Beyond compliance

Differentiating through Solvency II technology investments

IBM

Introduction

Solvency II has been in the insurance media headlines for over two years and as we approach the launch date of 1 January 2013, the column inches will certainly continue to grow. Amid the speculation and spirited discussion regarding the impact of Solvency II, one thing is certain - this is a transformative moment for the insurance industry.

This paper provides a clarion call for company boards and the wider range of senior management to view Solvency II not only as a mandate, but also as an opportunity to fundamentally improve the way they do business. Insurers who are able to successfully develop an enterprise-wide plan of action for Solvency II will emerge as stronger, more agile and effective competitors. Those who do not may put their very existence at risk.

So far, much of the discussion and difference of opinion has been centred around technical financial and actuarial issues. However, as deadlines get closer for approval of Internal models and the finalisation of the QIS5 exercise (Quantitative Impact Study), a broader range of insurance management must become more involved. Solvency II touches every part of your business and will continue to do so.

The impact to Insurers' business

Whilst the major reason behind Solvency II is about protecting policyholders through adequate levels of solvency and capital, in a practical, day-to-day sense it impacts nearly every part of the business (see below). Considering the breadth and depth of this impact, successful compliance will require a continuous "finger on the pulse" across the entire organisation.

Areas Impacted by Solvency II

Operational risk	Reserving
Pricing	Business processes
Product range	Distribution channels
Underwriting	Market risk
Exposure	Credit risk
Claims	Investment policy

The involvement of the board and all senior management will support the most effective determination of future strategy. For example, whether to buy or sell, grow or contract, specialise or generalise, in addition to reviewing emerging market opportunities, increasing delegated authority, evaluating redomicile, simplifying group structure, competitive positioning, cost cutting and outsourcing/offshoring.

In fact, this is an ideal opportunity for insurers to get closer to their business in order to become more agile in decision making and taking quicker action. Indeed, this will be vital under the more sophisticated capital and risk regime in order to stay ahead of the pack.

Solvency II is not an option, but it is a strategic opportunity to achieve and maintain differentiation. Some leading insurers have already realised it is the right time to take decisive action that will determine future market positioning and build in flexibility.

The changing insurance markets will not wait for Solvency II as they continue to move to a 24X7 environment, shift to a consumer-focused mindset, assume wider risks due to climate change, and adjust to rising longevity that will strain the pensions and savings of the population.

The preparation for Solvency II has highlighted whether insurers are ready for the new level of transparency, governance and risk which will increasingly demand integrated reporting, capital, solvency and risk modelling, and automated audit trails. Solvency II is also driving change in the pace of global regulatory developments through the IASB (Insurance Accounting Standards Board), and Solvency II equivalence for key insurance territories outside Europe, whether they intend to do business in Europe or not. It could in time be the global regulatory regime for solvency and capital through enterprise risk assessment.

Indications so far

Initially, reaction to the global financial crisis was strong and much lobbying from industry trade bodies and the Geneva Association (the insurance economic think tank-whose board comprises insurer CEOs from around the world) pressed the European Commission legislators and regulators not to treat insurers like banks. The lobbying has had a significant positive impact, but there are continuing warnings from insurance trade bodies that the EC must not over-calibrate new capital requirement rules.

There is still much to be decided, but there are encouraging signs that regulator CEIOPS (The Committee of European Insurance and Occupational Pensions) is taking a more understanding line regarding potential future capital levels.

Assessment of assets and liabilities has been the subject of lengthy technical debate, particularly for life companies. UK life companies also have the impact of the Retail Distribution Review (RDR) to assess in the same timeframe as Solvency II. Other European insurers will be watching these developments with interest. Respected industry commentator Shirley Beglinger says overall that "Solvency II is a good thing" but feels it has been too life-orientated and not enough attention has been paid to the non-life sector.

The general drift is that diversified larger insurers could benefit the most, even though at this stage Group Supervision is on the back burner. Some insurers are already looking to simplify their entities. They are bullish about the opportunity to make early acquisitions and are already reviewing product offerings. Others prefer to wait and get more clarity from the QIS5 exercise that reports in April 2011 with feedback on Internal and Standard models. For example, Groupama has delayed its proposed IPO.

Small to medium insurers are most under threat because their products and strategy may not be sufficiently diversified, particularly if those products are capital intensive. Mutuals and co-operatives account for over 25% of European business and many of those are small. Trade body AMICE (The Association of Mutual Insurers and Insurance Cooperatives in Europe) says that the regulators have not spent enough time understanding the mutual model, and it has urged its members to participate in the QIS5 exercise to be able to put forward their case for special treatment when the results of the exercise are revealed.

Martin Shaw, Chief Executive of the Association of Financial Mutuals, added "Early indications from the QIS5 exercise are encouraging for UK mutuals. The indicative capital requirements compare well with those required under the ICA regime. However the exercise has demonstrated just how much of the final shape of Solvency II remain undecided. Our greatest concern at present is that there has been very little attention given to making the requirements proportionate and small firms face enormous disruption and massive increases in actuarial fees regardless of whether or not there is any change in their capital position or any actions needed to mitigate risk."

Trade bodies CEA and ABI have also pressed their members to participate in QIS5.

Risk manager trade associations AIRMIC and FERMA are concerned about the likelihood of higher premiums, a more restricted choice of insurer and potentially lower capacity.

Captives feel neglected, growth is stunted, and a recent survey of UK general insurance run-off from KPMG indicated that there was a strong possibility of mergers and acquisitions.

The major European reinsurers point to a more sophisticated model, rising longevity risk and potential for an increase in business. Some insurers are taking a more detailed, quantifiable look at the exposure and the capital aspect of their product set, bearing in mind what is known so far about the ethos behind Solvency II. There are indications in the UK life sector of product strategy reviews.

Actuaries and financial directors are poring over Internal Models and are beginning pre-application procedures with their local regulator. For instance, the Corporation of Lloyd's is working on a special Internal Model for managing agents to take on board. However, many small and medium sized insurers could well opt for the still to be finalised Standard Model, which will be not be geared to a specific insurer. Solutions and assistance with all or part of an Internal Model are being offered by actuarial consultancies and other software specialists.

CEIOPS is making progress on equivalence with other countries. Bermuda, Japan and Switzerland could have early equivalence agreements, with the United States likely to quickly join them once the new Federal Insurance Office is up and running. Non-European domiciled insurers doing business in Europe will also have to meet the requirements of Solvency II.

"I believe that a workable and successful Solvency II regime will be one where different product lines become integrated into the new regime on different timescales, depending on the term of the contracts concerned."

Tim Breedon – ABI chairman

CEIOPS has recently talked more about a transitional period. No doubt more flesh will be put on that particular bone in the coming months. Chairman Gabriel Bernardino said recently that "appropriate transitional measures may be used to give insurers and local regulators and supervisors enough time to fill the gap without disruption in implementing the new regime." He added that there needs to be "a prudent, balanced approach to calibration" but warned that, although many insurers survived the financial crisis, some will need to reinforce their capital position. ABI chairman, Tim Breedon, speaking at the same ABI conference, said "I believe that a workable and successful Solvency II regime will be one where different product lines become integrated into the new regime on different timescales, depending on the term of the contracts concerned."

Emerging commentary from the marketplace

Solvency II has ignited a wide range of perspectives from the market, as insurers seek out the most urgent priorities for short-term preparation as well as longer-term effects.

Here are few highlights:

Lloyd's and the IUA – The executive heads of both have been bullish about using Solvency II as an opportunity to review the business rather than purely comply with a regulatory requirement.

Ernst & Young and PwC – Both consultancies are stressing that a high level view of the broader impact of Solvency II should be taken.

Towers Watson – Emphasises that the challenge to assess distribution risk and planning priorities is vital, and that the approach of UK insurers was approximate.

Deloitte – In an April survey revealed that 36% of UK insurers were not confident, and a similar number were looking at reorganisation and restructure. In a separate survey by Deloitte on regulatory issues, insurers placed risk management and the balance sheet as top priorities.

Fitch – Emphasises the impact on investments and types of products.

FSA – Said that it is important to have an information technology strategy in place alongside business and pointed out the importance of management information.

EMB – Says compatibility with other regions is key.

ACORD – Sees industry standards playing an important long term part. The IUA suggested it should be a regulatory requirement to be ACORD Standard-compatible.

Morgan Stanley – A recent study by Morgan Stanley and Oliver Wyman suggests European insurers will face losing on average two thirds of current surplus capital under Solvency II rules.

Deutsche Bank – Predicts that some German insurers might outsource their asset management to banks.

Although some see this as a difficult exercise in changing insurance markets, it can also be a worthwhile and differentiating one.

How well do Insurers know their business?

Solvency II is an urgent strategic issue which, in time, is going to impact every aspect of insurer's business. For many, it will mean finding out more about their business in order to do more than merely meet minimum, occasional and ongoing regulatory requirements. To maintain differentiation, all levels of management need to be able to react 24 hours a day, seven day a week. That includes board and senior executives, strategy and innovation, finance, actuarial, compliance, underwriting, claims, risk management, sales, marketing, product development, investment and asset management, and human resources.

Information technology will act as the catalyst, working closely with business management to enable continuous competitive agility.

At present, Solvency II responsibilities rests more often than not with the finance department. There is an urgent "educational" requirement by those in charge of Solvency II to explain and debate in strategic terms the potential implications and opportunities with board and management. The ethos needs to be inclusive rather than exclusive.

Many small to medium insurers are likely to be threatened in this future marketplace and will be forced to stretch their resources, time and costs. Initially, they will likely opt for the Standard Model and consider transitioning at a later stage to a more focused partial or total Internal Model, but they have a real concern about proportionality. This begs the question as to whether all sizes and types of insurer should be treated the same.

There was encouraging news from the Financial Services Authority (FSA) at a recent conference held by The Actuarial Profession that they were gaining much from the early submission of Internal Models for local regulator oversight. It is hoped that this positive feedback will be shared with other national regulators and, along with the outcomes of QIS5, will tie up many of the loose ends.

Now is the time for all insurers to strategically plan and prioritise a phased approach for Solvency II compliance. There are many areas that have to be considered from a more in-depth and broader risk-based perspective. A phased approach could be targeted by product set, but the ultimate aim should be a seamless, comprehensive view of the entire company. This poses a real challenge for many insurers who still have separate silo systems and no single view of the customer. The opportunity exists to significantly streamline and optimise processes by reducing duplicate data and reviewing business procedures on a continuous basis.

Models run on data but data comes from the business. Whilst all the details of Solvency II have not yet been clarified, it looks increasingly as though there will be transitional arrangements, and future changes as a result of practical operations. There is no time to waste in carrying out a review of data for its Solvency II appropriateness, its quality, its governance, its audit trail, and its integration covering the enterprise and beyond.

"Beyond" is the "outer office" of brokers, salesforces, MGAs (a growing channel globally), business partners, outsourcing/ offshoring, and the customer. It's important to remember that the customer's mindset is changing as insurance becomes a multi-electronic distribution world. All of these are relevant factors in measuring operational risk under Solvency II.

Meeting the minimal requirements of Solvency II compliance is mandatory. However, that does not guarantee that insurer's operations will place them in an ongoing competitive position. Data must be translated into actionable information and intelligence through the application of analytics so that an insurance company will be more agile in this ever-changing marketplace. Newer technologies will play an increasingly important role in this transformation.

The right combination of proven business, performance and predictive analytics, together with geographic information systems (GIS), can provide the differentiators. They can make your modelling more accurate, precise and timely, and enable quicker, better decision making to be distributed and securely delegated. Ordnance Survey have reported that GIS at present is under used in Solvency II projects in the UK market and could have a much higher impact potential. Half of those survey respondents say they do not have sufficient resources.

Business processing management (BPM) and business rules will also play a key part in continual streamlining of straight-through processing, new product development, and widening electronic distribution channels, leading up to, and following, Solvency II implementation.

Insurers also need to complement their own modelling and analytics by keeping up to date with global and local business and IT trends, regulatory moves, research and surveys, your competition, and by identifying possible acquisition targets in your chosen and potential markets.

As stated earlier, the Solvency II strategic challenge and opportunity requires the participation of a wide range of management to ensure a collective and enterprise view. Operational managers who are closer to the front lines have much to offer and will be rewarded with better, quicker intelligence for decision making if the opportunity of Solvency II is to be grasped.

Insurers will also need considerable assistance from trusted partners, whatever the insurer size, as skilled internal resources are thinly spread and sometimes not available. Pre-prepared solutions will get an insurance company through these transformative times much quicker and more cost-effectively.

The longer an insurer delays planning and prioritising, the greater the skills shortage will become when an accelerated plan needs to be deployed.

Choosing trusted partners is essential

Many insurers will look at the Solvency II strategic challenge (and opportunity) as a time versus cost issue.

The choice of trusted partners should be geared to achieving the initial timeframe in a cost-controlled way whilst assessing the benefits of a long term relationship, as Solvency II outcomes will be both business and market transforming.

There are an increasing number of point software and consultancy offerings across the Solvency II spectrum. Having too many partners requires more management and could result in a more complex, costly and delayed solution. While it's unlikely that any one partner will be able to provide all an insurer's requirements themselves, one of the key attributes will be a track record of working with other specialists and being able to effectively integrate solutions.

An insurer's main trusted partner should have a clear and detailed Solvency II strategy and solution that enables them to benefit in the short term through pre-packaging that can be quickly adjusted to suit a company's present and future positioning. Because of the strategic, ongoing implications of Solvency II, a trusted partner will also need to have an in-depth understanding of all aspects of life and non-life insurance globally. In particular, they should possess deep expertise in insurance management data requirements (specification, identification, cleansing and integration), along with regulatory and executive governance, and audit trails.

They should demonstrate a proven framework to transform data to intelligence through business, performance, and predictive analytics, and possess the necessary business process management and business rules expertise to enable the insurance company to continuously improve agility for superior differentiation. They should also be able to offer solutions for all sizes of insurers across all business and product lines. Actuarial, financial management and modelling expertise should also be offered by the partner or though a close working relationship with specialists.

The practical business and market aspects of future positioning and agility to achieve continual differentiation must not be lost in a sea of technical jargon. Now is the time to address the wider strategic business issues and opportunities. Involve management across the enterprise who know how the insurance company ticks, know what the strengths are, and where the insurer is going to be best placed in the future. An insurer's trusted partner should support them in these efforts and understand those long-term goals.

An insurance company's very existence could depend on bringing together the right blend of internal and external skills and solutions in a timely and cost effective fashion. Getting the time versus cost equation right on both counts could result in an ongoing win-win outcome. Insurers will not only master the new requirements of Solvency II, but also transform their core business so it is positioned to succeed in an ever-changing market.

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Suggested additional reading by the author

'Stay agile and stand out in changing insurance markets'
An IBM sponsored white paper – September 2009. A free copy can be downloaded at:
http://forms.cognos.com?elqPURLPage=3959&offid=wp_ins_shillito_uk&mc=-web_shillito

About the author

Douglas Shillito is a leading insurance business analyst and commentator.

After starting his career with Royal Insurance in a variety of management roles followed by a spell as a business consultant with a company of insurance systems analysts, he formed Shillito Market Intelligence in 1981, pioneering a number of newsletters, other publications and conferences on the strategic application of information technology to the insurance markets. He started Insurance Newslink in 1993 – the global structured internet database has now more than 34,000 articles.

He acts as chairman, facilitator, speaker and trainer at public and private events worldwide. In a consultancy capacity he has advised over 100 clients—market players and leading IT suppliers. He regularly writes sponsored white papers for major IT companies on the insurance markets and the business impact of IT.

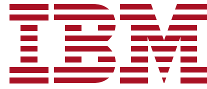
Douglas is a past vice president of the Chartered Insurance Institute, was a founder and past chairman of the CII Society of Fellows, and has been a judge at the British Insurance Awards, the Insurance Times Awards and School of Finance Innovation Awards. He is a member of the Geneva Association Communications Advisory Committee.

IBM Insurance Solvency II solution provides following key functional capabilities:

- **Risk Intelligence** – Includes CP58 / QRT reports, decision support reports, and configurable dashboards
- **Risk Analytics** – Includes integration capabilities for carrier-specific calculation engine
- **Operational Risk Management** – Includes own risk solvency assessment, loss events and risk indicators
- **Risk Data Management** – Includes business glossary, Solvency II data marts, Solvency II data warehouse, ETL (extract, transform, and load), data quality of source operational systems, and metadata management

Based on initial assessment, insurers can save around 40 percent of the time for the analysis/design/development lifecycle of a Solvency II solution by leveraging the Solvency II solution from IBM. (The exact ROI depends upon the specific solution components that are used by the customer as well as integration required with their existing application infrastructure.)

Further information is available at: ibm.com/insurance



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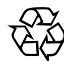

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