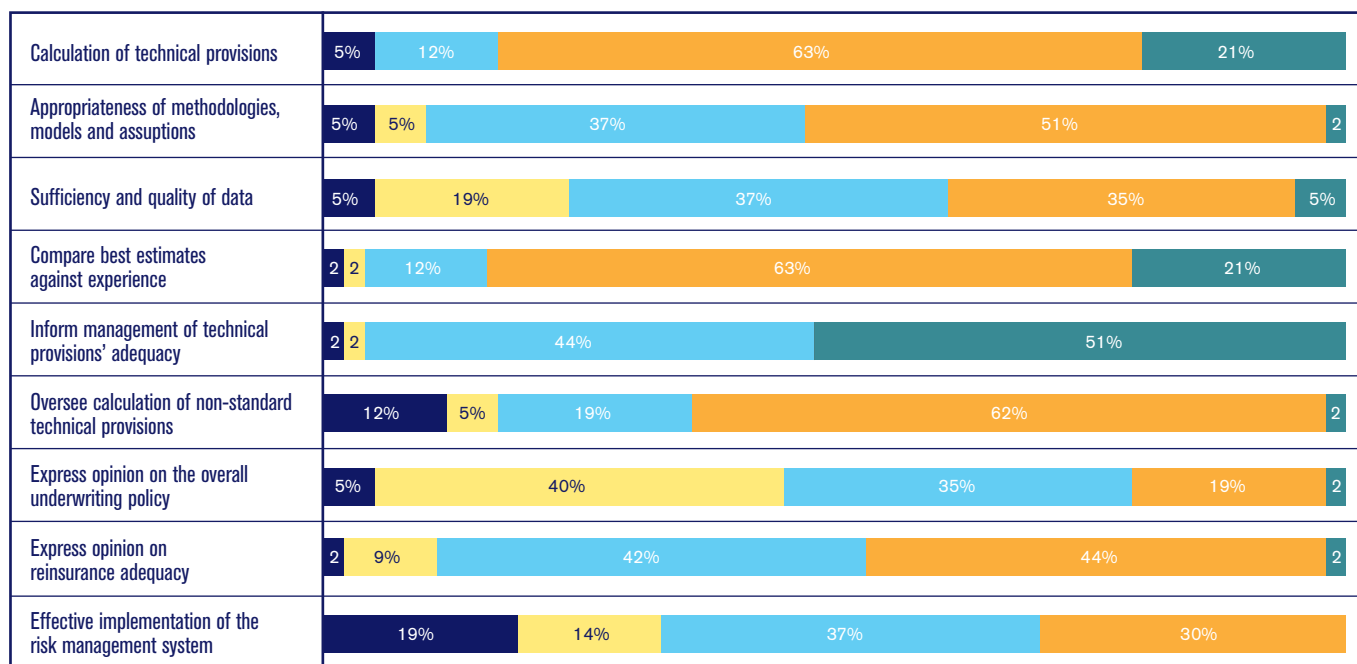
Despite the benefit of using internal models under the ICAS regime, the FSA has indicated that the UK's current level of compliance with these six tests is still low. Insurers need to prepare now for the challenges of the six tests, by carrying out a gap analysis of the internal model – including data, systems and processes – and develop implementation plans.

## Actuarial Function

The introduction of the ‘Actuarial Function’ is one of the most significant changes proposed under Solvency II. This will be the first statutory actuarial requirement for the UK non-life industry since the requirement for Lloyd’s managing agents to obtain a Statement of Actuarial Opinion (SAO) on syndicate reserves.

The anticipated role for the Actuarial Function, as defined in Article 47 of the Solvency II Framework Directive, consists of nine areas of responsibility. As part of our survey, we asked for practitioners’ views on the challenges faced by the actuarial team in meeting each of these responsibilities. This has revealed a wide range in the perception of the difficulty of implementing each Actuarial Function requirement (see Figure 5).

**Figure 5 | Difficulties of implementing each Actuarial Function requirement**



■ Do not know ■ Very difficult ■ Quite difficult ■ Quite easy ■ Very easy

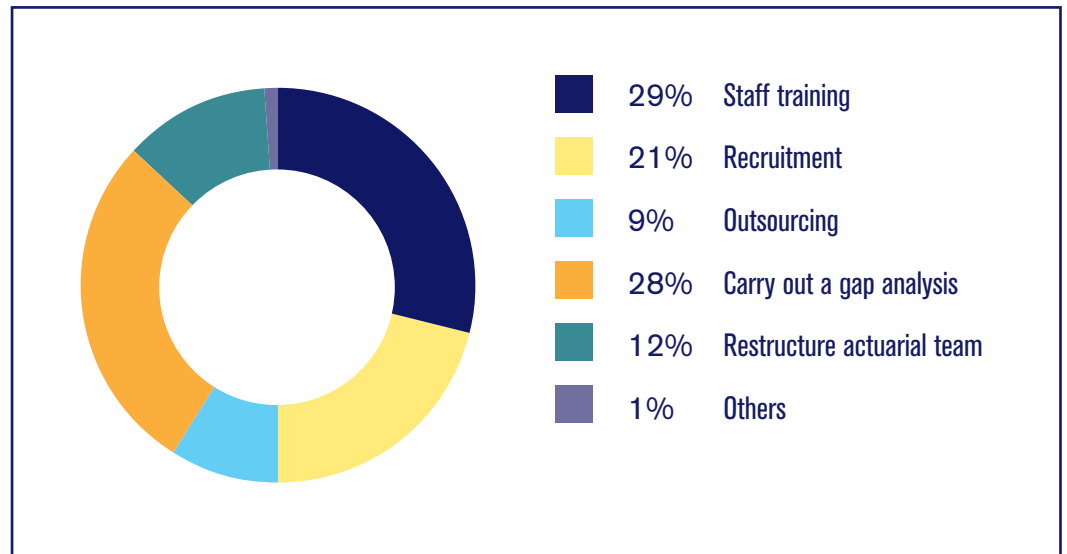
### Key challenges

The vast majority of respondents feel that to comment on the overall underwriting policy would be challenging, with 40 per cent saying it will be very difficult. Of all the requirements, this one in particular stands out as being the most significant extension to the role typically currently assumed by an actuarial team. In particular, whilst the 'new Lloyd's' (that is, post-Equitas in 1996) is more efficiently run and leading the world in some respects, many syndicates are still underwriter-led organisations and so actuaries could find themselves in a difficult position when expressing an opinion on the underwriting policy.

Another key challenge in this area is that the actual requirements of an opinion on overall underwriting policy are unclear. The recent CEIOPS draft Level 2 guidance has given some clarity in this area, in particular that an integral part of this opinion will be an assessment of rate adequacy.

Making sure that data is of sufficient quantity and quality is viewed as quite difficult or very difficult by 46 per cent of respondents. Respondents feel that these requirements are particularly onerous for actuaries working in the London Market, where data quality has improved considerably over the last 15 years but is still far from perfect.

**Figure 6 |** How to deal with challenges posed by Actuarial Function responsibilities



The greatest uncertainty surrounds how the actuarial team will contribute to effective implementation of risk management systems with almost 20 per cent of the respondents replying do not know. This may be explained by the fact that many UK non-life actuaries currently have limited involvement with the actual implementation of risk management systems. This will require an increase in responsibility for actuaries, although the extent will vary across insurers.

Of the respondents, 51 per cent feel that the requirement to inform the management of the reliability of the calculation will be very easy, while 44 per cent feel that it will be quite difficult. The difference in opinion for this particular challenge may be fuelled by differences between companies; possibly firms with more actuarial involvement in management may face less difficulty in communicating the reliability of technical provision calculation.

### Dealing with the challenges

In our survey, we asked practitioners to comment on how they intend to deal with the challenges posed by the Actuarial Function responsibilities.

Many respondents feel that staff training is one of the better ways to meet the requirements with 29 per cent identifying this option, while 21 per cent intend to recruit additional resources. A number of insurers will be carrying out a gap analysis to help decide what changes might be necessary.

### Summary

In conclusion, it can be seen that the Actuarial Function will have considerably more responsibility than actuaries in non-life companies do today. Insurers need to consider how their actuarial teams will be structured and incorporated into the organisation as a whole. Given the new areas of responsibility, existing actuarial skills will need to be enhanced through additional training, recruitment or outsourcing to experienced consultants. All in all, it seems that there will be plenty of demand for actuarial skills over the coming decade at least!

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