How to be a Solvency 2 winner?

by Jermund Ramsfjell

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The new Solvency 2 framework gives insurers a series of choices and challenges. Those who see it as an opportunity, rather than a regulatory burden, will benefit from the change, says Jermund Ramsfjell of EMB Nordic.

How will the new Solvency 2 framework directive, published in July, affect your company? This is the question being asked by insurers all over Europe, and they are coming to very different conclusions. Everyone agrees, though, that there will be winners and losers. And, of course, we all know which of these two outcomes is preferable.

The directive is a long, technical document, but it gives companies a clear choice: to adopt the standard formula approach where individual risks are considered on their own and then aggregated; or to opt for internal capital modelling, which gives firms a true understanding of the risks they carry. The first approach is easier in the short run, whilst the second is widely agreed to carry much greater business benefits.

Many commentators have said that Solvency 2 will give competitive advantage to the largest firms at the expense of the rest, but there is actually a more fundamental differentiator. The real winners will be companies – small or large – that really understand their risks, and there is a simple reason for this. The better you understand them the more efficiently you can deal with them. For example, you can maximise the value of your reinsurance programme.

So much for the theory, but what does all this mean in practice? Fortunately, we do not have to look very far to see for ourselves. In the UK, the FSA (Financial Services Authority) has been practising risk-based regulation, with internal capital models for all but the smallest companies, since 2004. It is widely recognised, even by those insurance executives who initially opposed the idea, to have

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brought greater professionalism and improved use of capital right across the market.

The ICAS (Individual Capital Assessment Standards) lies at the heart of the FSA regime. It requires insurers to demonstrate that they have understood the risks inherent in their businesses and have taken the steps necessary to address them. The risks involved go well beyond underwriting, incorporating operational and investment risk, among others.

Although it is up to companies to decide how best to achieve these objectives, they have nearly all decided to produce internal capital models. These models enable you to test any number of possible real-life scenarios, measuring their potential financial impact on the company.

As well as being an excellent way to assess financial stability, these models have all kinds of far-reaching business benefits, including greater transparency, more capital-efficient reinsurance buying and better investment strategy. In fact, they have become essential management tools, helping firms to make decisions on wide-ranging strategic questions, such as what classes of business to write. They have stimulated big improvements in management standards and professionalism. Risk management, technical competence and business processes have all advanced significantly.

The ICAS regime is enforced through so-called 'Arrow' visits by the FSA. These are basically a means of checking that risk management is being applied effectively right across the organisation. Although capital models are usually an essential component, on their own they can never guarantee good risk management. The FSA wish to be assured that risk management is embedded in the company. For example, do all senior staff understand the process of risk management and their roles in delivering it?

Although the details will inevitably differ, Solvency 2 is based on the same principles as the FSA's regime, with one important qualification. As I explained at the start of the article, Solvency 2 gives companies a choice. They can, if they wish, opt out of this beneficial process and choose the "standard formula" instead. This allows companies to evaluate risks separately, without having to understand how they relate to each other.

The big fear is that smaller companies will take this route because it appears to be easier in the short run. If they do, they will lose out to their competitors and may well have to pay additional capital loadings to compensate for their reduced understanding of risk. The European Commission themselves make the point that internal models remain a desirable goal.

In fact, models are much easier than many people realise. They can actually be easier for smaller companies, because they are less complex organisations. The best approach is to start with a limited, well-defined project and then build on it once you have understood how it works. Many companies in the UK found that the money these models saved on the first year's reinsurance purchase alone more than paid for the start-up costs.

There is one question that firms often ask: when is the best time to start creating and implementing these models? And the simple answer is, now. The deadline for Solvency 2 may have been put back two years to 2012, but there is a good reason for that. There is a lot of work involved, and companies will need the extra time in order to get it right.

There is an even better reason, though, for starting work on these models. They will help you to run your business, to make better strategic decisions, to use your capital more effectively. That is why it is also very important to make the right choice when implementing Solvency 2.