

# Solvency II...To the finishing line and beyond

Solvency II is officially being implemented on January 1<sup>st</sup> 2016. It's taken years for businesses, regulators and the European Commission to agree the requirements and despite this, there are still areas of uncertainty, in particular around the external reporting.

Here are facts about Solvency II, before we move into the detail:

**175 = number of internal model applications**

**£200m = cost of compliance for the UK's largest insurers**

**£3bn = cost of Solvency II for UK companies**

**65% = spend allocated to new technology**

As we move closer to the New Year, the focus needs to shift from implementation to embedding Solvency II into business as usual, especially as funding and programme structures will disappear, where project resources are deployed elsewhere.

## So what does embedding Solvency II actually mean?

Partly it will depend on whether the business is using Internal Model or Standard Formula. Internal Model firms have more rigorous "tests" to overcome, one of which is solely based around how risk and capital information is used in decision making. There is no prescribed standard, so it is up to firms to interpret the regulations, implement, embed and use "Solvency II" outputs. However firms choose to demonstrate "use", it must be practical and sustainable. Often we have found "Use Test" is currently "owned" by the Project and this is one area which needs to transition to the business.

One way to embed this information is incorporating risk and capital information into existing processes, such as:

- Business planning
- How the business strategy is informed and influenced by the risk strategy (along with many other factors)
- The impact of a business's product mix and product strategy on its risk profile
- The impact of a transformational project on a business's risk profile and capital requirement

The regulations don't advocate just using this information alone to make decisions – risk and capital information should be used alongside a whole host of other factors, which businesses should be using already. For example, sales MI, retention information, financial projections etc.

There needs to be clear responsibilities and accountabilities in relation to Finance (1<sup>st</sup> line) and Risk (2<sup>nd</sup> line); any activities supported by the programme need to be transitioned to the appropriate functions. It may be useful to consider if you have the right amount of people (capacity) to support the new processes, in particular the reporting and documentation requirements; and the required skill-sets (capability), to then assess any gaps which need to be addressed. For more information, read more about our solutions on headcount modelling

Most businesses will be familiar with the concept of "three lines of defence" – this translates to Solvency II, using some examples below:

Finance Activity (1 <sup>st</sup> Line)	Risk Activity (2 <sup>nd</sup> Line)
<i>Production of the results</i>	<i>Challenge, oversight and sign off of the results</i>
<i>Actuarial modelling</i>	<i>Challenge, oversight and sign off of the modelling approach</i>
<i>Sourcing of the data to support the modelling</i>	<i>Challenge the type and source of data</i>
<i>Production of the external reporting templates</i>	<i>Oversight and sign off of the reporting templates</i>
<i>Identify, own and manage the risks (this will also include other business areas)</i>	<i>Define, implement and embed a holistic and proportionate risk management framework Provide oversight and challenge / advise on the risks</i>

Risk and governance are core components of Solvency II, as part of Pillar 2 (see figure 1), requiring firms to have a clear understanding of their risks, to protect policyholders against those risks and for those risks to be owned by the accountable people in the business. Therefore it is important for firms to have the appropriate governance structure. The challenge for some firms is the capital requirements are calculated on a legal entity basis and businesses often aren't managed by legal entity but by function or shared service, which would cut across many legal entities – often the way these are governed and decisions are made are through “Exco’s” or Management Committees, which are less formal than board meetings. Therefore it is difficult to be able to use the legal entity numbers and apply them in a meaningful way in that sense.

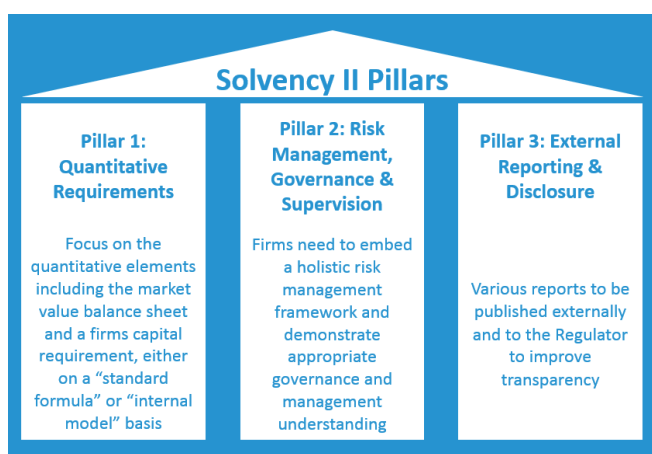


Figure 1: The 3 Pillars of Solvency II

A possible solution for this is to relook at the governance structure of the business to see whether a formal board needs to exist to oversee the other legal entities (at a group level). The capital requirement numbers can be consolidated and this strengthens the board structure and oversight. The question is, are you comfortable with the level of oversight? Would the regulators be comfortable with where decisions are made and what they use to make decisions? Does it reflect reality?

### How to embed?

Typically Solvency II programmes are well understood within the Finance and Risk communities, but mean very little to those elsewhere in the business. It's been a challenge for firms to make Solvency II “meaningful” to other business areas. It has been too easy to “hide behind” the complexity of the numbers – for Solvency II to remain a dark art, for it to be overcomplicated and therefore impossible to embed. Part of the transition process must be to educate the business (and this is likely to be Board

Members / Executives). In our experience the best way to do that is to start using the information and outputs from Solvency II in board reporting, making it part of the existing processes so the business grows more familiar with the metrics, what they mean, what changes / impacts them and how these metrics can be used to help decision making.

The element of Solvency II which impacts the most people in a business is risk management (within the pillar 2 requirements). This is often the most challenging element to “embed” as people see it as a tick box exercise, an unnecessary burden, an additional piece of work which adds no value to them and they don't understand why they are doing it in the first place. Risk management is a simple concept which can easily be over-engineered and over-complicated. Not everyone in the business needs to be an “expert” in risk management, however every person in the business needs to understand their role in the bigger picture and what could stop the business achieving its goals.

Risk management should become part of what a business does. Some firms have included risk management in everyone's performance objectives and role profiles; other firms use a risk adjusted metric as part of their bonus calculation. It's whatever is proportionate and value add for that particular business. We have seen firms with hundreds and hundreds of risks logged into a system which never get used. They are updated in the system, many people contribute to that assessment process but nothing is ever done with the output. There is almost too much detail and it has become a tick box exercise. Risk is common sense...the best way to embed risk management is to make it approachable, practical, value add and proportionate.

If a firm has applied for “Internal Model Approval”, they will need a mechanism to make changes to that model once Solvency II is implemented. New legal entities may come into scope, methodologies and approaches may be refined and improved. Some firms have appointed an existing Risk or Finance Committee to have oversight of the Internal Model – therefore it could simply be a change control process (based on the firm's existing change and project process) which feeds into that committee. It doesn't need to be complex but it should be documented, communicated and governed to ensure the appropriate level of control and awareness.

## But there are still challenges...

With the implementation date looming, there are still a number of challenges facing businesses who are impacted by Solvency II.

Currently, Insurance firms complete regulatory reporting on an annual basis through the PRA returns. Solvency II requires both quarterly and annual regulatory reporting through a set of Quantitative Reporting Templates (QRTs) and Financial Stability Templates (FSTs). In the Wealth Management and Life & Pensions sector, one of the biggest challenges is the Asset Reporting QRT – firms are required to report the assets on a ‘look through’ basis which means that instead of just reporting the value of all the funds, firms will have to get information on the assets within the funds and report that. This is a huge challenge and involves speaking to data providers who are going to act as middle men between the fund managers and the insurance firms (i.e. they will collect the data from the fund managers and put it in a format that can be extracted, and firms will then pay a premium for the provision of this information). New legal agreements may also be requirement with fund managers.

The sheer amount of reporting is overwhelming – there are over 200 QRTs which need to be completed either on an annual or quarterly basis. Then there is an annual report (Solvency and Financial Condition Report) which is disclosed publicly and a Regulatory Supervisory Report which needs to be produced for the regulator every 3 years. Firms will have to look at their systems, processes and people, given the scale of the change. The timetable is equally as challenging, as firms have less time to complete more complex results, and more templates! This is compounded if there is any consolidation of results required. As this is transitioned into business as usual, processes need to be streamlined and automated to support the rigid timetable, especially around external publication. This is all in the backdrop of businesses having to reduce costs and deliver more for less. Read more about our process improvement solutions

Another challenge is how businesses will demonstrate ongoing compliance, once the project structure is no longer there. If a firm has opted to define and implement an “Internal Model”, this could be achieved through “Use Test”. Use test can be seen as a measurement of a firm’s maturity so it could be measured in this way, especially if the business already has some form of risk maturity model. The risk maturity model can be adapted to incorporate

key elements of Solvency II. Another potential way is through policies – we are not advocating having a “Solvency II” policy – as that is not embedding Solvency II into the business; but it is likely new policies will need to have been written or existing policies will need to have been amended, for example, policies for the different risk types, data governance, Internal Model governance (if applicable). Firms need to measure compliance against their policies, as a minimum, on an annual basis. This is another existing process which could be adapted to support Solvency II compliance.

## Key Points

There are 5 key points which businesses should be thinking about now to ensure Solvency II is effectively embedded post January 2016:

1. See how risk and capital information can be used in existing processes. How can the outputs of Solvency II add value and be used to supplement decision making. Many firms have invested millions in Solvency II programmes – the only benefit can’t be compliance...
2. Ensure roles, activities and accountabilities are clear between the Risk and Finance functions and they demonstrate the “three lines of defence”
3. Map out the reporting process and timetable to ensure it’s as efficient as possible – see what can be automated, what could be removed. Undertake headcount modelling to ensure you know how many people you will need to support the new process. Investigate how you could improve efficiency.
4. Keep risk simple and link it back to the strategy of your business.
5. Ensure you have appropriate governance and oversight in terms of your board / committee structures.



Jan 2016 isn’t the finishing line, but it is the start line. For the past few years, it’s been all about training for the race, but the

race doesn’t start in reality until it’s all being used in anger, which is post-Jan 2016. Simplify Consulting are experts in delivering and embedding Solvency II (both Internal Model and Standard Formula solutions) – contact us to see how we can help your business overcome the Solvency II challenges.