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Unwinding the insurance industry's regulatory requirements

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Regulatory forum

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The path to compliance

Regulatory scrutiny continues to intensify within the insurance industry – according to some industry estimates, risk managers must now be able to track as many as 50 pieces of current or proposed legislation at any one time. While some requirements, such as data protection initiatives, have been designed with a more general audience in mind, others are aimed directly at the insurance industry. One such example is the European Union's Solvency II directive, which was designed to harmonise European insurance regulations, focusing primarily on strengthening capital requirements to reduce the risk of insurer insolvency. Pillar 3 of the Solvency II framework places considerable reporting requirements on insurers to provide risk and solvency assessments, as well as details of risk governance procedures. As a result, insurers must make significant investments to strengthen data management on an enterprise-wide basis. However, this is easier said than done amid current market pressures such as the low interest rate environment and growing competition from tech-focused start-ups.

In this forum, convened by *Insurance Risk* in association with *Risk.net* and supported by BearingPoint, a panel of experts provides insight on how to address the new regulatory landscape, and how insurance firms are approaching reporting and risk management in the wider context of current market conditions. What are the best tools and strategies for compliance purposes in this new regulatory era? And how do national supervisors interpret Solvency II in relation to key issues such as volatility adjustment, the treatment of sovereign bonds and credit and longevity risk?

As organisations make the significant investments that are necessary to update and strengthen data management infrastructure for compliance purposes, these changes can and should be leveraged to derive internal value for the organisation as well. The wealth of information that must now be produced to satisfy regulators can be repackaged and disseminated internally to improve analytical capabilities on an enterprise-wide basis.

To benefit from the changing regulatory picture in this way, however, it is not enough to simply implement a new technology solution. Any new organisational infrastructure must be underpinned by robust governance processes to ensure that only quality data is used and that internal resources are fully optimised. By taking such an approach, insurers can start to refocus, developing strategies that will lead to more sustainable growth and facing up to changing market conditions now and in the future.

Anne Leslie-Bini
Director, RegTech Solutions
BearingPoint

How has the insurance industry been impacted by the current regulatory environment?

Anne Leslie-Bini, BearingPoint: The insurance industry is currently grappling with a volatile regulatory environment, compounded by challenging economic and competitive conditions: just when firms were breathing a minor sigh of relief after the go-live of Solvency II, along came Brexit. Then there's the ongoing search for yield in the presence of low and negative interest rates, which is creating untold pressure. And, if that wasn't enough, traditional insurance players are feeling added discomfort coming from disruptive and agile start-ups of the 'insurtech' type that are challenging industry fundamentals. Incumbents have been so preoccupied by regulatory and economic constraints that they may, in spite of themselves, have been somewhat distracted from driving the transformation of their own businesses.

Staying relevant and competitive means finding a compelling value proposition and an economically viable business model, which, in these conditions, is no mean feat. More than ever, insurers need to understand changing customer habits and focus on ensuring that the product and service offering they are delivering to customers – and how they are delivering it – is fully aligned with what customers are looking for.

Solvency II has long been at the forefront of insurers' preoccupations. At its core, the directive is designed to make the insurance sector more robust in order to protect policyholders. However, one could perhaps contend that insurers have been so preoccupied with the nitty-gritty of implementing the three pillars of Solvency II that their customers – the same policyholders that Solvency II aims to protect – have been somewhat forgotten. In this hostile economic and regulatory environment, traditional insurers may have taken their eye off the ball in terms of staying focused on their customers' evolving needs, which is why the competitive pressure from insurtechs is now being felt.

After all the effort and investment that went into Solvency II compliance, there now needs to be a period of stabilisation and refocusing: on delivering a compelling offering to policyholders that is economically viable for the insurer and desirable in the eyes of the customer.

Erik Vynckier, Foresters Friendly Society: Recently, a large number of regulations have impacted on the insurance sector: the European insurance capital standard, Solvency II, the clearing obligation enforced by the European Market Infrastructure Regulation (EMIR), and the pending Packaged Retail and Insurance-based Investment Products (PRIIPS) regulation, which transparently maps out terms and conditions – including hidden costs and miscellaneous fees – of insurance investment wrappers in a format appealing to consumers.

Further initiatives are not aimed directly at insurers but still interact with the insurance investment function. Basel III applies to banks, the main trading counterparties of insurers; the Markets in Financial Instruments Directive II (MiFID II) from 2018 will replace the original MiFID, and adds pre- and post-trade transparency, best-execution and trade reporting obligations to any investment activity. Finally, the very broadly aimed General Data Protection Regulation, covering data protection and cyber security, is of acute interest to the insurance world.

While most firms are still perfecting their approach to – and their internal strategic use of – Solvency II, the sector is alerted by the prospect of international capital standards and, for the larger and more complex insurance groups, systemic capital add-ons. Getting agreement between the US and the EU on harmonised international capital standards announces itself as a very difficult project, given the very disparate regulatory philosophies on opposite sides of the Atlantic.

Tom Wilson, Allianz Group: The regulatory environment has impacted insurers in many areas. First, there continues to be uncertainty with regard to key capital regime issues – for example, the recent changes to the volatility adjuster in Solvency II and the risk-based capital rules from the National Association of Insurance Commissioners – which impact capital planning and risk management decisions. Second, regulatory developments, including Solvency II and financial conduct, are also influencing the underlying business models of insurers, especially for long-term life savings products. These impacts are exacerbated by the current political and market uncertainty, especially in Europe.

Roger Dix
Chief risk officer
Wesleyan Assurance Society

Roger Dix, Wesleyan Assurance Society: It depends on whether one's view of the world is of the glass being half-full or half-empty. In half-full mode, the needs and outcomes specified by the regulatory environment are delivered by all the proactive enterprise risk management (ERM)-related work performed by companies in any case, and merely provides an external confirmation of the approach taken. In glass half-empty mode, the regulatory environment has obliged us to deliver a large amount of work, much of which feels over the top and gold-plated. In reality, the position is somewhere between the two, with the regulations providing us with a clear standard on which to deliver, and enabling funding for the project to be provided. At the edges, some of the requirements appear gold-plated and of no immediate value to the organisation, although over time our view might change.

Jérôme Berset, Zurich Insurance Group: Regulatory scrutiny has increased and is expected to increase further in the coming years. In terms of prudential regulation, the trend is towards more principles, more economic valuation, more risk-based capital requirements and, hopefully, more focus on considering groups in their entirety. This is also accompanied by more costs, in the form of IT investments, project execution, resources and management's attention. The question is, therefore: where will the regulatory demands stop? The Swiss Insurance Association recently raised awareness around the risk of the increasing cost of regulation – increased regulatory requirements come with higher overall costs for the insurance companies to deliver insurance protection. As these higher costs must be covered, this will lead to a tendency to higher premium rates, which in turn – as with every price increase, while everything else remains unchanged – will reduce demand for such services and result in less risk being transferred from customers to the insurance industry. If the risk, which now remains to a larger extent with the customers, is highly significant or essential – imagine, for example, longevity risk in the context of retirement – it may trigger political pressure on governments to take over those risks through their social protection, possibly when public households are already financially stressed and unable to take on additional liabilities.

Alberto Corinti, Ivass: The governance of companies has certainly been impacted because the implementation of Solvency II requires significant changes in technology, human skills and processes. It changes the way in which the insurance company needs to meet the supervisory requirement, and the way the supervisor has to actually supervise the insurance company.

The governance of the company has changed because now the risks taken by an organisation become the focus of regulation, moving from a strict compliance approach to a proportionate application of principles. Based on our experience up to now, we think companies are moving in the right direction. It is a long process, so there is clearly room for improvement, but we are urging the companies to put these governance changes in place.

We should avoid, however, transforming the good incentives of Solvency II into burdensome administrative compliance. We do not want the board, for example, to perceive the new regulations as its sole or main task. The board should obviously take care of the business, but taking regulation – and therefore risk implications – into due consideration. From a governance point of view, we would like to see this regulatory framework drive the governance of the company, but not dominate it.

The introduction of Solvency II did not have a disruptive impact on the level of solvency of Italian insurers taken as a whole. The move towards Solvency II has been quite soft and, other than a few situations that were quickly addressed, this move has not revealed any shortage in terms of capital. Arguably, even in light of this soft impact, the sensitivity and the consequent volatility of the solvency ratio is new and important; we are going to monitor it, in order to interpret any early signal on the solvency situation of the companies. Also, the reliability of the companies' calculations of the Solvency ratio deserves particular attention in this first phase of application, and we are working diligently to review it.

So far, Solvency II has not impacted so much the way in which insurance companies invest. Certainly the approach to investment is more influenced by the low interest-rate scenario and the general economic scenario rather than by the regulatory framework. Investment behaviour has not changed yet, at least not in Italy.

The application of Solvency II has made it more difficult for the company to carry out activities that absorb too much capital. As expected, in life insurance we have seen concrete signals of a shift towards unit-linked products, at least in 2015; early 2016 figures are less evident mainly due to the experienced volatility in the stock market. Anyway, we are aware that transforming all product features in linked products would make the insurance activity very similar to asset management contracts, and the nature and advantages of the insurance process would be disregarded. To this end, we are committed to working with the industry in order for it to design products that find the right balance between the capital absorption and the value for the insurers and the insured.

How has risk management's role evolved to keep up with the increasing regulatory burden?

Roger Dix: Many years ago, when regulatory interventions could be counted on one's fingers, each business adopted an almost bespoke process. Today, we have an almost industrial process, given that my regulatory team are tracking upwards of 50 pieces of actual or proposed legislation. This increase has forced us to consider our role and, more relevantly, what our internal customers require from us.

As a team we provide foresight, insight and oversight. Our response to regulation follows this approach. When regulations are initially suggested or proposed, we provide foresight – advising impacted areas of the possibility of regulation in their space – and working with them to identify key issues for us. Once something firmer is published, we review in detail, provide insight – via a summary of what is expected and what is not – and work with the business to deliver a compliant solution. Once the regulations are in force, we provide oversight, generally via formal monitoring activity or compliance.

Jérôme Berset: As a critical function, risk management has a prominent role to play under both Swiss and EU regulation. However, it is more important to recognise risk management as an activity that is part of the insurance industry's DNA. Cecilia Reyes, Zurich's group chief risk officer, says: "We are in the business of taking risks. Therefore, Zurich's profits and losses should be a direct result of its deliberate risk-taking decisions. At Zurich, everybody has a role in practising sound risk management and thus every employee contributes to its success. Our mission as the risk management function is to enhance the value of our group by embedding disciplined risk-taking in its culture, where risk/reward trade-offs are transparent, understood and risks are appropriately rewarded."

One proof of the value of risk management is the strengthening of the connection between business strategy and risk-taking through an agreed risk appetite, within which business can pursue opportunities, and which is at the heart of the Own Risk and Solvency Assessment (ORSA). In the ORSA, for example, regulation meets value creation for the company.

As a function, the key word for risk management is 'agility': risk management must become agile in managing rapidly evolving risk regulatory frameworks that affect the design of the ERM. Risk management must also engage actively with the regulators to provide an industry perspective on risk.

Alberto Corinti: Risk management has evolved significantly with the introduction of Solvency II, and the regulatory changes should not be considered only as a burden. If the new approach means that risk consideration is embedded in the wider company organisation, it should be considered more an investment than a cost.

So far, the experience we have is positive with regard to the risk management function, but the whole organisation and all the other key functions need to improve.

What we still need to attain is consideration of the risks at all levels of the organisation within the company, starting from board level. We are urging companies to do this, and also conduct a frequent and deep dialogue regarding how risks are assessed and mitigated within the company. This is mostly based on the analysis and discussion of the ORSA. This is not only a report for supervisors; it has to be used as a basis for an open discussion between companies and supervisors on their approach to risk management. Through this dialogue, we think – and hope – that companies will improve their risk assessments and supervisors will better understand the solvency situation of the companies.

Tom Wilson
Chief Risk Officer
Allianz Group

Tom Wilson: Risk management has had to adapt to increasing and changing regulatory requirements in two specific areas. First and foremost, risk functions are forced to become more efficient at meeting regulatory requirements, focusing on automating reporting processes, redesigning systems to lower run costs, exploring offshoring, and so on. Only by capturing these efficiency gains can risk functions continue to focus on supporting the business in making better risk/return decisions and adapting their business models to changing market conditions, regulatory requirements, and so on, which should be the ultimate objective of the risk functions.

How are firms dealing with multiple regulatory compliance projects, and where are the greatest regulatory demands coming from?

Roger Dix: The overall direction of travel from our primary regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), is reasonably clear, so our business-as-usual work is determined with this in mind. However, with each thematic review or regulatory data request, we have to reset and adjust or amend our priorities to meet the delivery deadline. A regulatory data request can often lead to greater clarity of regulatory expectations, so the work might be more than simply responding – there might be some form of legacy or ongoing work identified as a consequence. Currently, the biggest challenge is how and in what form to respond and act on regulations still to be finalised; although we know something will transpire at some stage in the future – for example, MiFID II.

Alberto Corinti: We recognise that regulatory demands are high because of Solvency II and a number of regulatory approaches that have been or are going to be implemented including the Insurance Distribution Directive (IDD), the Product Oversight and Governance (POG) guidelines and the PRIIPS regulation.

We are trying to introduce these measures as progressively as possible, allowing ample preparation for those companies, as in the case of Solvency II. For example, we are going to introduce guidelines on POG based on the European Insurance and Occupational Pensions Authority (EIOPA) guidelines, even before the actual implementation of the IDD.

From a practical point of view, one of the challenges we now see in the creation of new regulation is related to cross-sector regulation, whenever insurance specificities are not recognised. This might be the case in product design and distribution, when principles and rules for the insurance sector are copied – or at least strongly inspired by – those related to the financial one. This sometimes leads to the wrong solutions: the PRIIPS regulation is an example of the undesired results of this approach to regulating insurance products. Coherence between sectors is important, but coherence also means treating differently what is actually different.

Jérôme Berset
Head of Risk Strategy and Reporting
Zurich Insurance Group

Jérôme Berset: Mark Twain said: "Continuous improvement is better than delayed perfection." Regulation does not and will not replace good management but, considered with the right mind-set, regulatory compliance can support improved decision-making and risk management, and help larger companies to get a better grip on organisational complexity, as well as reinforce the organisation's resilience and agility.

Increased expectations force companies to approach new requirements with the right mind-set, to develop smart solutions for compliance and to proactively engage with supervisors and reinforce trust relationships.

How are national supervisors interpreting Solvency II with regard to the volatility adjustment, matching adjustment, treatment of sovereign bonds and credit and longevity risk?

Jérôme Berset: Insurance Europe has taken a very proactive role in identifying areas of concern in the implementation of Solvency II, particularly gold-plating. Insurance Europe's internal surveys indicated a materially increased level of concern, with respondents saying their member states were adding requirements. Areas of concern relate to topics such as the use of volatility adjustment or the treatment of sovereign bonds. They are also broader across all three pillars: in some cases, supervisors treat internal model companies differently to standard formula users in the definition of the risk in scope to determine the capital requirements; in others, supervisors have extended powers to impose Pillar 2 capital add-ons; and, in more cases, external audit requirements of the Pillar 3 disclosure diverge materially. Solvency II's original objectives were to enhance policyholder protection, strengthen the competitiveness of the insurance industry with a level playing field and reinforce the EU single market. With the concerns about implementation of Solvency II, the last two objectives – at least – are at risk.

Alberto Corinti: Many of these measures are key aspects of Solvency II that have been under discussion for a long time, and will be subject to review at the European level. We support the long-term guarantee (LTG) measures and their objectives, which are an important element of Solvency II, and believe that the ability of those measures to achieve their objectives should be the focus of the review. If necessary, these types of measures should be strengthened.

It is important to note that in Solvency II there are adjustments that appropriately soften artificial volatility and better reflect the long-term business of insurance.

We will work with EIOPA to improve the LTG measures, not to limit them. Insurance companies in Italy have used only the volatility adjustment measures; they have not used any transitional or any other LTG measures.

At this time, the impact of these measures in Italy is not particularly significant. This is understandable because we are not in a situation of particular volatility or crisis. However, it is important that the mechanism of the volatility adjustment is in place and functions well, as it should adjust the consequences of any abnormal widening of credit spreads whenever the company is not exposed to the risk of forced sales of bonds. Although the impact is currently low, we are going to check the eligibility of the volatility adjustment for each company, considering the financial characteristics of its assets and liabilities.

With regard to the treatment of sovereign bonds, we believe any introduction of a capital charge should be the result of deep cross-sector and international analysis that takes into account all the difficulties of measuring the credit standing of countries, and also the macro consequences of this initiative. We are open to working with the European institutions on this subject but, at the moment, we do not think – all costs and benefits considered – that sovereign bonds should be subject to Pillar 1 requirements. Any new requirements, in any case, should be applied in a progressive way through transitional measures.

We are asking each company to include a deep assessment of risks related to sovereign bonds in their Pillar 2 reviews. We specifically asked companies to assess this and to check whether any widening of the stress of those bonds would put into question the solvency of the company, depending on the capacity of the company to hold those assets.

Erik Vynckier: The national supervisors have implemented frankly idiosyncratic interpretations of some rules in what was intended to be the harmonised Solvency II approach to insurance regulation.

The volatility adjustment may be dynamically recomputed in most jurisdictions, whereas the UK imposes a fixed adjustment shared by all scenarios in all time steps. Consequently, the UK treatment is time-inconsistent: should a scenario materialise for real in the next reporting time frame, the volatility adjustment is to be recomputed, and therefore it will not coincide with the fixed numerical value imposed in the simulation. The rationale of the UK authority thus seems to hold no logical merit.

The matching adjustment is applied to individual annuities and pension buyouts in the UK and Spain, but not to other potentially qualifying products in other countries, such as disability income support. The matching adjustment requires specific approval by the national regulator, and other countries have not welcomed the regime.

Sovereign bonds of EU countries – when issued in domestic currencies – are exempt from Pillar 1 capital charges, irrespective of their rating. Sovereign exposure can only be addressed in internal models – and only for those insurers that have opted for internal modelling – or in Pillar 2 reviews.

Generally, there is very limited insight into the variability of internal models across firms, let alone across countries. Even the presence of internal models themselves varies dramatically across the EU and the European Economic Area (EEA) – in particular, UK and large multinational, multi-line insurers apply internal modelling, whereas the domestic leaders in France, Germany and Italy, often very large firms too, have shied away altogether from using internal models for Pillar 1 capital computation.

Should insurance companies be using the tripartite template and, if so, what are the benefits for insurers?

Anne Leslie-Bini: It is maybe overly prescriptive to say insurers should definitely be using the tripartite template, but it is definitely a good starting point. A great deal of effort and expense goes into collating quality asset data, and it is essentially the same effort being reproduced time and time again between asset managers and all their customers – the insurers. There is no real competitive advantage to be gained by an insurer from being a champion of managing their asset data for Pillar 3 reporting. My view is that significant economies of scale could be realised across the industry if there were greater harmonisation, standardisation and collaboration around finding a shared mechanism for managing the Pillar 3 asset data reporting challenge, but that value will only be realised if the standardisation and harmonisation effort covers the full scope of the requirements.

There would be merit in further industry-wide dialogue and collaboration around this topic to gain greater consensus and to obtain a critical mass of stakeholders to adopt the tripartite template as the industry standard. But, to achieve that, the template itself may need some further adaptation to ensure it is fully fit for purpose.

Erik Vynckier: My advice is yes, to use the tripartite template. Supported by Club Ampère in France, the Investment Association in the UK and the German Investment Funds Association (BVI) it covers all asset data necessary for Solvency II Pillar 3 reporting of assets in a single template. It has become the de facto standard for asset reporting by asset managers to insurers. The vendor ecology, too, has adopted the tripartite template, which has become the lowest-cost approach to regulatory asset reporting.

What efforts are firms making to ensure publicly disclosed reporting is being interpreted accurately by the markets and stakeholders?

Tom Wilson: Firms are attempting to have their disclosures correctly interpreted in the following ways: by converging disclosure standards, in terms of sensitivities, for example; by increasing disclosures, through capital movement analysis, for example; and by spending more time during analyst meetings to discuss the movements and their implications. The need to improve disclosures and understanding is critical, as Solvency II now drives capital management, dividend policies and, through these, share valuations.

Anne Leslie-Bini: Looking at Solvency II, there is a huge volume of data being produced and a much greater volume of information being communicated externally – arguably with a quicker time-to-market than previously.

To lay a solid foundation for external disclosure, many firms are taking a step back and ensuring that their internal stakeholders are fully familiar with the information and really understand the business fundamentals that underpin it – there is no way of explaining something clearly to a third party unless you already have a solid grip on it yourself. The firms doing a good job of communicating externally are typically spending time on ensuring that, internally, the right people have access to the right level of information at the right time. This, in turn, allows firms to adjust and amend their message prior to disclosure, allowing a better quality of dialogue with external stakeholders, who also have their own learning curves when interpreting the different types of information they are now receiving.

Roger Dix: Management and boards also need to interpret it correctly. There are two styles of delivering this new information. The glass half-empty approach will be to simply answer the questions or data requests as put. This will deliver – just – a compliant set of answers, but that is about all. It is not obvious that this route will lead to third-party readers being able to understand and interpret it correctly.

Alternatively, the glass half-full approach sees the publicly disclosed information as an opportunity to leverage the regulatory requirements for disclosure to enhance a third party's view and understanding of us. We produce several documents or publications annually for both internal and external use, covering broadly similar ground – annual reports and accounts, ORSA, strategic plan and Pillar 3 reporting – both public and to the regulator. We aim to use the same words to answer the same questions throughout, and therefore focus on ensuring the words we use are readily comprehensible to non-expert readers. We have found active review by both the executive and the board very helpful in improving the clarity of what we say. We have also found that the normal tabling of reports to executives on all manner of technical subjects enhances our ability to produce clearer reports, as any lack of clarity or ambiguity is pointed out to us, often very directly, by our executive colleagues.

Alberto Corinti
Board of Directors, Italian Insurance Supervisory Authority (Ivass)

Alberto Corinti: This is a key issue. Pillar 3 cannot achieve its objective in terms of solvency if the disclosure is not appropriate and not properly harmonised. So, we share the view that this is something EIOPA and the national supervisors should work on collaboratively.

At this stage, we see that the level and granularity of disclosure made by the most significant European companies – i.e. the listed ones – is not harmonised. However, we should not forget this is a disclosure that is not yet actually regulated by Solvency II. The first Solvency II disclosure will be applied in 2017, when the first Solvency Financial and Capital Reports will be made public. A more harmonised way to report the information, as provided by Solvency II, could improve the situation and can certainly highlight the direction EIOPA and national supervisors should take to improve it further.

It is also important to take any necessary initiatives to improve the capacity of the users to interpret the Solvency II reporting. All the participants should be more familiar with the new indicators of Solvency II and, in particular, with the volatility of the new indicators.

A breach of the Solvency Capital Requirement does not necessarily indicate a solvency problem. The signal given by the solvency ratio must be interpreted by the reader, by considering the reasons of the breach together with all other information that can be drawn from the reporting. Solvency II disclosure is certainly more meaningful but also more complex than the public information under the Solvency I regime; readers should be more prepared. In this regard, we are organising conferences and taking other initiatives to ensure all the readers, including journalists and consumers, are more familiar with the new regulation, and help them read and interpret the Solvency II outcomes in an appropriate way.

Jérôme Berset: Some companies, such as Zurich and Swiss Re, have begun to take the initiative, but little effort is visible at industry level – where are the challenges? Recently, I delivered a risk management module to students, and when reviewing the upcoming disclosure requirements – to be introduced in 2017 in Europe and in 2018 in Switzerland – we went through some of the associated challenges. For example, customers and other users of the reports will need to interpret and compare 'equity' under international accounting standards, 'risk-bearing capital' under the Swiss Solvency Test, 'own funds' classified into three tiers under Solvency II and 'available financial resources' under the company's ORSA – not to mention the European embedded-value results. All are expressions of how much money an insurance company needs to survive a very large, unexpected and adverse event, yet every concept follows different valuation rules.

Meanwhile, EIOPA speaks of Pillar 3 as "an opportunity to address stakeholders' perception of alleged opaqueness and inadequacy of publicly disclosed information. We encourage insurance and reinsurance undertakings to embrace this opportunity and to actively engage in consistent, comparable and high-quality communication with their stakeholders on their solvency and financial condition."

Regarding comparability, solvency ratios of 200% under Solvency II will not necessarily be equivalent, due to the different application of transition measures or the buffering mechanisms that are the volatility adjusters or matching adjustment, among many other factors. Only a deeper analysis will restore some form of comparability. And regarding consistency, Solvency II has been a reality for less than one year, and the European Commission has already mandated EIOPA to review critical elements of Pillar 1. While revisions of the framework will eventually become necessary, proper consideration of the trade-offs between the necessary improvements to the framework and, I believe, the no less necessary stability of the framework to ensure consistency and allow all stakeholders to learn from the new framework will be critical.

Erik Vynckier: Chief financial officers and investor relations managers are putting in the effort to explain their capital computations and capital strategies to debt and equity investors. The Solvency II coverage ratio is a much more volatile capital metric than its predecessors in the different European jurisdictions, and information on the significant components making up the capital requirement is augmented with sensitivities to market risk parameters.

Equity analysts are still struggling to understand and interpret the number, given the differences between internal models and the standard model, and the sheer diversity of the insurance sector. Unlike the fairly homogeneous banking sector – overwhelmingly deposit-taking mortgage lenders – the insurance sector is very diverse in economic activities undertaken and risk exposure, from natural or man-made catastrophe risk to capital markets facing long-term savings. An identical capital number across two very different insurers – for example, a property and casualty insurer versus a life company, or a multi-line insurer versus a reinsurer – does not necessarily vouch for their equal financial robustness.

Debt investors continue to put their faith in bond ratings. The ratings agencies are possibly the furthest advanced in analysing the risks embedded in the insurance balance sheet. Two leading ratings agencies put as much faith in their proprietary capital models as in the internal or standard Solvency II models. At any rate, well-capitalised firms are driven more by their credit ratings in planning capital strategy than by Solvency II.

How are firms seeking to leverage infrastructure and processes that have been put in place to meet reporting requirements to improve their management information?

Anne Leslie-Bini: Firms have invested massively in systems infrastructure and processes in recent years, mainly driven by regulatory imperatives, and this process is still ongoing. While compliance is a must-have investment criterion, alone it is not sufficient to justify the types of expense we have seen. Where investment is high, the expected return on investment is naturally commensurate; meeting expectations in this area means being forward-thinking in envisaging how technology is deployed and leveraged. Technology delivers the best results when it is embedded in a holistic strategy that pays more than lip service to the importance of people and processes within a global architecture.

Firms are looking to realise a return on their investments by using technology to access higher-quality information on a more timely basis, breaking down silos and giving their business teams access to analytical functionalities. In augmenting the capabilities of the business, these teams can be more agile and creative in their use of data, instead of restricting themselves to a pure tick-box approach that focuses only on generating periodic reports for external stakeholders, such as the regulator.

Data produced for the regulator can, and arguably should, be re-used for enriching management information. The data may need to be reworked into a different shape or form, but the mass volumes of data that are being communicated to the regulator can be distilled and delivered internally in a much more visual form, for example, so that management are able to see at a glance the status of certain key metrics that are useful in steering the business.

Roger Dix: To misquote the old adage of advertising, 50% of my management information is worthless, but I don't know which 50%. The recent regulatory developments – not just Solvency II, but also recent FCA thematic reviews and PRA and FCA data requests – have given rise to more pieces of potential management information, but simply adding more to what is already a pretty thick book is not helpful. However, each piece by itself is useful somewhere; the challenge is how to distil what we have so we can see what is material. This becomes particularly relevant for boards, which should not simply be presented with a data dump, but with appropriated and possibly targeted data after due management process.

The need to simplify and keep the management information we use relevant is in line with a quote by former US secretary of defense Robert McNamara: "Measure what is important; don't make important what you can measure." A process, which can be led by the risk team, should be undertaken so that the important stuff is agreed and then measured. We should not assume that because we have been requested to deliver it the data is important for us – although you should ask yourself, why not?

Tom Wilson: The industry is recognising that Solvency II capital is shareholder capital, in part because it is the binding risk-based constraint to dividend and capital management strategies, and in part due to its increased volatility, requiring substantially more buffers than under Solvency I. Much of the volatility is driven by financial market movements, the impact of which needs to be monitored and managed dynamically. In addition, understanding how capital is invested in new business and how much capital is released by the legacy block and from ALM decisions is critical for managing shareholder expectations.

Answering these questions requires the leveraging of existing risk reporting systems, not in terms of quarterly closings but in terms of weekly financial market flash reports, capital forecasting and planning tools and ALM hedge ratio reporting. In other words, Solvency II is not just another reporting regime, it also drives capital, risk and balance-sheet strategy. As a consequence, Solvency II systems are much more than reporting systems, they are also information systems for managing under the brave new world.

Erik Vynckier
Board Member,
Investment Committee Chair
Foresters Friendly Society

How are insurance companies adapting their asset-liability management (ALM) strategies to sustain growth?

Erik Vynckier: Quantitative easing has forced insurers to look for the 'right' asset, one that has interest and inflation sensitivity, attractive spread and a low capital cost under Solvency II. A number of fixed-income strategies have been adopted: substituting corporate credit and small and medium-sized enterprise lending for short-dated sovereign debt, or residential mortgages and project finance for long-dated sovereign debt. Investment strategies aim to increase spreads earned above the swap curve, to improve the ALM fit and to reduce the notional size of derivative overlays – thus reducing collateral exposure – but to do so at an acceptable capital cost.

Tom Wilson: Insurance companies are adapting their ALM strategies to confront several important market developments, including low reinvestment rates and increased capital requirements. More specifically, insurance companies are building capabilities in sourcing and underwriting alternative assets, which offer liquidity and structural premiums compared with actively traded bonds and equities. In addition, strategic asset allocations are being tilted to asset classes that offer a better-perceived return on capital. Finally, insurers are focusing more on dynamically managing key rate duration mismatches to manage interest rate risk, credit spread duration to reduce spread risk and using derivatives to manage equity exposures and convexity. Because there is a natural limit regarding what can be done on the asset side of the balance sheet, insurers are also fundamentally redesigning liabilities to lower the cost of guarantees and make them more managable in the future.

Is International Financial Reporting Standard 4 (IFRS 4) Phase II tomorrow's problem? To what extent can Solvency II methodologies be used with it?

Erik Vynckier: One would hope for a maximal parallel treatment of insurance liabilities in both regimes, but it should not be forgotten that the origins and intentions of the capital and the financial accounting regimes are different. Solvency II intends to protect the consumer against distressed insurers, and IFRS to accurately reflect the financial performance of the insurer. Inevitably discrepancies crop up in measurement, profit recognition and contract boundaries. IFRS 4 Phase II covers only the insurance liabilities but does not discuss asset valuation.

Solvency II applies IFRS 13 to assets – it is a distinctly mark-to-market approach to the valuation of liquid assets, permitting mark-to-model for illiquid assets that are difficult to price. For liabilities, Solvency II again marks-to-market actuarial best estimates, adding a risk margin reflecting the cost of capital – presumed to mimic the market value of a liability in an arm's-length transaction.

On the contrary, miscellaneous systems using Generally Accepted Accounting Principles adopt IFRS 9 for assets – which amounts to historic cost accounting, associated with a regular impairment test – and IFRS 4 Phase II for liabilities embedded in insurance contracts.

IFRS 4 Phase II adds a residual risk margin according to different principles than those of Solvency II. There are also differences in contract boundaries: for example, an unbundling of non-insurance elements embedded in insurance policies. Furthermore, there are material differences in the timing of profit recognition between Solvency II and IFRS 4 Phase II. IFRS strives for wider 'international' acceptance than Solvency II, which is an EU and EEA-supported regulatory approach.

For all these reasons, IFRS 4 Phase II is not a carbon copy of Solvency II. While the input data may be – or should be – recycled across projects, the detailed implementation of Solvency II and IFRS 4 Phase II can be markedly different.

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