Solvency II: Threat or Opportunity?

An executive perspective

Dale Vile and Jon Collins

Freeform Dynamics Ltd

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The study upon which this report is based was independently designed and executed by Freeform Dynamics. Feedback was gathered from 100 Business and IT representatives of UK insurance firms during April/May 2010. The study was sponsored by SunGard.

Introduction

The emergence of new regulation always presents a dilemma, particularly when considered against the background of other, often-conflicting priorities for resources and investment. On the one hand you can respond to the immediate need, absorb the cost of compliance, and have done with it. This often translates to finance and operations staff simply implementing tactical changes to the way business activities are recorded and reported, minimising the impact on core systems and processes.

The alternative approach is to take a more strategic view, and address new compliance requirements in a more fundamental manner that leads to incremental refinement of core policies, systems and processes. While this may initially cost more, responding in this way is more likely to have a cumulative positive effect on efficiency and effectiveness, while avoiding the need to continually reinvent the wheel when it comes to new regulation.

Whichever way you have leaned in the past when faced with such choices, there is an event on the horizon that is likely to force your hand. In 2012, insurance firms in the European Union (EU) will be expected to demonstrate compliance with Solvency II. This new set of regulations changes the game by demanding a more fundamental approach. Transparency of how the company is directed and managed at the highest level is mandated, with a need for executives to demonstrate that certain principles of risk and capital adequacy have been worked into the review and decision-making fabric of the business from top to bottom.

Some might take this as a huge imposition, but the move is not surprising given that so many high profile issues in the financial services industry as a whole have been tracked back to board level behaviour and decisions. And while Solvency II was conceived before the most recent global economic crisis, the broad media coverage of risk related issues that underpinned the 2008 crash has put even more of a spotlight on industry regulation.

On a more positive note, however, while board members in some organisations may have mixed feelings about being forced into the root-and-branch treatment advocated by Solvency II, it is possible to view it as an opportunity to benefit from an overdue shake-up of business practices.

But how much have executives thought through all this, and how prepared are they and their management teams to deal with implementing Solvency II in the most efficient and effective manner? These are the questions we are concerned with in the remainder of this paper, with reference to a recent research study (Appendix A) which provides a flavour of the kinds of sentiment and activity that exist.

Before getting into this, however, let's just recap on some Solvency II basics.

Solvency II in a nutshell

Underlying Solvency II is a set of principles aimed at ensuring that matters of risk are fully and appropriately taken into account during the running of an insurance business, and that risk is properly and transparently considered when determining capital requirements.

In terms of specifics, Solvency II is based on the notion of three 'pillars' as follows:

The three pillars of Solvency II	
Pillar 1: **Quantitative requirements**	Concerned with the financial and operational models and metrics that underpin core business activity
Pillar 2: **Supervisory review**	Concerned with the governance and risk management framework for ensuring adherence to key principles
Pillar 3: **Disclosure requirements**	Concerned with the reporting requirements needed to provide adequate external visibility and transparency

This is a very high level summary and more in-depth information is available from the European Commission website (http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm) as well as a variety of other sources. Suffice it to say, however, that there is a quantitative modelling dimension, a governance and risk management dimension, and a reporting dimension to Solvency II, and all of these must be adequately taken care of to ensure compliance.

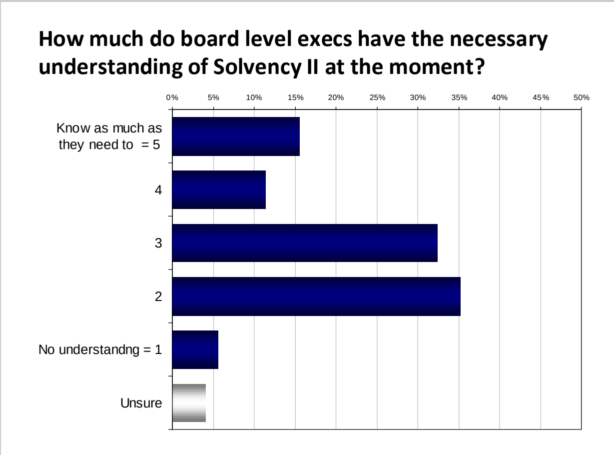
The snag right now though is getting a firm handle on what 'adequately' actually translates to as Solvency II does not seek to be prescriptive on mechanics; it simply outlines the principles that must be applied. Furthermore, Solvency II is still a work in progress, so requirements and expectations remain fluid to a degree at the moment. Having said this, the meat of the principles has been defined well enough for most insurance companies to make a reasonable assessment of the likely impact on their business, and to start much of the preparation work that will be necessary for ultimate compliance.

But coming back to our key questions, where are organisations and the executives that run them at the moment in terms of readiness?

Starting at the top

For many organisations, Solvency II is likely to translate to a significant change in working practices, and as with all change programmes, success will be dependent on executive commitment. Without this, initiatives are likely to be starved of the necessary resources and funding, and the potential to generate strategic level benefit is unlikely to be realised.

Put this together with the fundamental nature of Solvency II outlined above, and the finite amount of time organisations have to act, and it would be reasonable to expect most insurance company executives to be up to speed in this area. When 100 IT and business professionals involved in one way or another with Solvency II related activity were asked about executive level readiness in their organisation, however, it became clear that this is not always the case. In fact on a scale of 1 to 5, the majority of executives were only regarded as being at level 3 or below in terms of them having so far acquired the necessary level of understanding, with over a third reportedly still not making it beyond level 2 (Figure 1).

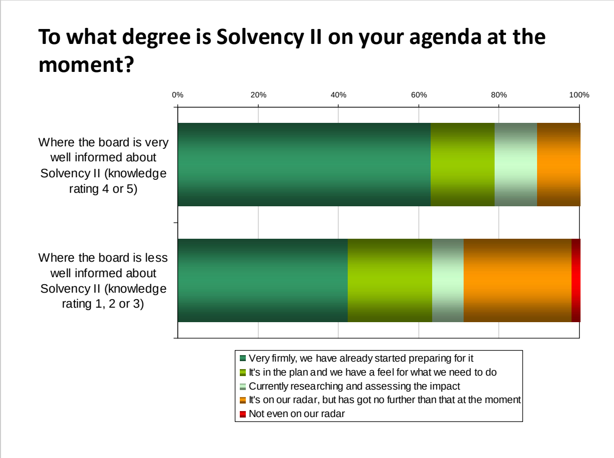


While just over a quarter of senior executives are reported to be pretty well informed, the majority have limited or poor understanding of Solvency II at the moment.

Figure 1

Data like this is useful because it reflects the views of those in the organisation who are involved in evaluating the impact and practicalities of Solvency II from an operational perspective. These employees are in a good position to assess how well senior management is able to enter into an informed and objective discussion of priorities and requirements. Such dialogue is clearly an important prerequisite for putting the necessary plans in place and making sure initiatives are properly supported and have the right level of air cover.

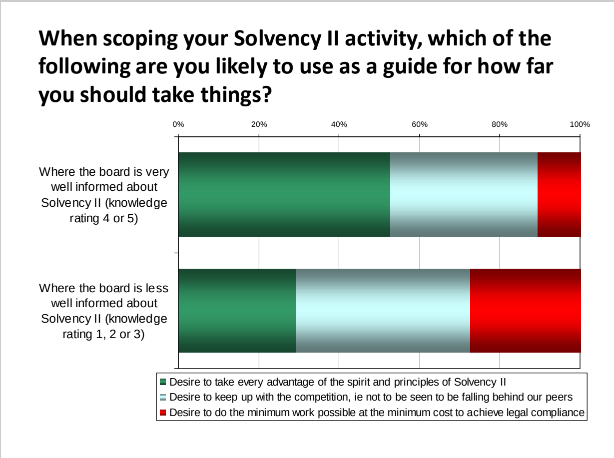
There is, however, the principle of 'ignorance is bliss' to consider. The danger is that executives with a limited understanding of the nature of Solvency II and the aspects of the business it will touch will be more likely to put off action. Indeed, there is evidence of this happening already, e.g. while it is encouraging that overall around half of those participating in our study say they have made a start on implementation, we see a significantly lower level of activity in situations where senior management is less well informed (Figure 2).



Overall, around half of organisations indicate that a start has been made on implementation of Solvency II, but the level of activity is higher where senior management is better informed.

Figure 2

The other important observation we can make is the relationship between executive understanding and the spirit and objectives associated with Solvency II activity (Figure 3).



Where executives are better informed, a more positive and proactive approach to Solvency II implementation is likely to be taken.

Figure 3

As we can see, some organisations are taking a very positive and proactive view, looking to take every advantage of the spirit and principles of Solvency II for the reasons we outlined earlier. Meanwhile, others just want to keep up with the competition. Finally there remains a significant minority in which the intention is to do the minimum possible to achieve compliance.

The danger with the latter perspective, which the research shows is more likely to be associated with executive ignorance, is that Solvency II implementation work becomes simply about cost management. This not only risks corner cutting and the potential regulatory exposure that comes with it, but it is also indicative of a fundamental misunderstanding of what Solvency II represents, not least how it is different from the majority of regulation that has hit the insurance industry in the past. Even those simply wishing to keep up with the competition are exhibiting a defensive or conservative rather than progressive mindset, the upshot of which is likely to be a poor return on investment from Solvency II related change initiatives, which is essentially a wasted opportunity.

The picture we see highlights the wide variation in attitudes to Solvency II, and how this is related to knowledge and awareness, but we must obviously be careful about making simplistic assumptions about causality. It could be, for example, that where management is well informed, it is not because they have taken the lead, but because they are responding to others in the business who have done the initial ground work.

Another interesting situation, which is clearly occurring in some organisations, is the one in which subordinates are seizing the initiative and moving forward progressively despite the relative lack of well-informed air cover. The danger with this last approach is that delays and roadblocks can occur if resource or budget intensive activities emerge that require the next level of commitment and buy-in from the board. In practical terms, the outcome of discussions in such scenarios will be dependent on the mandate provided to those in the business, which raises the topic of delegation.

Playing the delegation game

Few executives would attempt to plead ignorance on the matter of the board being ultimately responsible for Solvency II compliance. When it comes to the detail of implementation, however, much of the activity will need to be delegated to specialists within the business and/or those responsible for running specific aspects of business operations. But to what degree can responsibility for the overall change programme itself be delegated, and what are the consequences of this?

When we look at who is overseeing activity, the most prominent figure that emerges is the individual responsible for corporate risk management (Figure 4).

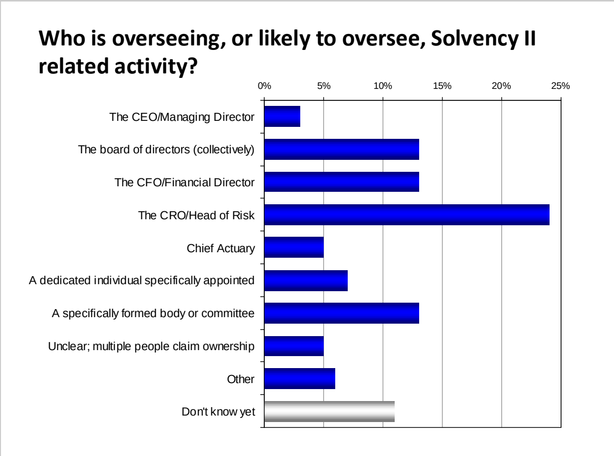


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Figure 4

This association with risk management is natural given that working risk assessment into business management and operations is a fundamental part of Solvency II. Whether putting such emphasis on the risk dimension is the most sensible way forward is something we'll look at more closely in a minute. In the meantime, it is telling that where the board maintains direct control of activity, the organisation is almost twice as likely to be taking a progressive view of Solvency II implementation (Figure 5).

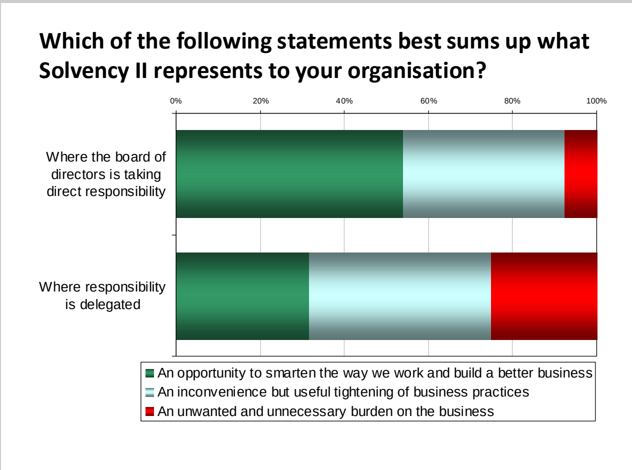

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Figure 5

The reference to smartening the way the organisation works and building a better business that we see on this chart is indicative not just of a progressive view of Solvency II, but also a more rounded or holistic one, acknowledging the need to think across the three dimensions of finance, operations and risk simultaneously. This is something worth looking at a little more closely.

Balancing the perspectives

Effective risk management may be at the centre of the rationale for Solvency II, but risk matters cannot be considered in isolation.

Firstly, putting measures in place to manage different aspects of business risk effectively will often have operational consequences. Business processes and the systems that support them may need to be adjusted or even completely re-engineered to deal with new or modified risk requirements, impacting multiple parts of the organisation including finance, IT and, of course, the actuarial function. Solvency II implementation is therefore likely to translate to significant disruption, which ironically creates a whole set of new risks around the execution and management of the change itself that needs to be understood and taken care of.

Secondly, enhancements to the risk management regime will almost certainly have financial implications. Implementation and management of the change and disruption we have just referred to will obviously have a cost associated with it. And depending on the gap between where processes and systems are today and where they need to be, this cost could be very substantial. Beyond this, any introduction of a new way of working will then have an impact on the cost and effectiveness of ongoing business process execution. There will be situations, for example, in which additional overhead is incurred, which could have a tangible impact on margins. Of course, approached intelligently and with the right spirit, the reverse could also be true. Taking steps to better integrate information systems, for example, might not only deal with the immediate Solvency II requirement, but also have positive operational spin-offs in general.

Against this background, it makes little sense to take a checklist approach to Solvency II compliance, without due consideration of the dependencies and trade-offs, and the opportunities for offsetting short term implementation costs against longer term benefits that stem from a more proactive and holistically managed change programme.

With this multi-dimensional view of Solvency II in mind, we would expect a broad range of roles to be involved in defining requirements and making decisions, and this is confirmed by the research findings (Figure 6).

A broad range of roles are involved in defining requirements and making decisions.

Figure 6

Again, we see the delegation game in play if we compare the degree to which board level executives are involved in requirements definition versus decision making on implementation specifics. This is fine if it is a case of managing different levels of granularity from a requirements perspective, but if it's more a case of kicking the entire problem down the management hierarchy and taking a rubber stamp approach to approval, then that's clearly an issue given the nature of Solvency II. At the very least there is a need for executives to be involved in the definition of performance and risk indicators, and the metrics that underpin them – not necessarily at a mathematical and statistical modelling level, but at least in terms of the business rationale. This is not something that can be safely delegated blindly.

Another key observation from this last chart is the relative prominence of the financial and risk management roles. While we don't see much difference from a requirements definition perspective, which makes sense given the need to consider multiple dimensions, the financial card clearly trumps the risk card in most cases when it comes to decision making. At one level this is understandable, as there is no point in implementing extreme risk management measures if the cost or performance impact is going to lead to financial difficulty or significant competitive disadvantage. It is important, however, not to let tactical financial considerations override strategic risk management decisions.

Indeed, the same warning could be issued with regard to operational input from the actuarial and IT functions. In both these contexts if tactical cost related pressures lead to process or system level workarounds being implemented, rather than re-engineering or re-architecting where it's really necessary, short term compliance may be achieved, but the shortcuts are likely to come back to bite down the line, with longer term risk, cost and performance implications.

Given the high stakes and importance of making sure all appropriate angles are covered and balanced as we have discussed, it is important that the various stakeholders and advisors are properly prepared so they contribute in an objective and informed manner. When we look overall, however, we see that a lot of knowledge gaps currently exist, with two important groups standing out as being particularly weak – the executives as previous discussed, and the IT department (Figure 7).

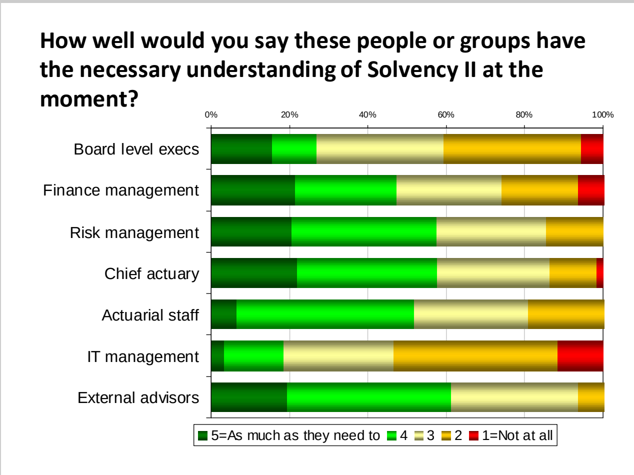

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Figure 7

Given that the insurance business is so information intensive, and the information involved is largely held in electronic format, the lack of preparedness of IT is particularly concerning. While a lot of the work associated with Solvency II will be policy and process related, there is no getting away from the fact that information management and systems integration are going to figure prominently in the detailed work plan. Involving the IT function early in the process could have significant benefits, as they will be aware of not just the practical aspects of modifying the existing systems infrastructure, but also the technology options available in the market that could ease implementation of the necessary operational changes at a business level. In information management in particular, it is worth bearing in mind that from an IT perspective, things that were considered impractical or cost prohibitive even a few years ago can nowadays be achieved efficiently and economically.

Conclusions

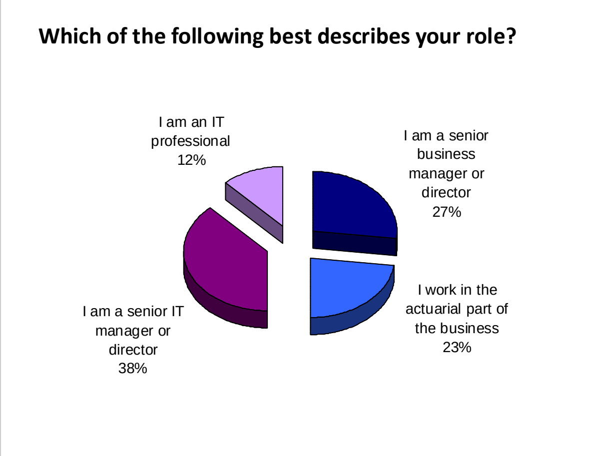
From the considerations and research findings outlined in this paper, it should be evident that dealing with Solvency II in the most appropriate manner in your business environment is something that is worthy of serious management time and attention. Sure, you can elect to take a minimalist approach, but the chances are that you will not only incur significant short term cost for little or no business benefit, but also have to revisit the question of Solvency II compliance at some point down the line.

With a more proactive and holistic executive driven approach, however, the Solvency II imperative can be thought of as an opportunity to achieve significant positive change that will deliver long term benefits to the organisation. With the necessary re-engineering, integration and optimisation of business processes and support systems, however, the strategic payback is there for the taking. But it all starts with executive commitment coupled with the right mindset and attitude.

We hope the material in this paper helps you optimise your approach to Solvency II implementation.

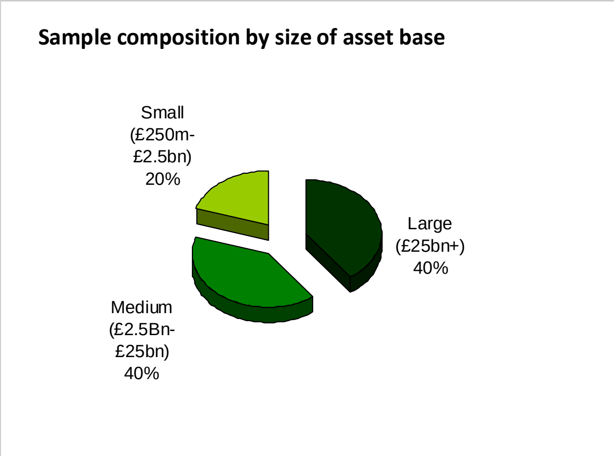
Appendix A – Research Sample

The charts presented in this report were derived from a research study completed in May 2010, during which feedback was gathered from 100 Business and IT representatives of UK insurance firms. The makeup of the sample was as follows:



All respondents were qualified into the study on the basis of their ability and willingness to discuss the implementation of Solvency II in their organisation.

Figure 8



The sample was composed of a range of organisation sizes, with an emphasis on medium and large insurance companies.

Figure 9

All design, execution, analysis and reporting were conducted on an independent basis by Freeform Dynamics Ltd. The study was sponsored by SunGard.

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