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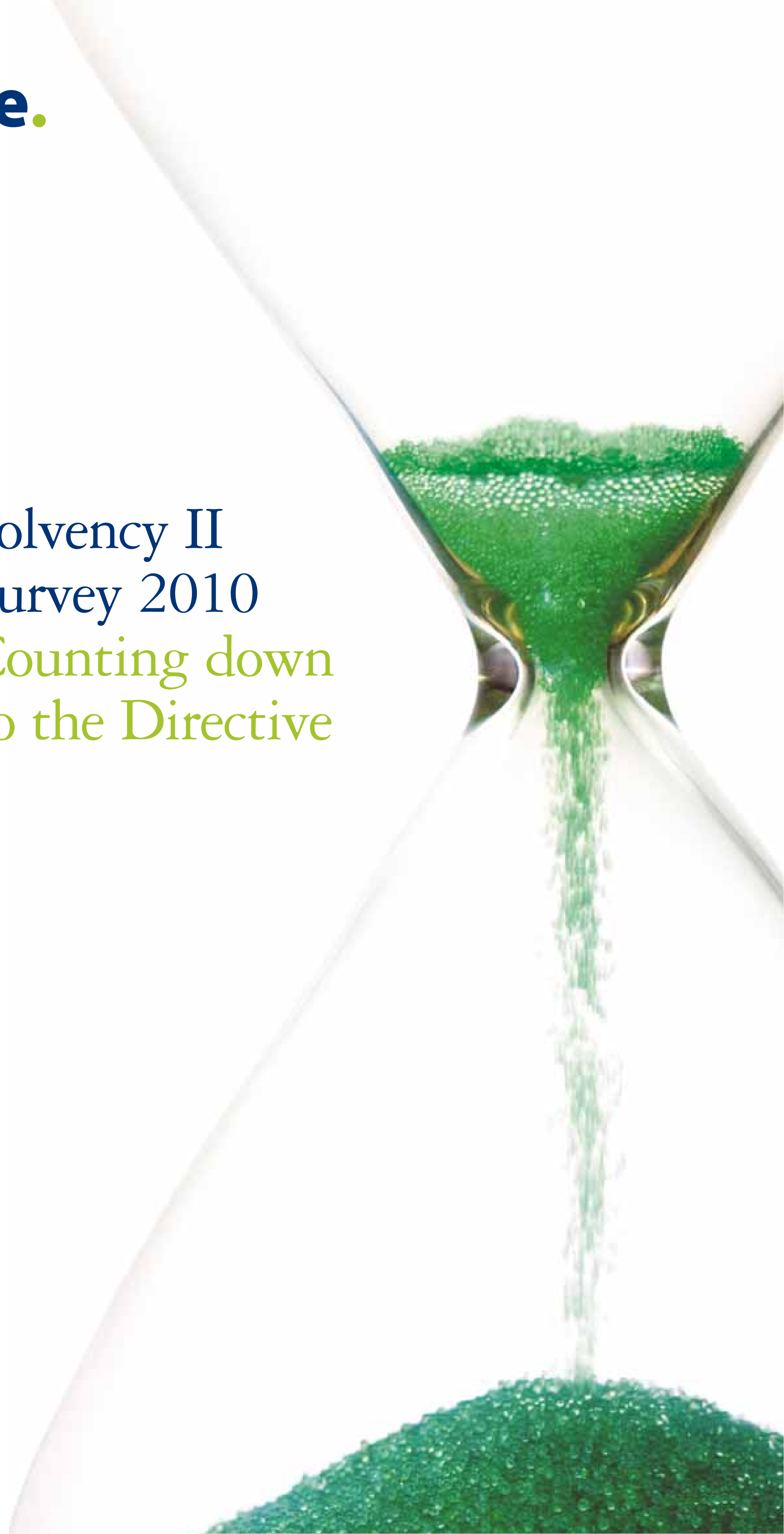
Solvency II Survey 2010
Counting down to the Directive



We are delighted to present this third annual Deloitte Solvency II Survey. This research was conducted on our behalf by the Economist Intelligence Unit who questioned 61 insurers with UK operations in quarter one 2010 and produced this report based on their findings.

As we are all more than aware, Solvency II is a mandatory change the UK insurance industry is facing, however the way in which insurers are responding to this change is far from uniform. The regulatory agenda continues to evolve and therefore firms are having to plan and deliver their Solvency II programmes whilst a degree of uncertainty remains around the finer details of the new regime.

In such circumstances, survey information can help organisations understand where they lie in relation to their peers, providing a useful benchmark as preparations continue. Deloitte commissioned the Economist Intelligence Unit to undertake a broad market survey on our behalf.

Through their fully anonymous survey process, they are able to offer a view of the true state of play for UK insurers in the countdown to 2012. We are very grateful to the EIU and to all participants for their contribution to this research.

I hope you find the Solvency II Survey 2010 useful – please do contact me if you would like to discuss any aspect of this report.

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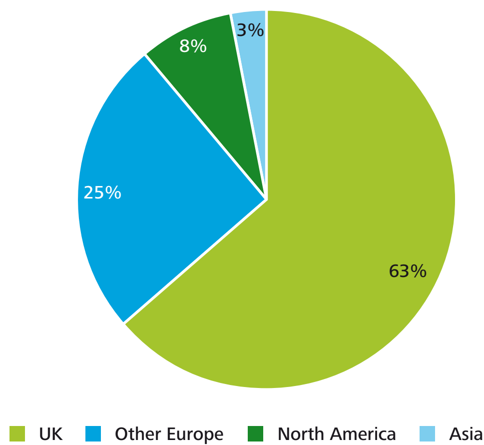
Introduction

For the past decade European Union regulators have been working to harmonise the laws governing insurance companies across the continent. Motivated by a desire to improve protection for consumers and create a level playing field for providers, the European Commission embarked on creating the Solvency II framework, which will impose stringent capital requirements and reporting standards on the EU's insurers.

At the end of January 2010, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) gave its final advice on implementing level two of the Solvency II regulations. Further consultation and impact studies are planned for this year as the proposed legislation continues its journey towards the scheduled implementation date in October 2012. But as the framework begins to resemble its final form, how prepared are the EU's insurers for this sweeping change?

Figure 1. Where is your head office domiciled?



This report, commissioned by Deloitte, is based on an Economist Intelligence Unit survey which interviewed 61 insurers operating in the UK to garner their preparedness for and attitudes to Solvency II. Respondents covered all types of business from smaller stand-alone organisations to large groups.

Respondents were grouped by size with the very largest insurers reporting more than £5bn in net written premiums; large insurers with between £1bn and £5bn NWP; those with £500m to £1bn; £300m to £500m; £100m to £300m; and less than £100m NWP. Twenty-seven respondents were life companies, 30 were non-life while four were composite insurers.

Figure 2. Where does your group operate?

Awareness and preparedness

Given the huge impact Solvency II will have on the insurance industry it is no surprise that 62% of respondents said that all members of their boards of directors were fully briefed on the directive and engaged regularly on the implications of the new framework. However it is a surprise that 16% of respondents said their boards still need to be briefed. A further 21% said some board members are fully briefed and engaged – mainly larger companies with larger boards, which may not require all members to be actively engaged in every project.

Nearly all respondents (93%) had completed a gap analysis to ascertain just where they need to invest resources to keep in line with proposals. More unexpected, however, is just how prepared some of the insurers say they are; more than one in 10 respondents (13%) have validated their new Solvency II systems, while two insurers believed they had 100% of the necessary resources in place to comply with the new regulations. But those eager Eddys are the exception, not the rule; 69% of respondents said they have 40% or less of the resource required for their Solvency II programmes in place, and 61% do not yet have their budgets for Solvency II approved.

Sophie Lloret, policy adviser with the Association of British Insurers' (ABI) financial regulation and taxation team, says: "There is still a long way to go with Solvency II; we are more than two years ahead of completion and we are still waiting for more detailed advice on what it means for insurers' businesses. This is the stage where you need to plan what resources you might need and the changes you need to implement."

Although a couple of insurers felt ready for Solvency II, the lion's share of respondents appreciate there is significant work to be done. About three-quarters of respondents (74%) identified data infrastructure, handling and quality as a key area of focus over the next six months. Irrespective of size, geography or type of business, appropriate data management is the cornerstone of compliance with Solvency II, particularly if insurers plan to use an internal or partial internal model.

Lloret says insurers appreciate that ensuring data quality needs to be prioritised over other considerations since it is this element that will determine the success of all other processes. "Solvency II is a risk-based approach so the focus must be on control, governance, documentation and accuracy of data," she says.

Figure 3. Which of the following areas will your organisation be focusing on in the next 6 months?

Area	%
Data infrastructure, data handling and data quality	74%
Internal model development	59%
Risk strategy, policy and appetite	46%
Culture and training	44%
Embedding and use	41%
ORSA	38%
Risk governance and control environment	38%
Management information and reporting	31%
System selection and implementation	13%
Business performance measurement and personal incentivisation	11%

Deloitte comment – Alex Arterton

The findings indicate that whilst all firms have started working on Solvency II there is still much to be done as the scale of the requirements and the impact on firms becomes more fully understood. Initial efforts have understandably centred on the detailed modelling required since that is where early guidance was focussed.

However, as the Level 2 guidance has evolved and become clearer through the consultation process, the scope of Solvency II has become more apparent in that it impinges on the wider business and infrastructure of firms' people, processes and systems. As the wider guidance has dealt more broadly with risk, governance, capital management and group structure, firms have realised that the implementation of Solvency II is a significant project that not only requires alignment of financial reporting and management information to support the monitoring and projection of capital requirements but a change management programme to ensure behaviours are changed to align with those needs. The survey clearly indicates that priorities have been focused on quick wins and on addressing the more developed guidance (as one would expect) but that focus now needs to change to the organisational and operational changes that will be required to deliver Solvency II.

Cost and resource

Just over a quarter of insurers (28%) said meeting the cost of compliance was a top three concern, with the smaller companies slightly more likely to express concern – not a surprise considering their lesser resources. Of insurers with less than £500m in NWP, 45% have yet to compile a budget or are in the process of doing so, so their concern may also stem from not yet having a good idea of what they will require.

In comparison, 63% of insurers with more than £500m in NWP have completely or partially signed off their budgets, with the majority (58%) expecting to spend under £10m. Cost concerns for the largest insurers may stem both from uncertainty over the lengthy procedure for having an internal model approved, but also the significant staffing requirements they anticipate. While none of the insurers with less than £500m in NWP expected to have more than 50 employees dedicated to Solvency II, three of the larger organisations said they would need more than 100 employees working full-time on Solvency II.

Lloret says: "Such a large regulatory change is bound to have cost effect. That doesn't mean in the future this won't be translated into a benefit, but there is an entry cost."

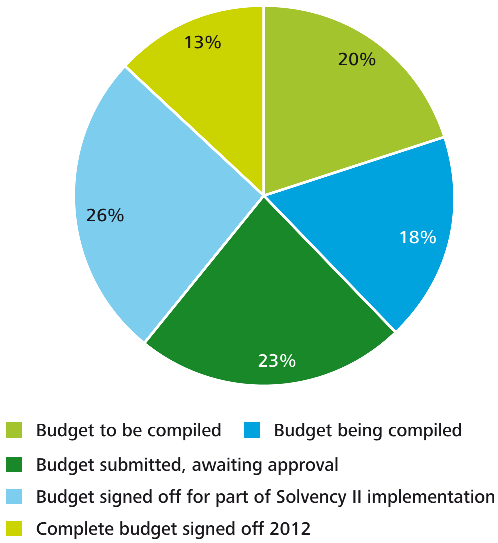
The importance of engaging all staff in Solvency II was highlighted by statements from CEIOPS's chairman Thomas Steffen arguing that the new regime is as much about a change in attitudes to risk as it is about capital requirements. Consequently, two-fifths of respondents had implemented general Solvency II training for all employees, combined with tailored training for some. However, 16% of respondents said they had no structured training programme in place, as they are still unsure which areas of their business will be impacted by the new regime.

Given the considerable investment insurers will make in meeting the Solvency II requirements, 'cost versus benefit' remains the key consideration for survey participants and was the most selected area for lobbying activity in the coming months (chosen by 41%).

Deloitte comment – Alex Arterton

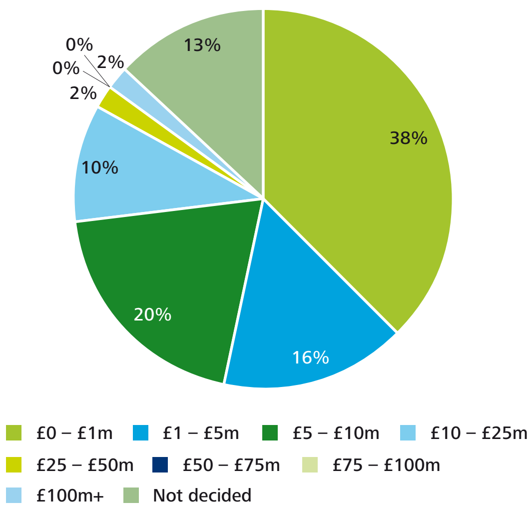
The survey has shown a disparity between life and non-life insurers regarding total Solvency II budgets. Nearly a third (29.6%) of life insurers stated that they have allocated between £5 and £10 million, which comes in contrast to just over 6% of non-life insurers. These results, in addition to others included in this research, indicate that life insurers are approaching Solvency II with a greater sense of urgency. This may be due to the fact that the models for life insurance are more complicated than those associated with non-life insurance, and require additional time to be adequately addressed. It is also possible that these complexities have driven life insurers to budget more money for the Directive to ensure that the requirements and processes can be addressed and rolled out in advance of the October 2012 deadline.

Figure 4. Which of the following best represents the stage of your overall Solvency II budget (to 2012) in the approval process?



Budget to be compiled
Budget being compiled
Budget submitted, awaiting approval
Budget signed off for part of Solvency II implementation
Complete budget signed off 2012

Figure 5. Which of the following best represents your total budget for Solvency II, approved or otherwise?



£0 – £1m
£1 – £5m
£5 – £10m
£10 – £25m
£25 – £50m
£50 – £75m
£75 – £100m
£100m+
Not decided

Figure 6. How many full time employees do you predict to be involved in the delivery of your Solvency II programme?

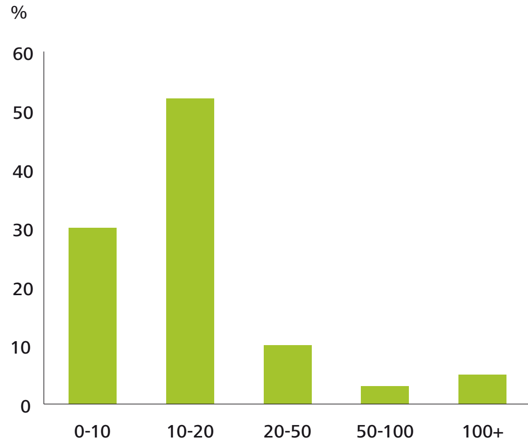
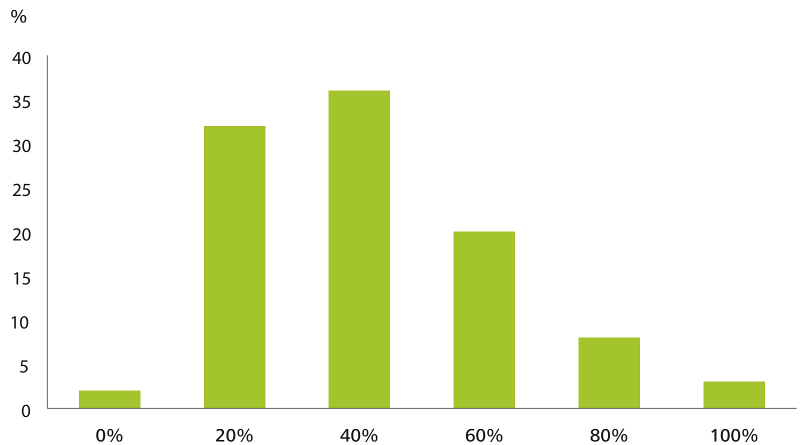


Figure 7. What percentage of the resource required for your Solvency II programme has been put in place?



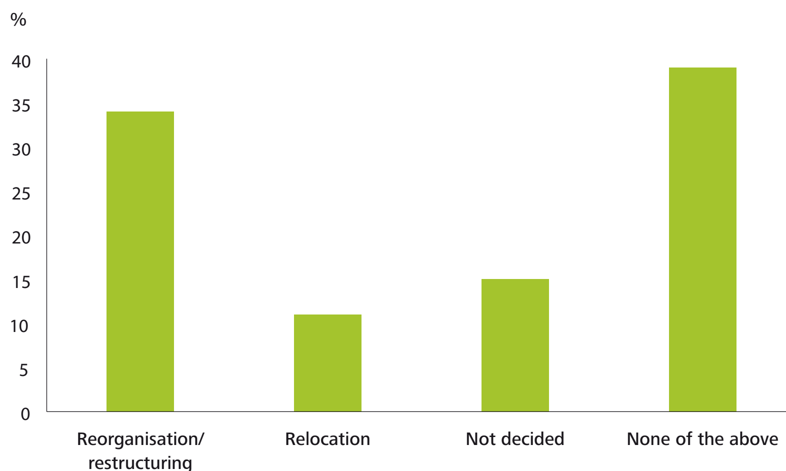
Business impact

More than one-third of organisations (34%) will be forced to restructure as a result of Solvency II, with the smallest insurers (44%) and composite firms (75%) most likely to be affected. One third of non-life and just under a third of life companies (30%) would be forced to restructure, and only one of the largest respondents thought it would need to reorganise its operations. Fifteen percent were undecided on whether they would need to restructure.

Lloret says: "Smaller firms' capital structure might not be in best position to fit Solvency II and they will need to restructure, but it's up in the air at the moment. It's very much still Pandora's Box."

As Solvency II applies across all EU countries, moving their businesses would ultimately make little difference to insurers operationally. However, in some cases changing the group's structure and reinsuring outside the EU could bypass some of the capital requirements laid out under Solvency II. Such a move would undoubtedly encompass its own set of complications and challenging regulatory regimes, and would be no small undertaking. It is therefore significant that 11% of respondents said they are considering relocating.

Figure 8. As a result of Solvency II, do you envisage your organisation will need any of the below?



Deloitte comment – Rick Lester

A year ago insurers were primarily focused on responding to the regulatory agenda and getting their Solvency II programmes operational. In the last 12 months we have seen the business implications coming to the fore of the senior executive agenda. In part this is down to increased understanding of the implications and consequences that has been gleaned from the Level 2 advice which CEIOPS has produced.

Solvency II is undoubtedly going to have a huge impact on organisations, with more than one third of insurers saying they will be forced to reorganise and restructure their business as a result of the regulation. Some will view this as a further stretch on management's attention and time, but others will see this as a catalyst to address other structural issues and deliver efficiencies.

The significant finding that 11% plan to relocate their business will have broader consequences well beyond the insurance market. It has always been predicted that Solvency II could lead to re-domiciling, but if UK based insurers leave it will affect areas such as employment and taxation levels in Britain.

Implementing Solvency II

Given widespread concern over the limitations of the standard formula dictated by current Solvency II proposals, the majority of insurers plan to use their own internal (49%) or partial internal (18%) model. Typically the larger non-life and life companies favour an internal or partial internal model as their operating models are often too complex for the standard formula, and they also recognise there are competitive advantages to be had by having bespoke arrangements.

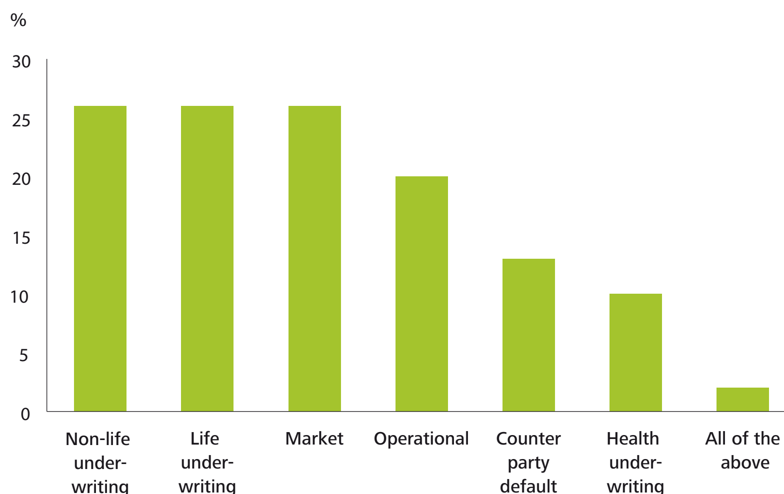
Further, in the UK the Financial Services Authority (FSA) has made clear it will encourage insurers to use an internal model and has set up a pre-application process to assist companies putting an internal model in place. However, this preparation by the regulator has not diminished insurers' worries; UK-headquartered respondents to the survey ranked the internal model approval process as the second biggest cause for concern for their businesses in implementing Solvency II, with 53% selecting it as a top three concern compared to 39% of non-UK-headquartered insurers. Overall, 59% of insurers say internal model development will be a focus in the next six months.

Lloret says: "In the UK we are fairly advanced in comparison to other countries in Europe because the FSA has been at the forefront of discussions on internal models. Now is a good time to be focusing on the internal model because the pre-application phase will start officially in April this year."

Of course, not all insurers will be in a position to use their own internal model and just over one-quarter (26%) of the survey participants will use the standard formula. Putting an internal, or even partial internal, model in place is a costly and protracted process requiring in-house expertise and external support, which will not be within every insurer's remit. Additionally, companies may be electing to wait until there is more finality over the shape of Solvency II before submitting an application.

The internal model approval process remains a significant area of concern for respondents with nearly one-third (31%) saying they would lobby regulators and industry bodies for clarification and support in this area.

Figure 9. If you intend to apply for a partial internal model, which risks are you planning to cover in your model?



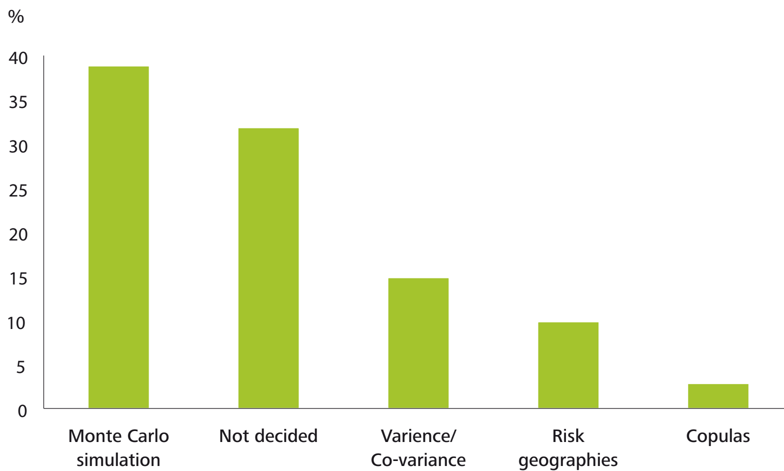
Deloitte comment – Tamsin Abbey
Using an internal model is expected to benefit non life insurers due to the view that the prudent assumptions in the standard formula mean that the resulting capital requirements can be reduced by an internal model. This is not the case for life insurers and so the industry focus on internal models is interesting. It is not at all clear that internal models will give lower or even different capital requirements to those achieved by using the standard formula. Given this, the main driver for the use of the internal model in the UK appears to be the expectation of the regulator rather than a real capital benefit. There should however be benefits from modelling risks in detail which should lead to the increased flexibility of the models and so their ability to support management in making broader and more complex risk based decisions. The cost of implementing such a model will fall on shareholders and policyholders.

Stochastic modelling

Insurers have long used stochastic models to project their capital requirements yet the limitations of current approaches, which often fail to take account of the impact of extreme market conditions, were made clear during the financial crisis. Solvency II attempts to respond to these failings by subjecting chosen models to a series of seven adequacy tests.

While insurers have decided on an appropriate model for the new regime, they were divided on whether a curve fitting approach (16%), replicating portfolio approach (17%) or combination of the two (19%) was most suitable.

Figure 10. What is your approach to economic capital aggregation?



The replicating portfolio approach uses financial instruments to reproduce the insurer's capital requirements into the future and are much like standard asset/liability modelling, but are widely considered to be quicker and more efficient. Meanwhile, curve fitting models allow insurers to simulate how liabilities will react under different stresses and risks.

The level of indecision on which model to choose – 48% of respondents remain undecided – could reflect both the persistent lack of clarity over just how the legislation will look and the fact providers of economic scenario generators (ESGs) continue to innovate in this area, leading insurers to wait for the latest market developments.

A third of respondents are also yet to decide on their economic capital aggregation models. However, of the insurers that had made decisions, the Monte Carlo simulation approach was the clear favourite (39%) over the variance/co-variance (15%), risk geographies (10%) and copulas (2%) stochastic models. Although the regulator will not dictate a favoured ESG, the popularity of the Monte Carlo model, which calculates the value of the liabilities across a large number of scenarios where one or more assumptions are changed, reflects Solvency II's demand to test a number of possible outcomes. The models institutions use will differ according to their business model – variance and co-variance matrices are more popular in banking while simulation approaches and copulas tend to be favoured in insurance – and the key consideration for all senior managers and those involved with implementing Solvency II is understanding what their ESG can do, and more importantly what it cannot.

Aligning Solvency II with other initiatives

Anxious to avoid a repeat of the financial chaos endured following the collapse of Lehman Brothers in 2008, European regulators are tightening other pieces of regulation alongside the implementation of Solvency II. The coincidence of these regulatory reviews should allow for synergies across insurers' finance and technology departments, yet a disconnect in the timing and precise shape of the different pieces of legislation has made it difficult for insurers to coordinate their efforts into one single programme.

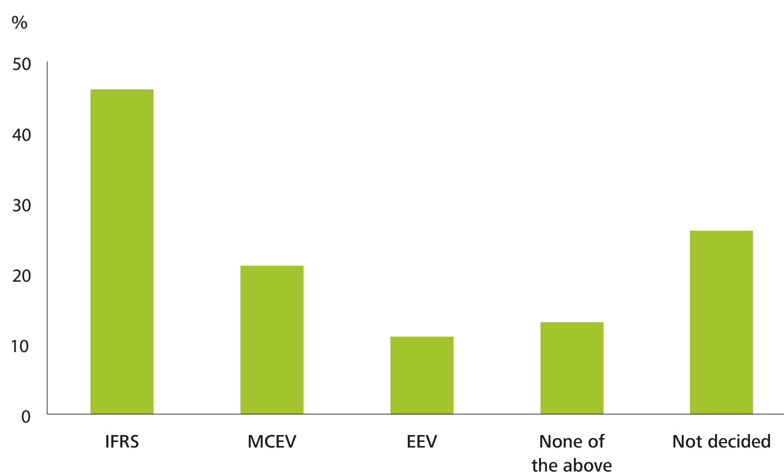
Half of all respondents (52%) will not integrate Solvency II alongside the transition to IFRS Phase II – also due for implementation in 2012 – in a single programme, with just under two-thirds (63%) of non-life and two-fifths (41%) of life companies choosing not integrate the two regulatory demands. Half of composites would integrate, while one-quarter of all respondents were yet to decide.

Lloret says: "It doesn't surprise me that [insurers] can't have a single programme. We don't have much clarity on IFRS or Solvency II and we don't know how much alignment we are going to get."

Similarly, just 21% of insurers would align reporting close processes with the Market Consistent Embedded Value (MCEV) and just 11% would align them with the European Embedded Value (EEV), while over one in 10 (13%) said they would not align Solvency II's reporting requirements with any other basis. The reluctance to align EEV, introduced in 2004, with Solvency II may be based on a belief the older standards will become less relevant in the ultra-prudent post-Solvency II world. MCEV was introduced more recently – 2009 results were the first to require its use – but it may still be seen as a construct of the pre-financial crisis world, and therefore less relevant.

In spite of the lack of consistency in regulatory requirements, just 16% of insurers identified Solvency II's interdependency with other change programmes as a cause for concern.

Figure 11. Do you intend to align the reporting close processes for Solvency II with other bases?



Lobbying activity

The European Commission has been widely praised for an open and effective consultation process on Solvency II, allowing insurers and their respective representatives to shape the legislation.

As the regulations continue their march towards the October 2012 deadline, insurers say they will continue to lobby all the relevant EU regulators and industry bodies including contacting CEIOPS directly. Given the high number of UK-headquartered respondents in the survey, the ABI was the most popular target for lobbying activity, chosen by 61% of respondents, followed by the FSA with 38%. Just 8% said they would target government and MEPs directly.

Figure 12. Which of the following organisations are you lobbying?

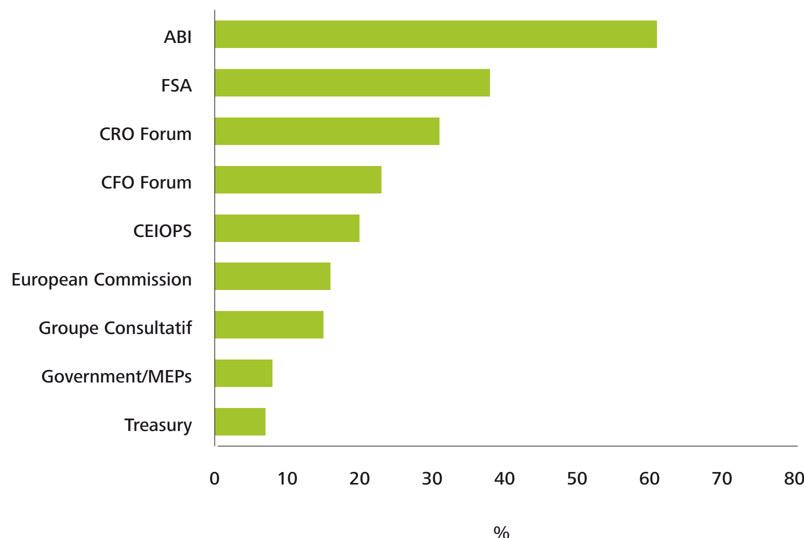
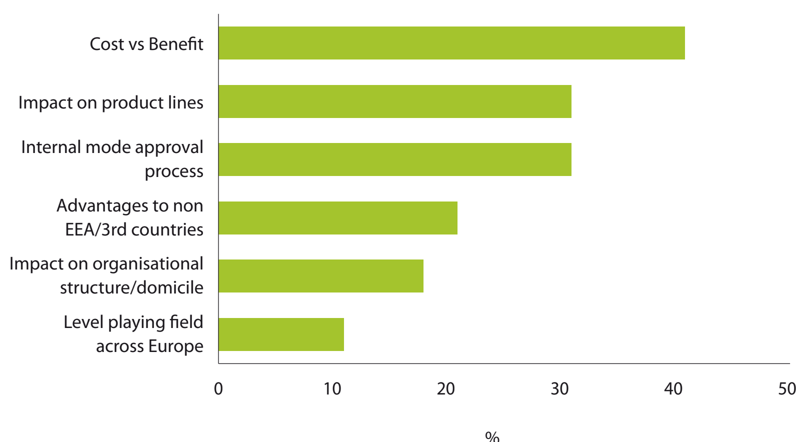


Figure 13. What areas are you lobbying on?



As noted, cost versus benefit is the critical lobbying area, but impact on product lines and the internal model approval process will be targeted by one-third as well. Understandably, insurers are also keen to have clarification from both the FSA and the EU on the direction of future regulation – something Lloret says remains a key focus for her organisation.

"If we want to get the best result, we need to focus on all the dimensions and we have been actively engaged with the Commission because they hold the pen with which the level two measures will be drafted," she says.

In spite of all the uncertainty surrounding Solvency II, more than half (52%) of respondents to the survey were confident the industry would be compliant by October 2012, and more than one in 10 (11%) were very confident. The greatest confidence was demonstrated by insurers with over £1bn (28%) and over £5bn (20%) who recognise that, even if they fail to get their internal models signed off in time, at the very least they will meet the SCR requirements and thus be technically compliant with Solvency II.

However, 16% of respondents were either concerned or very concerned about the looming deadline – although only the smallest insurers fell into this latter category – and 20% were either not sure or waiting to make up their minds.

Lloret says: "If insurers are engaged, doing their gap analyses and working out what they need, they will be in a good position to be ready for Solvency II when it comes into effect."

However, it is possible that because the October deadline does not work well with reporting and accounting schedules, the final deadline may be pushed back to 2013, which could alleviate some of the concerns insurers have about the industry being compliant in time.

Conclusion

Insurers appear to have resigned themselves to sweeping changes in how they do business, and in many cases they are embracing the new regulations as an opportunity to improve efficiency and protect their customers. Budgets are being compiled, systems updated and employees trained and put in position. Further, they are preparing for the fifth quantitative impact study (QIS5) scheduled for later this year and the first wave of the FSA's internal model pre-application which began in April.

However, with so little clarity on how the final regulations will look, there is only so far insurers can go in preparing themselves for the new regime. Consequently, the next six to 12 months will be critical in getting as far as possible towards compliance, while engaging in continuous lobbying and interaction with the key European Solvency II decision makers.

Figure 14. How confident are you that the insurance industry as a whole will be able to achieve compliance with Solvency II by October 2012?

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