Solvency II – An Overview of the Challenges for Insurers
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Introduction

Solvency II, until recently, was still in some doubt, but now it is clear that the new rules will apply from 1st January 2016 with some transitional measures during 2014 and 2015.

In this paper, we will review some practical aspects of Solvency II compliance, particularly Aon’s approach to meeting the needs of its insurer clients.

Solvency II is often categorised into 3 pillars, and whilst this is helpful, this is in fact a convenience. As a matter of law, the directive contains hundreds of numbered articles or paragraphs, supplemented with further detailed regulations by the European Insurance and Occupational Pensions Authority (EIOPA). Moreover, leading practitioners have long realised that an effective response to Solvency II requires an integrated strategy.

This paper is split, as is conventional, into the 3 Pillars, but the links and dependencies will be expressly considered.

Solvency II – What are the challenges?
The schematic below shows the key challenges and links between the three Pillars.

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**Pillar 1**
- Quantitative Modelling
- Data Requirements

**Pillar 2**
- Board Engagement
- System of Governance

**Pillar 3**
- Qualitative Reporting
- Quantitative Reporting

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3  Solvency II – An Overview of the Challenges for Insurers
Solvency II is often seen as a regulatory burden for insurers, but what is the nature of this burden?

Some relevant questions are as follows:

1. Can smaller insurers adopt a proportional approach?
2. Does proportionality mean that “less” can be better than “more”?
3. Have national regulators defined their own approach to Solvency II implementation or are they just fully adopting EIOPA’s documentation?
4. Is there a painless and efficient way for insurers to meet regulatory expectations?

We provide some suggested answers to the 4 questions posed above:

1. The way that Solvency II has emerged (including the Omnibus II amending directive) means that Solvency II applies (with very limited exceptions) in essentially the same way to any regulated insurance company.

2. The concept of proportionality is a “silver bullet” principle because it is stated in the primary directive and applies over all aspects of Solvency II. An insurer should seek to build its Solvency II approach with this principle in mind at all times. From the point of view of governance, “less” is often better than “more”, because the governing entity (the Board) will not govern effectively if it is overwhelmed with unnecessary complexity.

3. ‘Post-boxing’ may happen in some cases to limit additional layers of specification but this will change rapidly as national regulators seek to reinforce local market practice. Influential regulated entities and Insurance managers (such as Aon) will play a role in building up this market expertise to achieve some level of consensus and common expectations so as to minimise regulatory uncertainty.

4. One way to minimise regulatory uncertainty and to achieve efficient Solvency II compliance is to build specific systems, such as IT platforms – based on a realistic and defined “target operating model”. Aon is leading the way in this space whilst actively appraising regulators of these innovations.
Pillar 1

The Solvency II standard formula calculation is complex, requiring a large volume of input data and numerous individual calculations, some of which are iterative in nature.

The iterations mean that the model answer is not always immediately apparent. The complexity is due to the following:

- The amount of input data required
- Restating the balance sheet on a market-consistent basis
- Alignment of the input data with the captive business - for example converting claims or premium data to categories which meet the required definitions
- The iterative calculations for the Solvency Capital Requirement (SCR)

The QIIS ("Quantitative Impact Study 5") spreadsheets released by EIOPA highlighted the significant complexity of the calculation process. Clearly, professional support is essential but very significant economies can be found if a system approach is used.

When considering a system or tool for Pillar 1, the following considerations are perhaps critical to a successful approach:

- How the tool copes with adjustments in underwriting and investments to quickly recalculate (without actuarial assistance) a new SCR
- How the tool enables the regulator and auditors to easily verify its accuracy
- How the tool acts as a database so that it can feed the Pillar 3 quantitative reporting requirements.

As a leading insurance manager in Europe, Aon has developed ASTRA – a solution applying these principles.
The diagram below conveys the relevance of Pillar 2 to an existing insurer business model. Whilst Pillar 2 can be seen as a regulatory burden, a well-structured system of governance is inherently valuable because it is efficient, not expensive, and provides security and confidence to a board.

The above diagram shows the challenges that may already exist for a board, and how the Pillar 2 requirements (in red) could be seen as just more things to consider. Whilst this is true in a sense, we have seen (with over a hundred case studies) that a good Pillar 2 system of governance can deal with these disparate challenges (from a governance perspective) in an efficient way, avoiding duplication.

With this in mind, the following are perhaps the key things to consider when constructing a system of governance:

- **Aligning strategy**, governance objectives, and risk appetite
- **Ensure consistency** at all levels
- **Avoid endless documentation** of policies, procedures and guidelines
- **Escape labyrinthine and uncontrollable implementation programmes**
- **Maintain a structured approach** across organisational levels
- **Balance comprehensiveness with fit to purpose**
- **Be cost efficient**
- **Ensure easy on-going maintenance**
A more formal way of thinking about this is that a board should seek to define its “target operating model”, and proceed to construct its governance system only once this is clear. For example:

- Set a transparent organisational structure
- Clearly assign roles and responsibilities within the organisation
- Document policies to identify, measure, monitor and mitigate the risks the company is exposed to
- Clarify key processes and the Internal Control System
- Provide effective internal audit, risk management, actuarial and compliance functions
- Ensure the organisation is adequately capitalised both now and over the business planning period

This is a more focused approach than just listing all the possible risks that could impact on the insurer. Whilst a “bottom-up” approach is important when identifying risks, the unlimited variety of possible risks makes this an unwieldy approach to start with. We suggest that a bottom-up check for consistency and risks is indeed undertaken, but not until the overall structure of the governance system is in place. The following graphic illustrates this idea.

If we put this into a paper document (what we might refer to as a Governance Manual), we can divide this into 4 main areas or 4 key deliverables as follows:

1. An overall strategy and governance framework summarising the insurer’s strategic objectives, the related governance principles and including an adequate and transparent organisational structure proportionate to the size and complexity of the insurer.

2. A risk management system which defines, details and formalises the risk appetite of the insurer, the consecutive risk policies and relevant roles and responsibilities.

3. A process & control architecture defining the high level processes required to manage the insurer. This architecture will underpin the principles and functioning of the internal control system embedded within the operations through a clear mapping of key processes and related controls.

4. A risk register listing the material risks which the insurer is exposed to and which threaten its strategic objectives as well as how they are measured and mitigated. Proportionality should just emerge automatically from mapping all of the requirements to the organisational framework and operating processes of the insurer.

**FLAOR/ORSA**

The Forward Looking Assessment of Own Risk (FLAOR) is a pre-cursor to the Own Risk and Solvency Assessment (ORSA). Of all the Solvency II requirements, the ORSA is the process that will require the most involvement from the Board and Executive management. The ORSA is a strategic risk assessment which identifies the key risks to achieving the company’s insurer’s objectives over the planning horizon, defines the amount of risk the Board is willing to take, and assesses whether the regulatory capital requirements are sufficient under stressed conditions and during the planning period. The main inputs to inform the ORSA are the Risk Register, up-to-date business strategy and financial plans, and risk appetite statements or KPIs used in Board packs.

The solvency projection (the prospective SCR and Solvency II balance sheet over the planning period) and the impact of stress testing on the solvency position will require some actuarial support plus some accountancy involvement in forming the projected balance sheet and income statements.

This regulatory requirement drives home the point that the three pillars of Solvency II are closely linked and need to be considered in their totality, and are not just focused on the financials.
It is often thought that Pillar 3 is a re-packaging of the work already done for Pillars 1 and 2 - this is partially true. Indeed, understanding how to map the outputs of Pillars 1 and 2 to the reporting templates required in Pillar 3 is going to be essential to maintain accuracy and efficiency, especially when the data and reports have to be refreshed quarterly or annually.

It is also true that there is a lot of information to be reported that is not covered in Pillars 1 and 2, and a data management approach is needed to bring all this together. The Quantitative Reporting Template (QRT) can be regarded as amongst the stiffest challenges of Solvency II due to the level of detail required, combined with the proposed tight reporting timescales. The Aon approach is to create the maximum linkages and synergies between the pillars, to expressly map this, and to identify the areas where the data needs to be handled off-line.

There are 3 reports within Pillar 3:
- Quantitative Reporting Template (QRT)
- Regulatory Supervisory Report (RSR)
- Solvency and Financial Condition Report (SFCR)

QRT – what is the basic challenge?
There are a number of different data sources needed for completion of the QRT. For most clients there will be data gaps where additional information will be required from certain sources to enable completion of the QRT (e.g. data from investment managers, actuaries, accounting system).
Aon is currently building an IT approach so that this data can be managed according to a “one to many” principle, taking into account the substantial amount of structured data already contained in Aon’s proprietary systems (“Globe” accounting system and ASTRA Pillar 1 tool).

QRT – practical requirements
QRTs will need to be submitted to the local regulatory body on a quarterly and annual basis. Following successful lobbying by the industry (in which Aon played a key role) there was a significant reduction in the number of templates that will be required compared with previous templates issued by EIOPA. Insurance companies will be required to complete templates on an annual basis but quarterly reporting will be more streamlined.

From analysis carried out on the templates issued by EIOPA, information required to complete the templates will typically be obtained from a number of different sources:

- General Ledger system and technical reports - 10%
- Pillar I calculation - 60%
- Investment reports - 10%
- Other sources - 20%

Insurers (or their managers) will need to liaise with third party stakeholders to ensure that reports provided contain sufficient information to enable templates to be fully populated (e.g. investment managers will need to provide additional details on bonds and securities than would be currently provided in investment reports).

RSR and SFCR – what are the challenges?
The RSR and SFCR have the following basic elements:

- Business and performance
- System of governance
- Risk profile
- Valuation for solvency purposes
- Capital management

Aon has reviewed the EIOPA guidelines for completion of RSR and SFCR reports. There are a significant number of disclosures required in both the RSR and SFCR reports. The ideal solution to facilitate the efficient completion of the RSR and SFCR reports would be to have one data source, containing all disclosures required for the reports. Aon is currently developing a system that will assist in the majority of the disclosures in both the RSR and SFCR reports being automatically populated from a single data source.

Pillar 3 Reporting - concerns
There are several areas where we are monitoring the developing regulations closely.

Principle of Proportionality – there are no specific reporting exemptions or simplifications for small entities. For example, the regulations do not specifically take into account the following:

- Level of detail compared to risk profile
- Size/materiality thresholds
- Frequency of reporting

National variations – some national regulators may require specific supervisory data which could propose a threat to harmonisation and a level playing field.

Nature and amount of public disclosures – there are a number of challenges in relation to the issue of the nature and amount of public disclosure.

- Commercially sensitive information into the public domain, especially where an internal model is being used
- Disclosure of the risks written provides a clear picture of the group’s insurance programme
- Disclosures may be detrimental to the business

It is true that Article 53 of the directive allows for the national regulator to consider, on merit, a request for a reduced level of public disclosure. However, the permissible grounds for agreeing this are limited to the following:

1. “by disclosing such information, the competitors of the undertaking would gain significant competitive advantage”
2. “there are obligations to policyholders or other counterparty relationships binding an undertaking to secrecy or confidentiality”
Conclusions

The Solvency II project is now running to a definite time frame. Aon has solutions to implement an efficient and proportionate approach that will protect the small insurer business model for our clients, whilst meeting regulatory requirements. Getting the approach and balance right is critical.

- Good data quality within systems, and data-mapping, can create efficiencies and synergies across all 3 Pillars
- Integrated systems approach, with suitable project management, will lead to an effective and combined systems approach

Aon catalysts
We have already outlined Aon’s solution strategy. The following elements are critical to delivering the right solutions.

Practical Experience
Across our actuarial, risk finance and insurance management businesses in Europe, we have already assisted numerous clients with Pillar 1 and Pillar 2 solutions. Much of this experience is embedded in IT platforms which we mention in more detail below.

ASTRA Tool
Unlike QISS, EIOPA will not provide a tool for SCR calculation to the market. Each company will need to procure a tool or build its own in line with the latest version of the Level 2 Technical Specifications. ASTRA is an Excel-based Solvency II Standard Formula tool, developed by Aon in response to the demand for an easy to use solution to completing the standard formula calculation. It allows non-life insurance companies to complete the full SCR calculation, and can also aggregate life risk charges into the total SCR. As most of the QRTs consist of information that is also used in the Solvency II Standard Formula calculation, ASTRA also allows for the automatic population of a majority of the QRT templates.

GRC platform
The Governance, Risk Management and Compliance platform has been developed in association with Optial UK Limited and has the following features:
- A software platform capable of reflecting a company’s governance model
- A powerful workflow engine which guides the user through their required actions from inception to process completion
- Highly granular access control ensures the security of sensitive information
- All actions performed within the framework are fully tracked and auditable
- A powerful reporting engine to visualise and analyse data

The GRC platform will allow existing GRC efforts to be organised, recorded and scheduled. This in turn allows interaction and reporting on the data to gain maximum leverage from the platform.

The GRC platform will allow a significant amount of information required in the ORSA report and the RSR/ SFRC Pillar 3 reporting to be handled within the system, thereby maximising the ‘one to many’ advantages of a combined Solvency II approach.
Contacts

David Crofts
+44 (0) 207 086 0259
david.crofts1@aon.co.uk

Fabrice Frere
+352 22 342 2402
fabrice.frere@aon.lu

Noel McNulty
+352 22 342 2220
noel.mcnulty@aon.lu
About Aon

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Aon UK Limited Registered Office: 8 Devonshire Square, London, EC2M 4PL

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