



# Association of Friendly Societies: Implementation of Solvency II

**July 2009**  
Survey of the UK market



2009

## Association of Friendly Societies: Implementation of Solvency II

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### Participating friendly societies:

Ancient Order of Foresters Friendly Society Ltd	National Friendly
Bacon and Woodrow Friendly Society	Nottingham Friendly Society
British Friendly Society Ltd	Police Mutual Assurance Society
CS Healthcare	Railway Friendly Society
Communication Workers Friendly Society	Royal Liver Assurance
Compass Friendly Society Ltd	Schoolteachers Friendly Society
Dentists' and General Mutual	Scottish Friendly Assurance Society Ltd
Druids Sheffield Friendly Society	Sheffield Mutual Friendly Society
Engage Mutual Assurance	The Children's Mutual
Family Investments	The Original Holloway Friendly Society Ltd
Grand United Order of Oddfellows Friendly Society	The Pharmaceutical & General Provident Society Ltd
Manchester Unity Friendly Society	The Rechabite Friendly Society Ltd
Kingston Unity Friendly Society	Transport Friendly Society
Liverpool Victoria	
Metropolitan Police Friendly Society Ltd	

We are very grateful to all those who took the time to participate in this survey.

## Introduction

Following the European Parliament's 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.

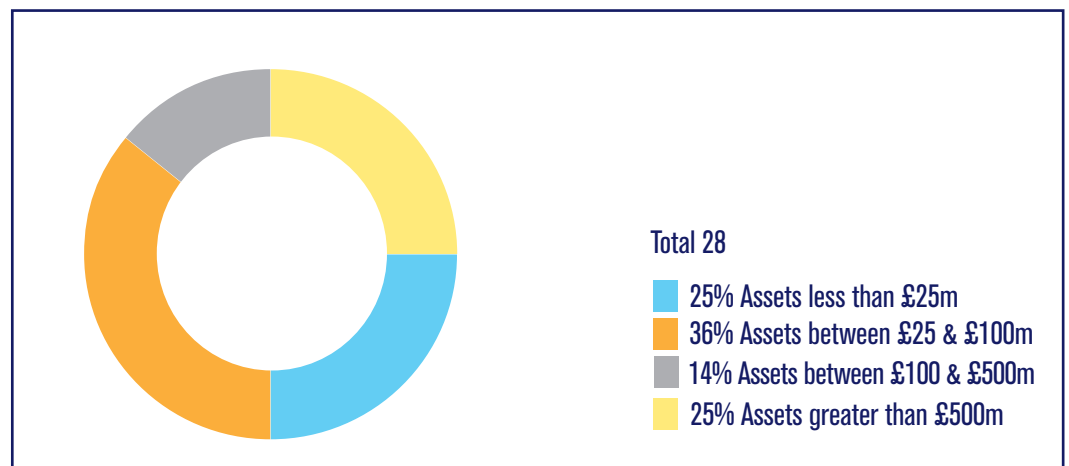
On behalf of the **Association of Friendly Societies**, Watson Wyatt recently carried out a **survey** to gauge the level of awareness and activity currently in place and areas of concern amongst friendly societies.

We received a total of 28 responses to this survey from UK friendly societies of varying sizes as shown in **Figure 1** below.

We asked participants how prepared they currently are for Solvency II as well as their future plans for implementation. In particular, we

asked whether they had assessed how their capital needs would change under Solvency II (through the Quantitative Impact Study 4 ("QIS4")) and whether a gap analysis had been performed and used to devise an implementation plan.

**Figure 1** | Company size of survey participants



# Executive summary

## Current engagement in Solvency II

### Board engagement

A high proportion (82 per cent) of participating companies have discussed Solvency II at some point at Board and Senior Management level, with larger companies discussing it on a quarterly basis. It was surprising to see that five companies have not discussed it. However, given the recent influx of information on the subject, including this survey, we hope this will instigate a higher level of engagement.

### QIS and gap analysis

A quarter of the surveyed companies had completed a QIS4 calculation as at the end of 2007; the majority of those being the larger companies, with one following exact guidelines and the others using adjusted ICA results.

Companies will need to develop an implementation plan to achieve Solvency II requirements. To help achieve this, the FSA expect companies to carry out an analysis – a ‘gap analysis’ – of the requirements under the Directive and assess where their company is meeting those requirements, and where not, devise a plan to do so. Six of the

participating companies have carried out a gap analysis, (half of them at a detailed level and half at a high level), with four of those going on to produce an implementation plan that they have yet to discuss with the FSA.

The most common gaps exposed by the gap analysis were:

- not having an Own Risk Self Assessment (‘ORSA’) in place
- not meeting the ‘use test’
- not meeting internal modelling requirements
- falling short on the new governance requirements.

Many companies are unsure as to the financial impact of the new regime but will have a clearer idea when they carry out Quantitative Impact Study 5 (QIS5) next year. However, companies would benefit from carrying out a high-level QIS4 calculation to better understand the financial impact and to provide them with an understanding of where their current models fall short in carrying out the necessary calculations. This would allow them time to make suitable changes in time for QIS5 in order to carry out a more accurate calculation rather than relying on high-level approximations.

## Completing the Implementation of Solvency II

### Current ICA

Most companies stated that they currently use the ICA as a risk management tool and believe their ICA process is generally well documented. This provides them with a strong platform from which to implement Solvency II.

### Estimate of future work needed

The companies identified the main challenges ahead in implementing Solvency II to be:

- embedding the overall model into the business
- developing the tools to carry out the calculation
- the expected costs
- the resourcing levels required.

Over half the companies had not put a budget together for the expected time and cost of implementing Solvency II. Those that had, covered a broad range from less than 30 man days to greater than six months of man days.

It is difficult to put together a budget until a gap analysis is carried out and a plan is created. The level of work will also vary depending on the type of business written and level of sophistication and adaptability of

systems currently in place. However, the level of requirements is subject to proportionality, with smaller companies having to adhere to a lower level of sophistication than larger companies.

Companies believe that the most likely functions to be impacted by Solvency II are the:

- risk management department
- actuarial department
- finance department.

This is not surprising given that much of the work is in respect of developing calculations, internal models (for those companies that choose to do so) and having strong governance and reporting measures in place.

### Internal or standard models

Most companies intend to use a standard model rather than developing their own internal model. A few companies intend to use partial models. One of the large companies plans to use a full internal model and said progress towards getting it implemented was good. We would note that partial models may be more appropriate for insurance risks where companies feel that their experience suggests they have very different levels of risk, and hence stresses required, compared to the rest of the industry and the standard stresses.

## Commentary from AFS SII working group

This survey allowed participants to benchmark preparations for Solvency II against others in the industry.

In our assessment:

- the level of progress of larger companies is greater due to their complexity and resources available
- many societies have made good progress, though there is a need for others to catch up
- with more intensive communication from the FSA, it is becoming clear to the sector that more societies will be caught by Solvency II
- whilst Solvency II preparations will undoubtedly be expensive and intrusive, many societies are reporting benefits, such as more effective risk management from their ICA work.

With Solvency II Principles being agreed by the European Commission in May, the implementation date of 31 October 2012 is now a hard deadline for Solvency II, and so the need for firms to remain engaged with Solvency II is now more pressing. It is encouraging to see Solvency II becoming a frequent item on the agenda for Board meetings.

It is good that some companies have carried out a gap analysis and we would encourage all other companies to have completed a gap analysis and created an implementation plan by the end of this calendar year.

With regards to the amount of work involved in moving to Solvency II, this depends on the current level of governance and use of the ICA within the management's decision-making. However the Proportionality Principle is referenced several times in the Directive. In particular, the FSA say that the Own Risk Solvency Assessment (ORSA) and the internal model approval process need to reflect the nature, scale and complexity of the firm. The AFS Working Group plan to hold workshops in early 2009 to assist in this area.

To allow coherence amongst our members, we plan to hold a forum later this year to discuss Solvency II in more detail and share thoughts and ideas in a similar manner to this report.

More information about the Working Group is included on page 19.

## Current engagement in Solvency II

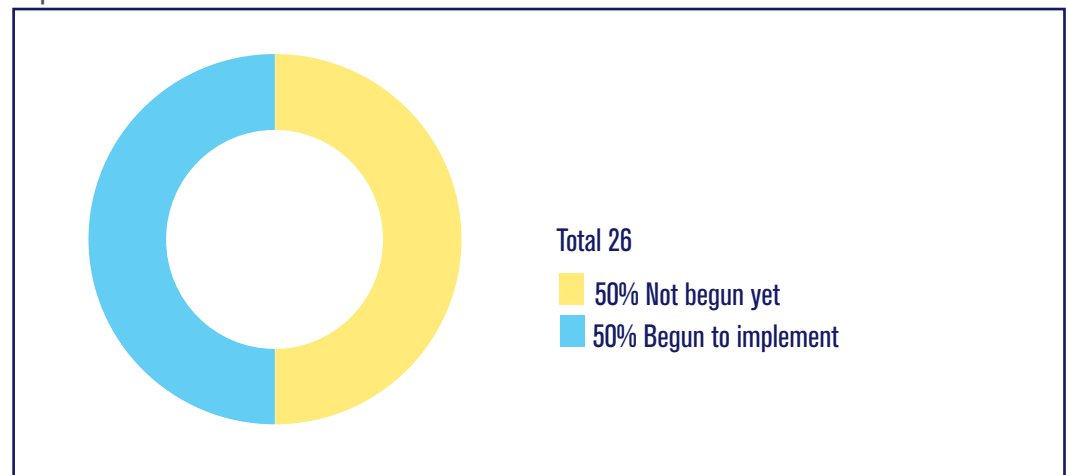
With Solvency II principles being agreed by the European Commission in May, the implementation date of 31 October 2012 is now a hard deadline for Solvency II, and so the need for firms to remain engaged with Solvency II is now more pressing.

As part of the survey we asked our participants about their level of engagement to date.

Figure 2 below indicates that half of the companies, which include all of the large companies, have begun implementing Solvency II.

The level of implementation will be varying degrees ranging from discussions to attempts to assess the financial impact, perhaps through a QIS4, and/or carry out a gap analysis all of which are discussed below. We expect other companies to follow shortly over the next six months.

**Figure 2** | Which of the following best describes the current state of your Solvency II implementation?



## Board and Senior Management involvement

'Dear CEO' letters were sent to all companies by the FSA asking them to respond by 30 June 2009 on how they are progressing with the implementation of Solvency II. This will have aided the level of involvement and understanding at the senior management level, with the majority of companies indicating that they had discussed Solvency II at Board and Senior Management level.

It was surprising to see that five companies had not yet discussed it, although they were some of the smaller companies with less than £100m of assets.

Of the companies that had discussed it, the level of frequency of these discussions was good, with the frequency being greater for the larger companies. See [Figure 3](#) and [4](#).

Figure 3 | Has Solvency II been discussed yet at Board meetings?

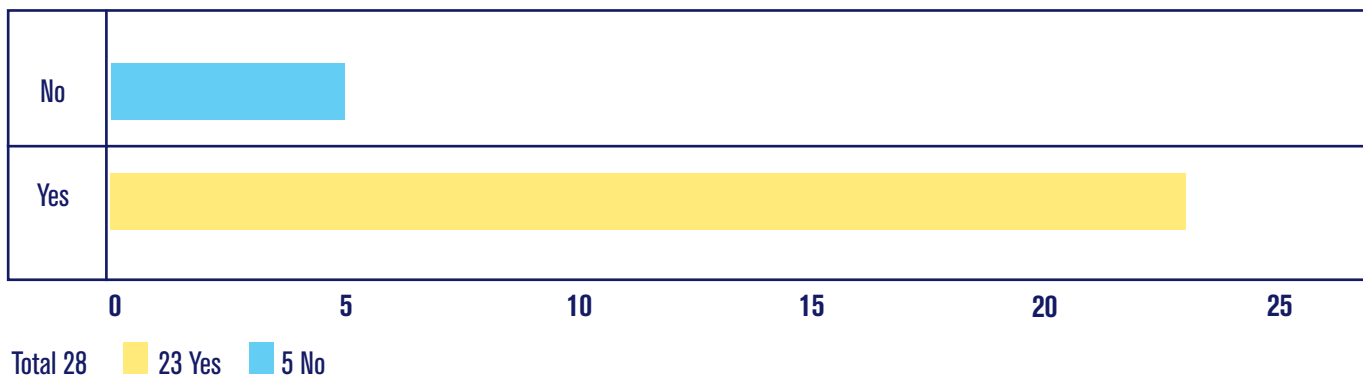
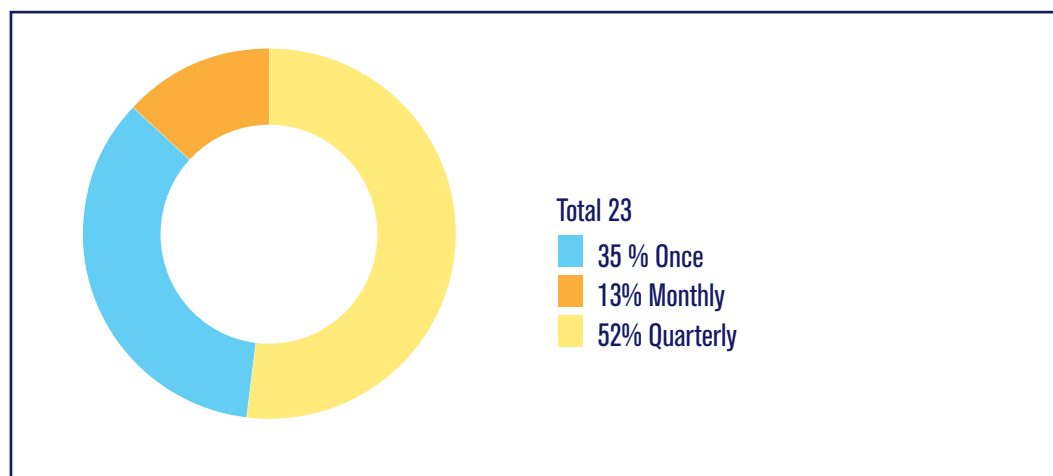
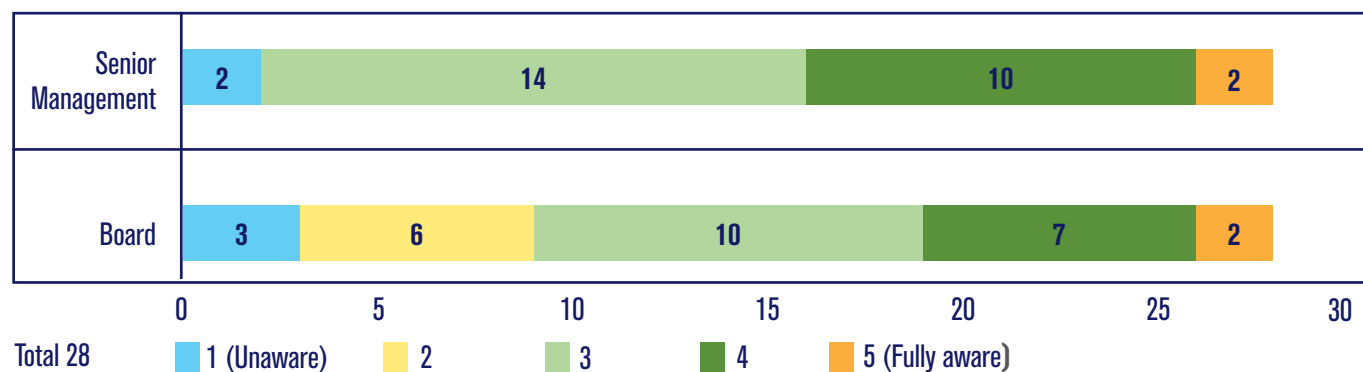


Figure 4 | How frequently has Solvency II been discussed at Board meetings?



The level of awareness on the changes that the new regime will bring was broad across the companies; ranging from no awareness (generally the smaller companies) to full awareness (generally the larger companies) with senior management having marginally more awareness than those on the Board. See Figure 5.

Figure 5 | How aware would you say the Senior Management and the Board of your company are of the changes that the new regime will bring?



## QIS 4

The FSA, as part of their work in monitoring the impact of the proposed change in regulations, have carried out a number of Quantitative Impact Studies, the latest being QIS4 carried out in early 2008. The number of participants has gradually increased with each study but participants have tended to be medium to large insurance companies. A further study, QIS5, is expected to be carried out in early 2010 with all companies required to participate.

Seven (25 per cent of) participants in this survey completed QIS4 as at the end of 2007.

Of those seven companies:

- four were large companies with assets greater than £500m and none had assets less than £25m
- one company stated that they followed exact guidelines, with the remainder using adjusted ICA results
- some used a single yield and others a yield curve
- some valued guarantees stochastically
- three of the companies had gone on to complete a QIS4 calculation at the end of 2008.

**Figure 6 |** Has your company assessed the potential financial impact of the new regime by completing Quantitative Impact Study 4 ('QIS4')?

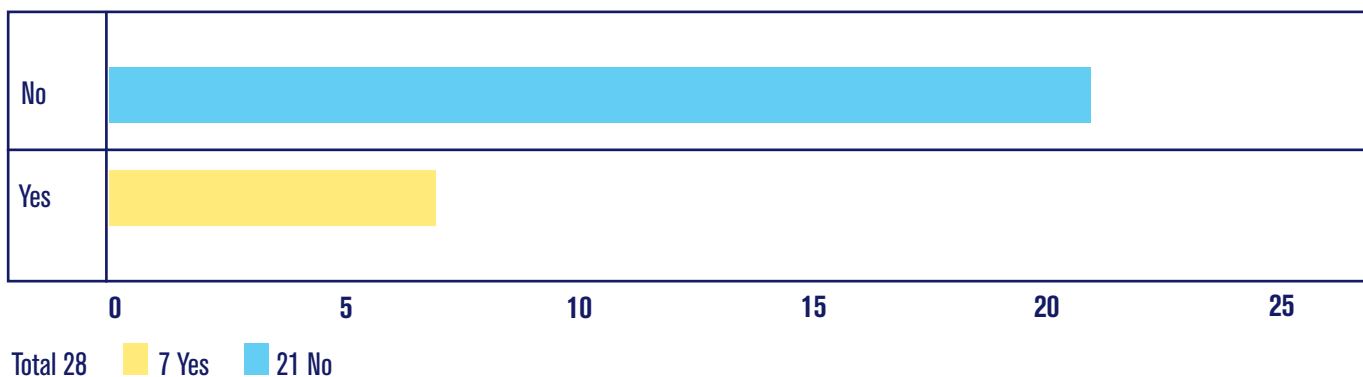
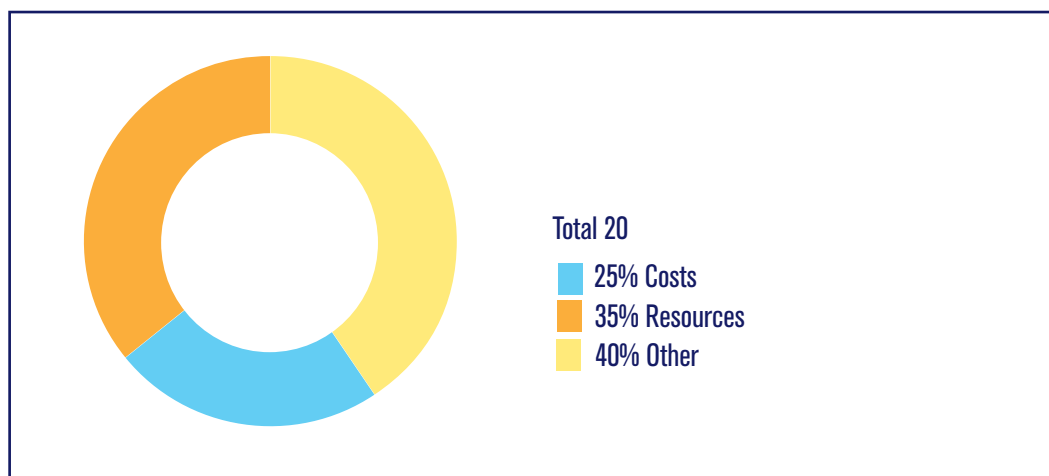


Figure 7 | If a QIS4 calculation was not completed, why not?



For companies that had not completed a calculation, the main reasons, shown in Figure 7, were:

- the extra costs in doing so
- the extra resource required
- being a non-Directive and so not expecting to be involved.

“ Our survey indicates that a quarter of companies completed the QIS4 calculation at the end of 2007, the majority of those being the larger companies ”

## Gap analysis

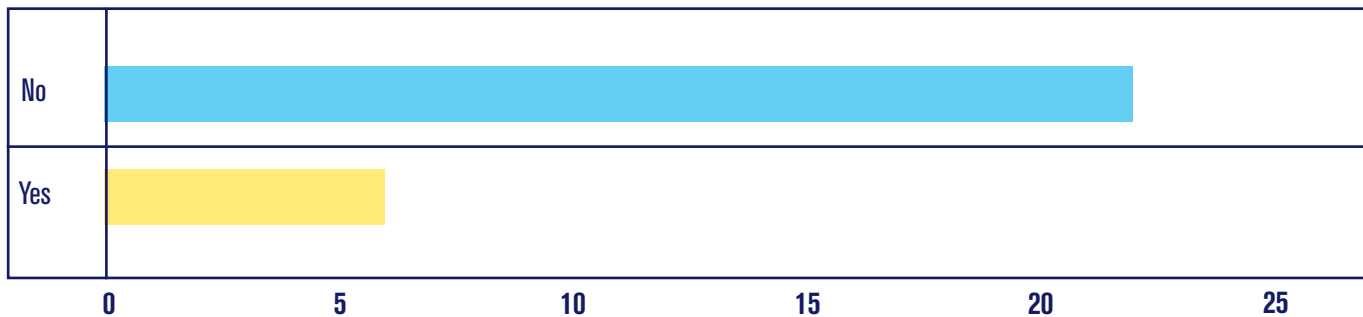
In devising a suitable plan to get to Solvency II, the FSA would expect a company to carry out a gap analysis that is essentially a check on whether and how well they are meeting all of the requirements within the Draft Directive. As a result of that analysis, the company can put together an implementation plan that they would discuss with the FSA.

Six of the companies had carried out a gap analysis with the majority of those being large companies.

Of those six companies:

- three carried out their analysis at a very high level and three at a very detailed level
- five companies stated they have quite a few gaps arising and these ranged from governance requirements, ORSA and use test to modelling requirements
- four of the companies have developed high-level plans on how to implement all of the different gaps, however none of the companies have discussed this plan with the FSA yet.

**Figure 8** | Has a gap analysis been carried out in order to identify any shortfalls in expected compliance with Solvency II requirements in relation to the three Pillars of Solvency II (measurement of assets, liabilities and capital requirements, governance and reporting/disclosure)?

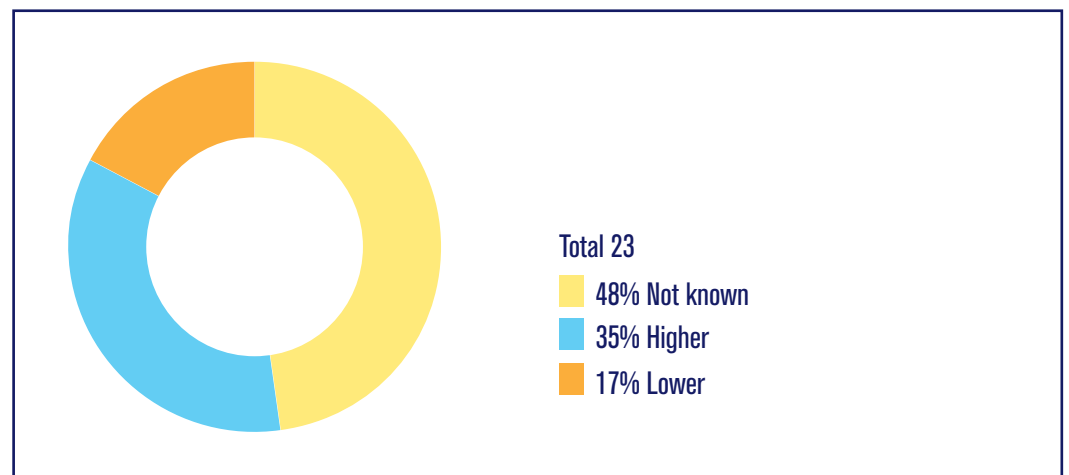


Total 28   6 Yes   22 No

## Expected impact on solvency

Although only seven companies had carried out a QIS4 calculation, **Figure 9** shows that twelve companies gave some indication on how their capital requirements under Solvency II would compare to any other internal capital measure. The majority remain unsure and it is difficult to say unless some assessment similar to QIS4 is carried out. In addition some companies may have assumed capital requirements included the risk margin (cost of capital) and the best estimate liabilities, while others did not.

**Figure 9** | Overall, how do the Solvency II capital requirements compare to any other internal capital measure that you currently use?



## Completing the implementation of Solvency II

Companies have to put together plans on how they expect to have Solvency II requirements implemented by 31 October 2012. Those plans are expected to be carried out within the next six months. An implementation plan will typically be put together based on of the gap analysis.

Many friendly societies will be in the early stages of getting ready for Solvency II and hopefully a large amount of the work will already be in place if they carry out an ICA calculation every year and use it as part of their risk management process. However, there is a lot more work involved in developing those calculations and developing the governance arrangements and reporting requirements to the

standards required. Within this section, we look at how well companies' ICAs are embedded into their risk management process and their current thinking on the expected level of work involved in achieving Solvency II requirements.

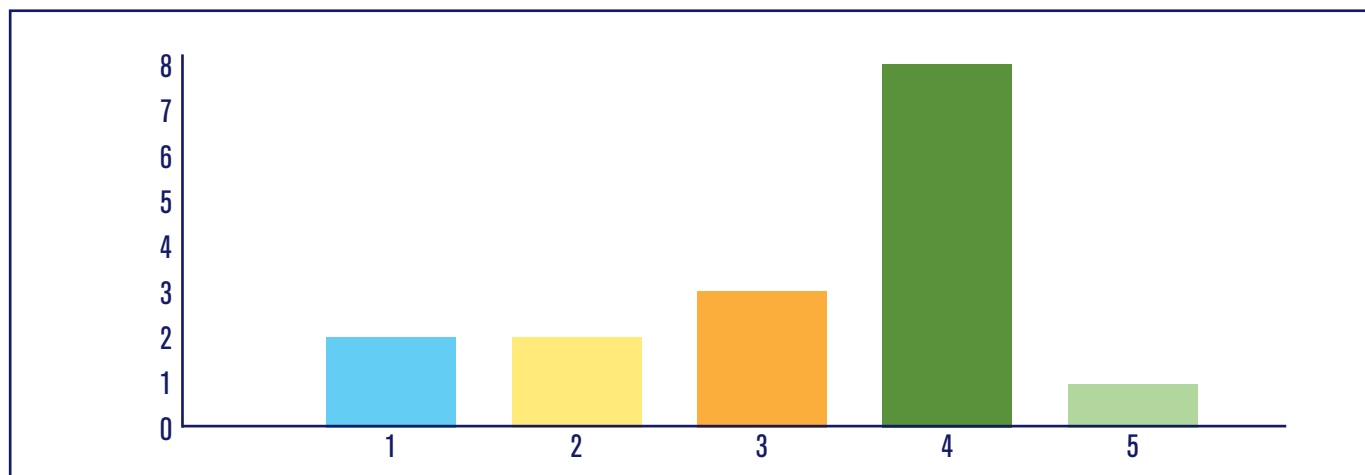
### Individual Capital Assessment

#### Embedding the process

Companies (16 respondents) generally felt their current ICAs were well embedded into the current management of the business (see Figure 10).

The companies with a low rating recognised that their use of the ICA results was limited and have identified areas where they can improve.

**Figure 10** | On a scale of 1 to 5 (1 being not at all and 5 being fully embedded), how much would you say that the ICA and its results have been embedded into the management of the business?



### Documenting the process

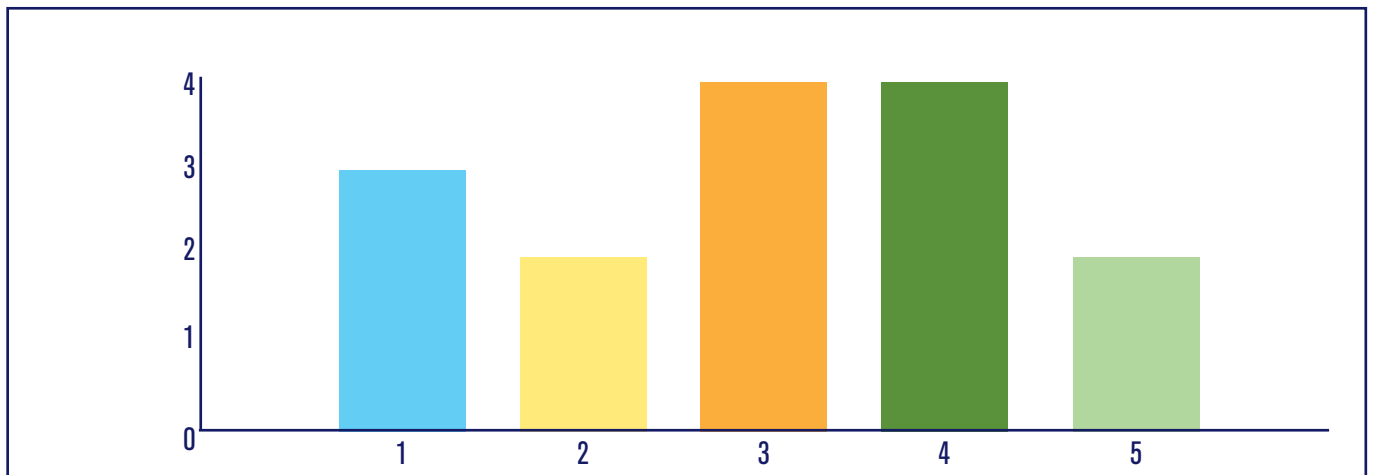
There was a broad range of responses (see Figure 11 below) to the level of documentation of their current ICA. However, on looking at supporting reasons for their choices more closely it is clear that:

- some companies provided a rating on current documentation relative to where they need to get to under Solvency II and the need for further documentation (and so generally responded with a 1 or 2)

- others provided a rating on current expectations independent of Solvency II (and so generally responded with a 4 or 5).

Most companies have identified areas where they felt it fell short. These were mainly around the actual documentation of the ICA.

Figure 11 | On a scale of 1 to 5 (1 being not at all and 5 being fully documented) what would you say is the level of documented support and evidence for the ICA calculation and process?



“ In devising a suitable plan to get to Solvency II, the FSA would expect a company to carry out a gap analysis ”

## Implementing Solvency II standards

### Challenges ahead

The biggest challenge identified in implementing Solvency II was embedding the model into the business, particularly for the larger companies. By that, we believe they mean embedding the calculations and using the results within the day-to-day management of the company (rather than embedding an 'internal' model).

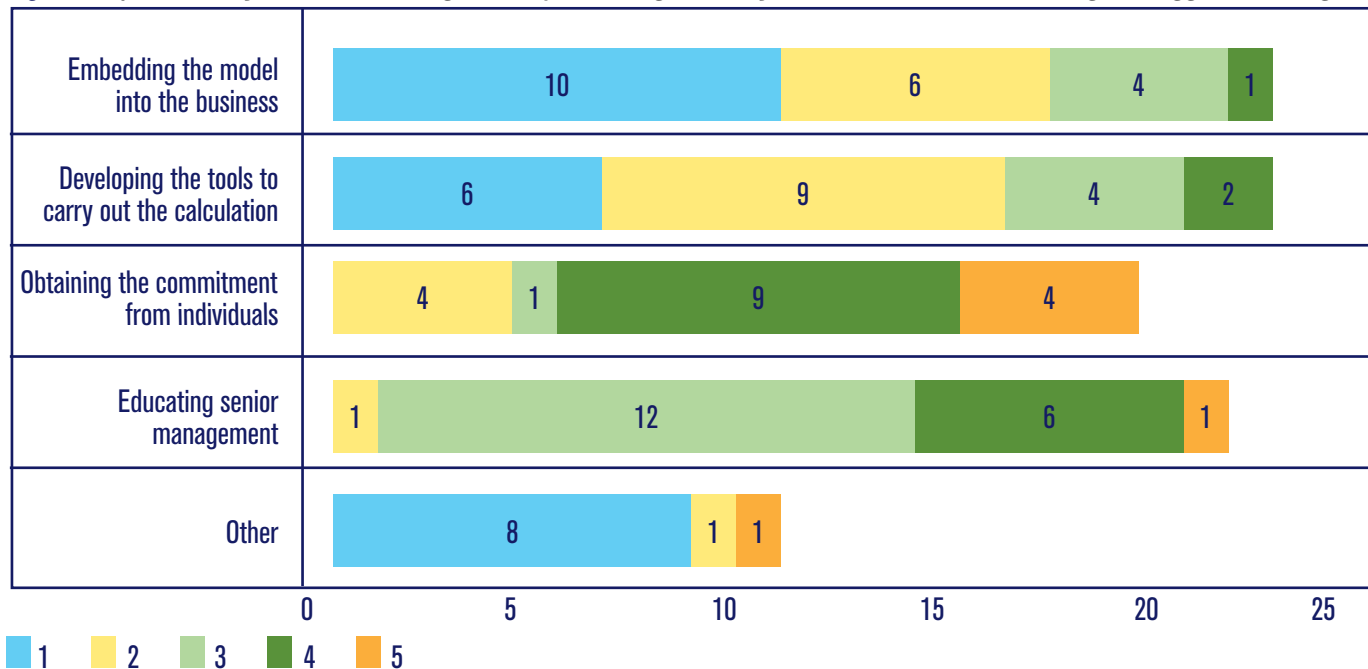
The next two challenges were:

- developing the tools to carry out the calculation
- cost and resource (shown under 'Other' in Figure 12 below).

Lesser challenges (but still challenges) were:

- obtaining commitment from individuals to achieve the requirements which may reflect some uncertainty as to what needs to be done at this stage
- educating senior management which may reflect that the ICA process may have gone a long way to understanding the principles of the proposed Solvency II approach (risk based approach).

Figure 12 | What are your main challenges in implementing Solvency II? Please rank with 1 being the biggest challenge.



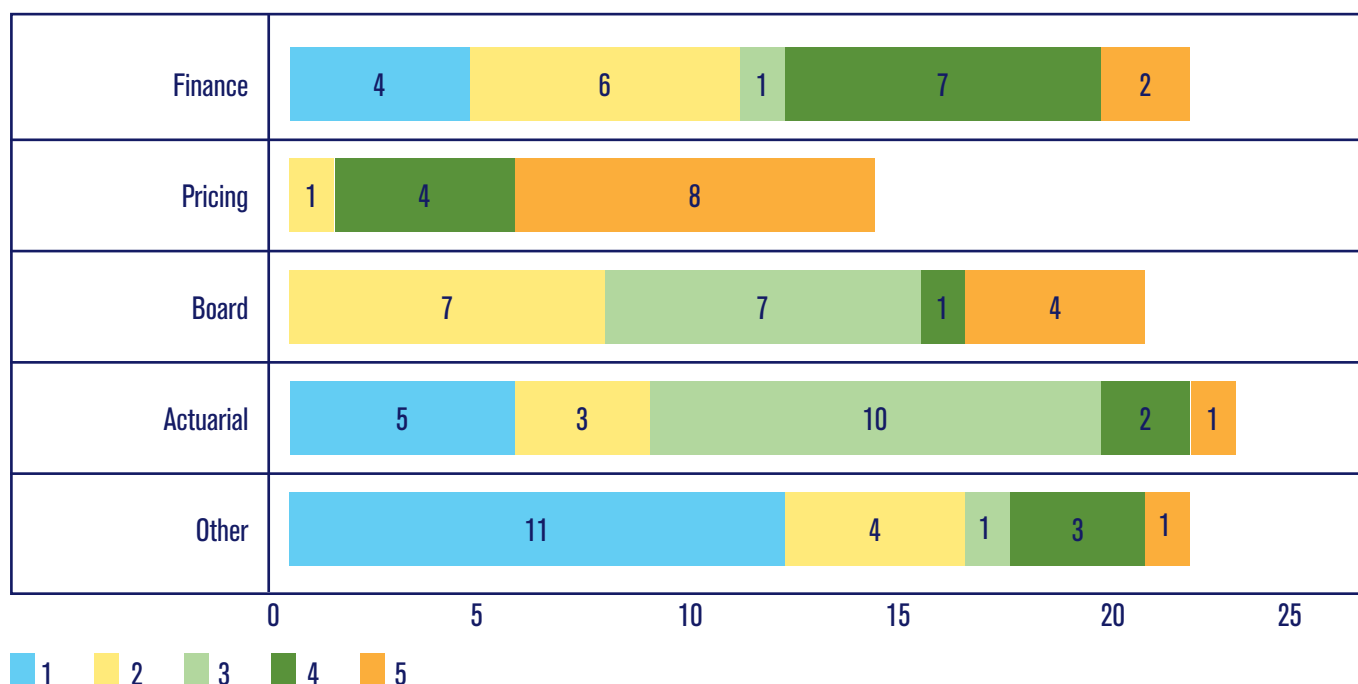
### Areas most affected

The business functions that companies thought would be most affected by Solvency II were ranked in order, starting with the area they felt would be most affected. See Figure 13.

Those using the 'Other' category generally allocated 'Risk Management' under this category,

which appears to be the one most impacted, closely followed by Finance and Actuarial. This is not surprising with internal models, calculations and governance all being the key areas that require large amounts of time in embedding this process.

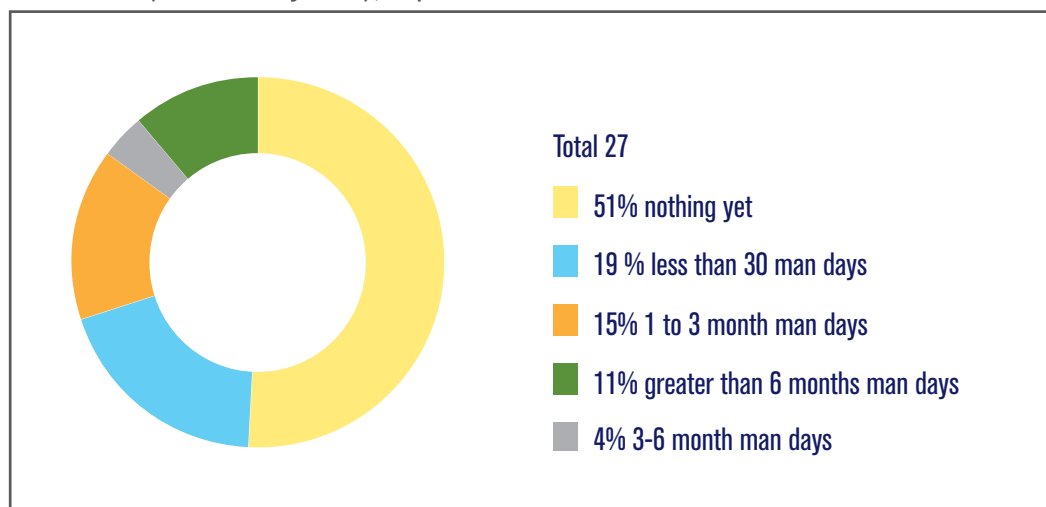
Figure 13 | Which of the areas is Solvency II most likely to impact on? Please rank with 1 being area most impacted.



## Budgeting for time and cost

Over half of the companies have not budgeted any time or cost to the implementation of Solvency II. Of those that have budgeted, there were a broad range of estimates which varied by the type of business that is being written and systems currently in place for current valuations.

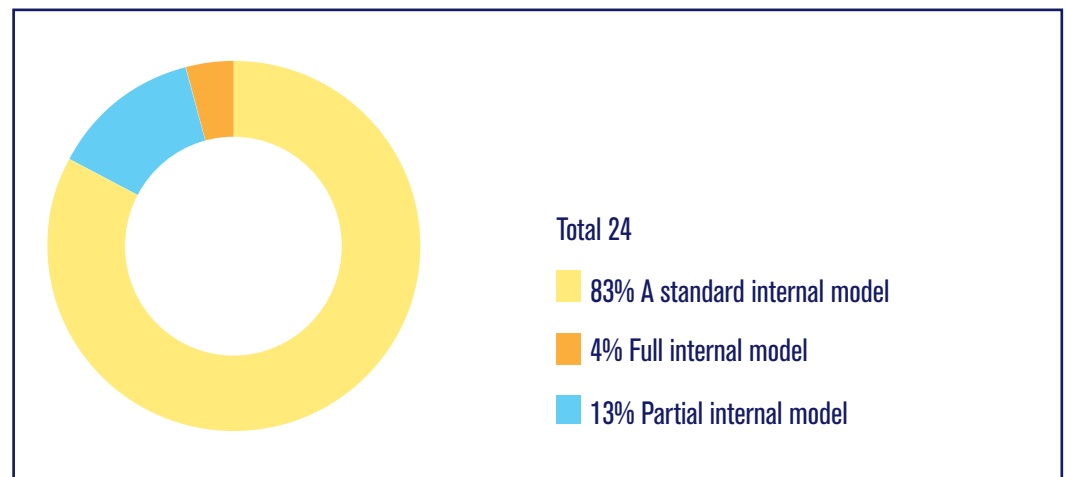
Figure 14 | How much time/cost have you budgeted for the gap analysis, quantitative assessment (if not already done), implementation etc?



## Internal Models

Most companies intend to use a standard model rather than developing their own internal model. A few companies intend to use partial models, and one of the large companies plans to use a full internal model and progress towards getting it implemented was good.

**Figure 15** | By the end of June 2009, the FSA are expecting firms to indicate whether they plan to calculate the solvency capital requirement using the standard formula or an internal model. What does your company intend on using?



“ **The Proportionality Principle is referenced several times in the Directive with the level of sophistication reflecting the nature, scale and complexity of the firm** ”

## The AFS Solvency II Working Group

The AFS Solvency II working group has been constituted to help members of AFS prepare for Solvency II.

The working group intends to:

- investigate the extent to which the Principles underlying the Solvency II specification in determining the best estimate reserves can be introduced as a proxy for realistic reporting and ICA calculations before the introduction of Solvency II
- investigate whether the technical reserve calculations and SCR calculations are likely to be practical and cost effective and examine alternative methodologies where necessary
- set out what firms need to do to meet likely Pillar 2 and 3 requirements
- lobby on behalf of friendly societies, where possible, to ensure that Solvency II takes into account the difficulties faced by these firms and that these are allowed for in the legislation
- help firms understand Solvency II better and highlight the benefits that this new regime will bring to the way that firms manage and understand their business.

As well as observers from the FSA, the members of the working group are:

- Christopher Crichlow, OAC  
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If you have any questions about the survey, or about your preparations for Solvency II, please speak to your usual actuarial contact or one of the Working Group.







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