



# Executive summary

While much of the debate around Solvency II has been dominated by the major insurers, its effective adoption by small and medium sized life companies will be critical to its success. This report and the survey behind it, therefore, aim to give small and medium sized life companies an opportunity to voice their opinions on Solvency II.

Between December 2008 and February 2009, we asked actuarial function holders, chief risk officers, CEOs and other senior management at 41 small to medium sized life insurance companies about their preparations for Solvency II, and 17 firms responded. The survey population included mutual insurers, friendly societies and UK branches of global (re)insurers.

## Key messages

The principles enshrined in Solvency II make good business sense. They are about improving the way that firms assess risk and deploy capital accordingly. If firms can express this assessment in the form of management information that supports strategic decision-making, they will derive value from the exercise, as well as meeting regulatory requirements.

In order to benefit from Solvency II we would encourage small and medium sized firms, that have not already done so, to:

- develop robust, timetabled plans for the implementation of Solvency II, based on the requirements of the directive and their business needs
- consider completing QIS4 as this provides an effective starting point in helping firms to consider the potential impact of Solvency II on their Solvency Capital Ratio (SCR)
- focus on integrating their risk and capital management arrangements into the day-to-day running of their business
- give careful consideration as to how best to integrate their risk and actuarial functions
- make a decision about the internal model as soon as possible
- take a pragmatic and proportional approach to Solvency II, being particularly mindful of the possibility of adopting a partial model.

# The case for Solvency II

By embracing the principles enshrined in Solvency II, insurers will be in a position to produce information that will:

- allow them to allocate capital more efficiently
- support strategic decision-making
- allow them to hold levels of regulatory capital that reflect their true risk profile
- ultimately help them to enhance performance.

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are about improving the way that firms assess risk and deploy capital accordingly. If firms can express this assessment in the form of management information that supports strategic decision-making, they will derive value from the exercise, as well as meeting regulatory requirements.

If Solvency II is seen in this light and key decision-makers are consulted on their needs information-wise, the directive can help firms to run their business better.



# Preparations for Solvency II

In order to benefit from Solvency II in the way that we suggest firms can, it is essential that they prepare properly for it. Firms that are able to embrace the principles of Solvency II early, in a way that enhances the information required by key decision-makers, are more likely to benefit from it than those that do not.

## Overview of preparations

Of the firms surveyed, 35% believe they have appropriate plans in place to deliver

Solvency II (Fig. 1). The remaining 65% are aware of the directive, but have not yet started to engage with it at a detailed level and plan accordingly.

Although 35% responded that they have appropriate plans in place, 59% of all respondents have no committee to oversee the transition to Solvency II and only 6% have a timetabled implementation plan (Figs. 2 and 3).

## Responsibility for preparing for Solvency II

The vast majority of firms (84%) have appointed a senior individual to take responsibility for the implementation of Solvency II (Fig. 4). The most popular choice is the finance director (42%). There is therefore engagement in Solvency II at the highest level in these firms, along with those that have appointed the CEO (11%). This is encouraging given the firm-wide, strategic nature of the directive.

The question of who is most appropriate to oversee the implementation of Solvency II will vary from firm to firm, but the individual should:

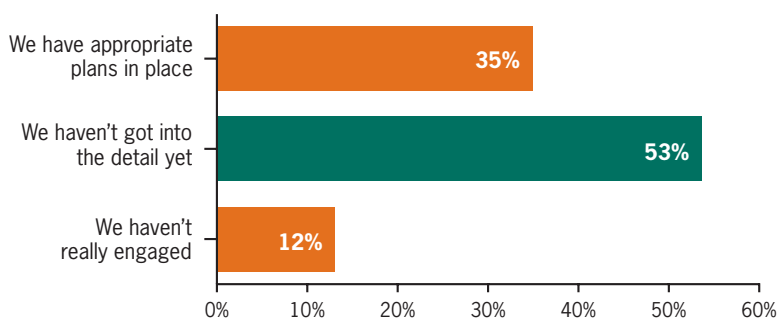
- have the support of the board
- be able to draw on technical and other support as necessary
- be able to access appropriate resources to implement Solvency II.

## Constraints in preparing for Solvency II

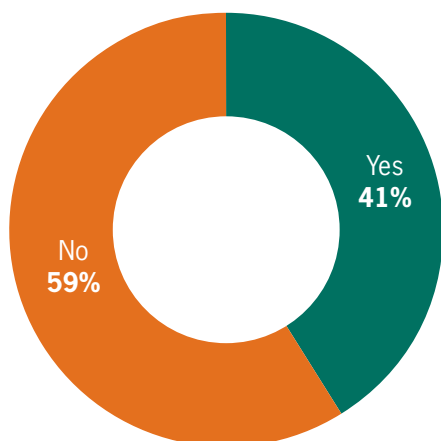
The two main constraints identified in our survey are that firms are awaiting further clarification as to the precise nature of the directive (48%) and that they lack resource to start work on the directive (38%) (Fig. 5).

It is perhaps unsurprising that these are the two main constraints, as in many cases, small and medium sized life insurers have been less engaged in the development of Solvency II than, and do not have the same levels of resource for such projects as, larger life insurers.

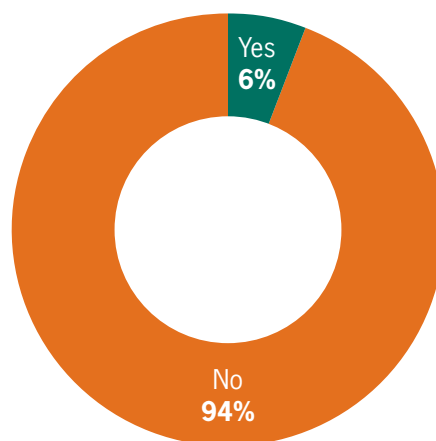
**Fig. 1 – How prepared are you for Solvency II?**



**Fig. 2 – Have you set up a committee to oversee the transition to Solvency II?**



**Fig. 3 – Have you put together a timetabled implementation plan to ensure effective delivery of Solvency II?**



“Any firm serious about gaining maximum benefit from the directive must develop robust, timetabled plans for Solvency II, based on a gap analysis between its current status and the requirements of the directive, bearing in mind the needs of the business.”

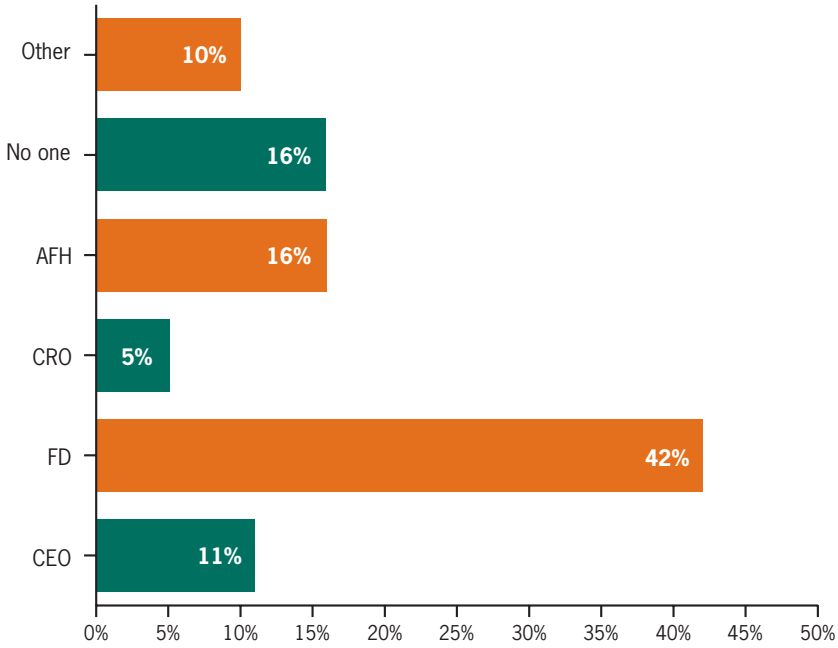
Until the directive has been finalised and further guidance on Solvency II has been released, there will always be an element of uncertainty about what the legislation will involve at a detailed level. Also, the current economic climate adds to the perennial pressure on resource.

The principles at stake, however, are now clear and if firms want to benefit from them in full, they will do so sooner if they start planning now.

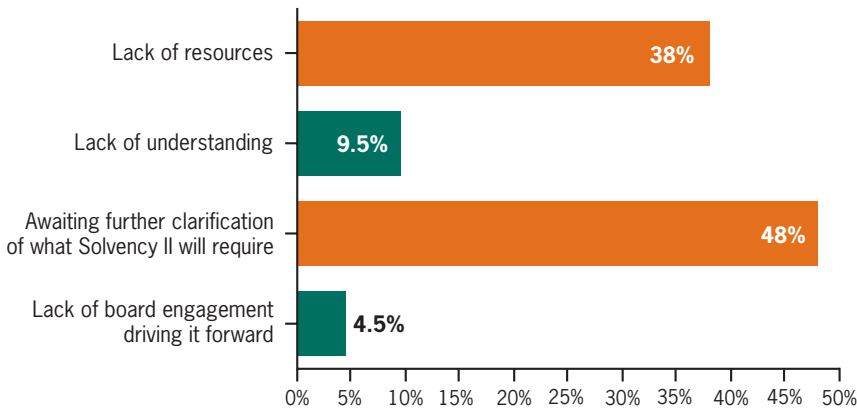
One of the key decisions that firms will have to make in relation to Solvency II is to determine how to calculate their SCR. The FSA has recommended that all firms should complete QIS4 as a means of supporting this decision. Of our respondents, 82% had completed and submitted QIS4, or planned to within the next six months; 18% had no plans to do so.

“Completing QIS4 provides an effective starting point in helping firms to consider the potential impact of Solvency II on their SCR.”

**Fig. 4 – Which board, or other senior management member, have you appointed to take responsibility for ensuring effective delivery of Solvency II?**



**Fig. 5 – What are the main constraints to your Solvency II preparation?**



# Integrating the Own Risk and Solvency Assessment (ORSA)

The ORSA is the engine of Solvency II: it will provide the information that we believe will help firms to run their businesses better. Key to the success of the assessment will be integrating it into firms' strategic decision making.

## Degree of integration

To understand how well risk and capital management processes are embedded within firms, as a means of assessing readiness for the ORSA, we asked firms what were their most significant shortcomings in their current Individual Capital Assessment (ICA) process that should be resolved in order to meet the requirements of the ORSA. More than one option could be selected.

Over half (53%) of respondents said the ICA is not fully embedded in making decisions (Fig. 6).

We also asked firms if they use risk appetite statements to make decisions. Overwhelmingly, 77% of firms said "not as much as we would like".

Both these responses suggest that there is work for firms to do in relation to the integration of their risk and capital management arrangements in order to obtain the full benefits of Solvency II. Understandably, much of the focus has been on the issue of the internal model. However, embedding risk and capital management arrangements is vital if firms are to gain from Solvency II.

**"There are clear advantages to integrating risk and capital management arrangements into the day to day running of the business."**

## Functional structure

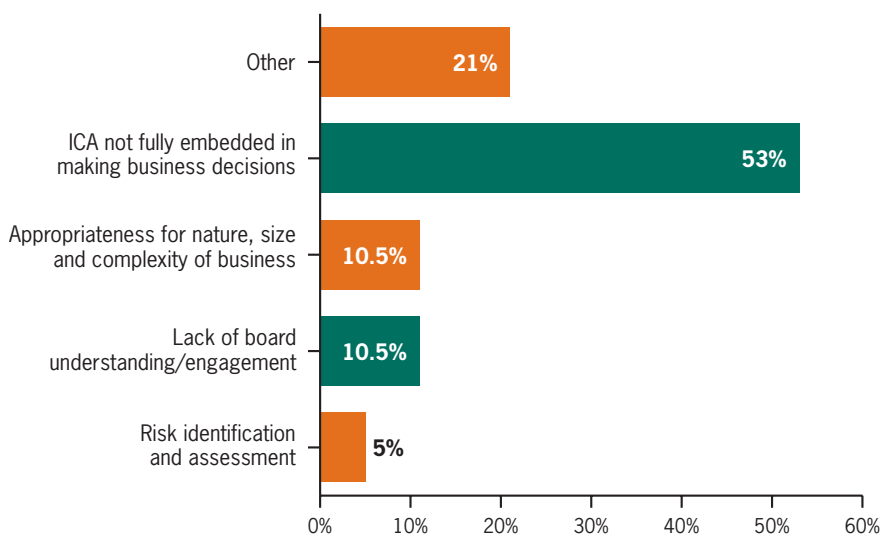
We asked firms to rate the degree of integration between their risk and actuarial functions. All respondents scored themselves as having some degree of integration, but none scored as fully integrated (Fig. 7).

The degree to which risk and actuarial functions are integrated will be critical to the success of Solvency II. Firms should consider carefully the

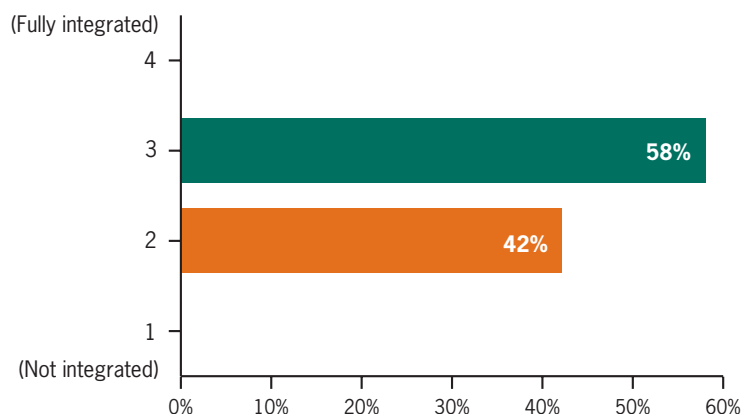
most effective structure for these functions, taking into account their relationship with other functions such as finance, compliance and internal audit.

**"Firms should give careful consideration as to how best to integrate their risk and actuarial functions."**

**Fig. 6 – What are the significant shortcomings in your ICA process that you need to resolve to comply with the ORSA?**



**Fig. 7 – How would you rate the integration between your actuarial and risk functions (1-4)?**



# Model considerations

Solvency II presents firms with the choice of calculating the SCR using a standard formula or approved internal model (full or partial). The key benefit of the standard formula is the simplicity of the approach compared to the development effort required to implement an approved internal model. However, developing an internal model has far reaching benefits in terms of quantifying the risks underlying the business and using this information to make better decisions.

## Internal model intentions

The majority of firms (65%) have not taken a view yet as to whether they intend to use an internal model to calculate their capital requirements (Fig. 8).

Firms are required to inform the FSA as to whether or not they intend to develop an internal model to calculate the SCR. Firms will then enter a period of engagement with the FSA during which the internal model will be developed and dry-runs will be carried out, culminating in an approved internal

model that is fit for purpose under the Solvency II regime.

## Standard formula choice

We asked firms if they were to choose the standard formula, why this would be. There is a perception that the internal model is too onerous (39%) or expensive (17%) (Fig. 9).

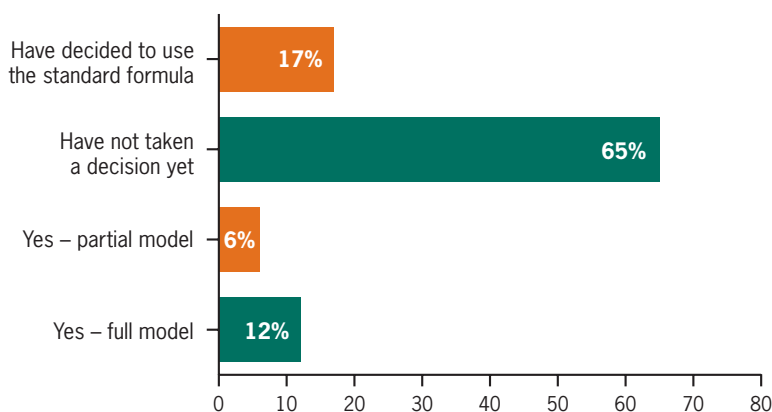
However, when asked for possible reasons to consider using an internal model, 33% of firms believe that the internal model is a better reflection of the business dynamics, capital and risks. Therefore many small and medium sized life companies appear to believe that the costs do not justify the benefits.

Firms may be able to square this circle by adopting a partial internal model. This has proved a common choice for many small and medium sized European firms: 63% of the companies that completed the QIS4 exercise in 2008 intend to adopt a partial model. Only 6% of our respondents have chosen to use the partial model approach.

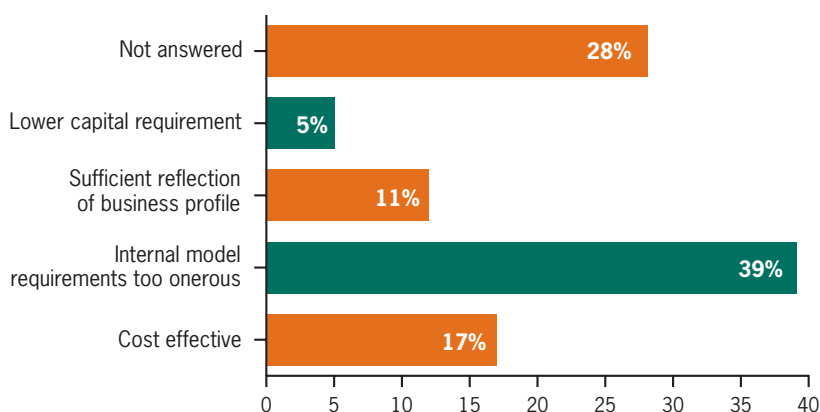
The use of a partial model will be a pragmatic response for many small and medium sized life insurers, allowing them to gain many of the benefits of an internal model without taking on the developmental burden of a full model. This would be consistent with the principle of proportionality, which is central to Solvency II.

**“We would encourage firms to make a decision on the internal model as soon as possible to ensure that they are able to maximise this opportunity to engage with the FSA whilst developing their internal model.”**

**Fig. 8 – Are you intending to use an internal model to calculate the SCR for your firm?**



**Fig. 9 – List the main reasons for choosing to use the standard formula?**



**“We recommend that firms are particularly mindful of the possibility of adopting a partial model, as this may represent a pragmatic and proportionate approach to the calculation of the SCR.”**

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