

Solvency II - What Insurers Are Doing To Get Ready?

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Highlights

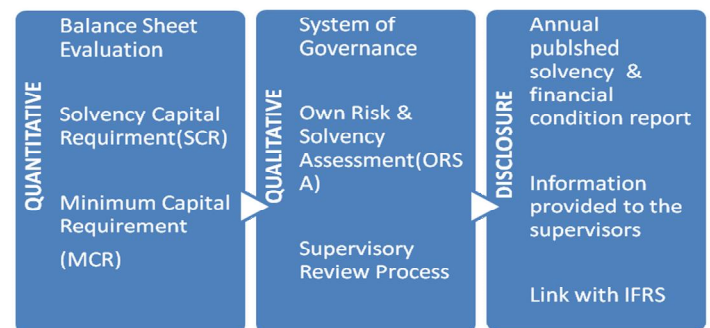
- * Opportunity to clean house
- * Data accuracy is key
- * Flexibility for future
- * Solutions

Solvency II Defined

In the year 2000, along the lines of Basel II in banking, a three pillar approach to insurance regulation was initiated by the European Commission to implement fundamental change to the current European insurance solvency framework. Although the directive has ‘Solvency’ in its title, the mandate explicitly states that capital is not the only (or necessarily the best) way to mitigate failure. Solvency II will produce a more consistent standard across Europe, ensuring that capital requirements are reflective of the risks being expected. The

date for the legislation to come into effect has been set at 31 October 2012. The directive aims to align risk measurement, management and disclosure as a safeguard against failure. A framework for private & public disclosure shows the 3 pillars of Solvency II in Fig1 below. This paper discusses what Insurers are doing to get ready and why Solvency II should be considered an “opportunity” and not merely a “cost of doing business”.

Fig 1: Three Pillars of Solvency II



The “Opportunity” viewpoint for moving towards Solvency II

Based on our research, we found that in the process of aligning to Solvency II, companies can accomplish significant benefits:

Risk is different for different insurers: A portfolio, which is heavy on investment prod-

ucts, should be setup for measuring and managing risks more frequently & accurately related to the risk profile of the insurer. At the other end of the spectrum consider an insurer that needs to evaluate risk from terrorist attacks. For them, risk assessment needs to be evaluated on



(a) Risk within a defined geography, (b) Risk in relation to known landmarks or trophy targets, and (c) Probability distribution of losses that can arise in the likelihood of an attack. This is a good time to take stock and find appropriate tools and methods for optimizing risk management systems.

Sensitivity to changing rules can be addressed: Compliance has always and will be a shifting target. Evolving market conditions is the key driver of regulatory standards. The regulators will raise the bar from time to time but those that will implement compliance & go even further will have a significant competitive advantage. Insurers must implement systems & processes that are by nature flexible in incorporating changing business rules.

Ability to measure operational efficiency: An optimum level of operational efficiency has to be calibrated by the insurer. For this there has to be a means to measure it from time to time. This will help with deciding when to invest for improvements and whether there should be automation of processes or to

deploy resources in a manual approach. According to a report by Capgemini, claims processing is the single largest efficiency killer. An amount of 13 cents in a dollar of claim paid out is lost on claims processing expenses. The estimated total expenditure in claims processing is a staggering \$336 Billion

The opportunity to do a Gap Analysis: In order to achieve accurate risk management calculations, firms need to take stock of the current processes of managing and measuring risk. This will give the insurer an insight into how big or small the gap is and therefore investment requirements. According to an article on the need for data accuracy in Solvency II, Axa's data governance project, Mr Drouffe said some gaps were identified. "Around 80% of these gaps were known. In the past we would have corrected them at the end of the chain but we have now amended this so they are corrected at source to ensure greater accuracy"

"13 cents in a dollar is lost in claims processing expenses which translates to \$336 Billion worldwide!"

What Insurers are doing to get ready?

Implementation Planning: Insurers are pressing ahead with their preparation for Solvency II even though there are some uncertainties around issues such as transition of annuities. Observers have said that the question over annuities could determine whether U.K. insurers will be forced to raise more capital to meet Solvency II requirements. Something that might force insurers to raise the price of coverage. Final calibration principles for the standard formula of solvency

capital requirements are expected following the outcome of the quantitative impact study (QIS). The focus should be on securing approvals for new internal models. Implementing risk governance tops the agenda for the next six months. The official date for the implementation of the solvency II directive has been set for 31st October 2012. A surge of Solvency II initiatives is now under way within the leading firms of insurers. See below estimated expenditure and resource requirements as reported in a recent



Deloitte report in Fig 2. and Fig 3.

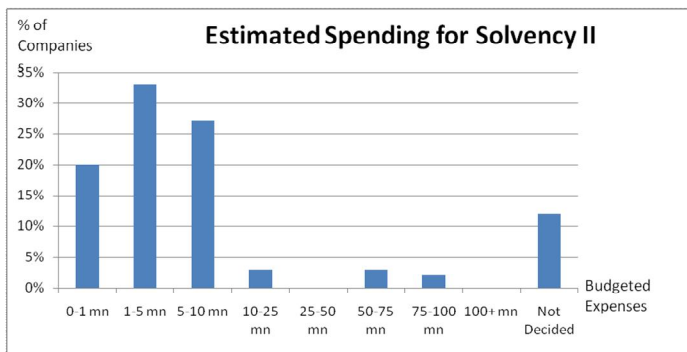
Mobilizing the workforce: The largest insurers estimate that they would need highest number of full time employees to deal with this new legislative demand. Companies with Net Written Premium (NWP) between 1-5 bn expect to dedicate over 100 personnel to implement Solvency II. Contractors would undertake a third of the Solvency implementation. Therefore on an average about 20 full time resources are required for Solvency II. See Fig 3. Maximum insurers are using a combination of general training for all and tailored training for some to get ready for Solvency II. A Deloitte survey shows that 58 out of the 60 insurers surveyed have training programs scheduled.

Data Infrastructure and Data Handling Process: Data remains the key area of concern, be it availability, integrity or quality of data. Hence many organisations are now looking at how they can simplify their data requirements in order to achieve solutions in a cost effective manner. There will be chal-

lenges in access to data for insights needed to meet the Solvency II directives. Conventional method is by use of Business Intelligence tools to consolidate data and create insights. However, this can cost upwards of a million pounds in license and resources. Watertrace has data integration tools that costs significantly less and can reduce operational costs by as much as 35%. For more information, see Watertrace website at www.watertrace.com

Risk Appetite Assessment: Solvency II demands that firms explicitly quantify the level of risk they face and identify the amount of capital needed to support that risk. Insurers are now getting ready to collect comprehensive information about risk sensitivity of their investment portfolio using various tools. A fair amount of research has revealed that there is no particular tool that has yet emerged as an industry standard.

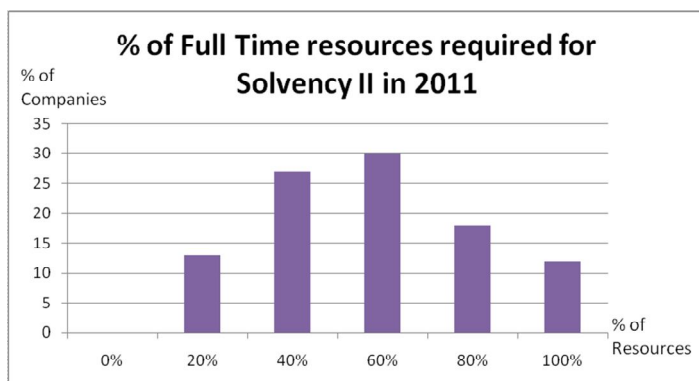
“Watertrace has tools for data collection from disparate sources and a flexible rules engine to reduce claims processing costs by as much as 35%”



Around 60% of the companies estimated expenditure between 1-10mn pounds for the implementation of Solvency II. 20% insurance firms expect to spend less than 1mn on Solvency II. Insurers with Net Written Premium (NWP) less than 500mn are expected to spend less than 5mn.

Fig 2. Estimated Spending Budget for Solvency II (Including Technology). Source Deloitte





In the year 2011, about 60% of the insurance companies will have 30% or more personnel to implement Solvency II. Remaining 40% will have to compete with reduced market of available skilled resources!

Fig 3. Resources in place for Solvency II.
Source Deloitte

“Education, smart systems for accurate data collection and flexibility in workflows is the right way to get ready”

Conclusion

For Solvency II directive, regulators require insurance companies to manage, measure and report risks. Insurers should view this as an opportunity to clean their house. This is an opportunity to take stock and invest to go beyond compliance, raise operational efficiency, realize competitive differentiation and be always ready for changing business environ-

ments. There will be a scarcity of skilled resources as the deadline for Solvency II draws close. Education, selection of smart systems for accurate data collection and flexible workflows is the right way to get ready.

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Watertrace Limited was established in June 2002 with a corporate strategy of providing key business management services to the UK and London Market Insurance Industry. From its initial setup of one consultant, Watertrace has undergone an intensive, but managed, growth phase. During this time, Watertrace has engaged in a number of reciprocally beneficial business partnerships which have helped to establish Watertrace as the pre-eminent business focused consultancy firm within the Insurance marketplace.

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- Process Development;
- Change Management;
- Data Management; and
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