Speech for Philip Scott, EAAC Conference.
Solvency II – the challenges and opportunities beyond Europe

Welcome

It's a great honour to be here today as the President-elect of the Institute and Faculty of Actuaries. While I have been to Singapore, Hong Kong and other cities in China, this is my first visit to Kuala Lumpur.

I am delighted to have been invited to attend this conference. It's always good when events like this bring like minded people together to share our thoughts and ideas. It was this idea of bringing people together and particularly, the theme of the conference, "Venture into Uncertainty, Capture Opportunities!" that got me thinking about what I wanted to talk to you about today.

As many of you will be aware, one of the biggest issues facing actuaries in Europe right now is the implementation of Solvency II – the drive to introduce harmonised solvency and risk management standards across the European insurance industry.

I believe Solvency II will have a truly global impact and I want to take this opportunity to talk about why Solvency II is important, its impact on the financial services sector and us as actuaries. You don't need me to tell you that in today's world, what happens in one part of the world affects another.

I would like to suggest that Solvency II, either directly or indirectly, may very well affect you, the organisation you work for and the work that you do –if it's not doing so already.

Some principles of Solvency II are likely to be carried across to the measurement and management of other financial instruments. For example, there is currently consideration in progress about which of these principles should be adapted for company sponsored pension schemes.

Over the last four years we have seen both Europe and the US battered by an enormous economic storm which has had a massive impact on the banking sectors of both continents.

By and large the insurance industry has held up much better in response to the massive financial strains, but this has not made the news headlines.

I would argue that one of the reasons why the insurance industry has not hit the headlines so much has been

- the regulatory environment which we operate in, and of course;
- the role that actuaries have played in helping insurance companies meet their commitments to policyholders.

Regulation and actuarial involvement have meant that insurance companies have generally remained solvent, have met their obligations and as a result have avoided the headlines that so seriously affected the banking industry.

Importance of insurance industry and good regulation

I am sure everyone here today will agree that insurance is an especially important industry to people across the world.

What began with merchants pooling their risks as ships set sail around the world, is now a global industry enabling people to protect their belongings from risks as diverse accidental damage to damage in a fire.

In the life assurance industry we provide products to help protect a person's dependents from the economic consequences of death -and to help them save for, and then manage, their income in retirement.

These needs are universal and so apply across much of the world.

The nature of all these transactions is that they depend on **trust**.

Before paying an insurance premium people will need to be comfortable that they can trust the company they are paying;

- to honour its promises and;
- to pay up if the contingency insured against occurs.

In an industry where these promises can last for decades, confidence and trust in the insurer - its ability to meet these obligations in the long term -is vitally important.

This is where regulation comes in.

In a world where most consumers have neither the skills nor time to individually assess the companies they do business with, the regulators play a vital role in making sure only those companies who have a good probability of standing by their promises are allowed to trade.

And this job of the regulators is becoming harder.

There are more multinational companies now who trade in more than one area.

Regulators need to balance their duty of care to consumers, prudence and the company's ability to meet claims with the company's ability to write profitable business. In turn, companies need to be confident that the jurisdiction of the area they base themselves in is an attractive place to write insurance contracts. And, of course, consumers need to benefit from being able to insure their risks at competitive prices.

Why solvency II is relevant to you

The European Union has turned to Solvency II which it sees as the best way for European regulators to step up to this challenge.

As I understand it, because of the boom in demand in Europe for actuaries who can support companies through Solvency II it is also now being reflected in some East Asian markets, particularly Hong Kong.
As I mentioned earlier, I believe that Solvency II may well affect most of you here today. It will do so in three ways.

Firstly the regulation of many global insurers (and reinsurers) headquartered in Europe will change. This will have implications for their worldwide operations - this will include an impact on the actuaries working in and advising them.

Solvency II affects all companies operating in the European Union and so will impact;

- EU insurers,
- parents of EU insurers,
- subsidiaries of EU insurers,
- branches of EU insurers and
- reinsurers of EU insurers.

So, within this part of the world there may very well be direct impacts on you, or for companies that own interests in companies that operate within Europe.

Solvency II will also impact on trade with reinsurers based in Europe.

Those of you who work for companies that have connections with Europe will already be seeing changes in the information and analysis you are being asked to supply to support the reporting needs of these companies.

Solvency II will also impact those companies offering reinsurance, so you may well find European reinsurers you work with also changing their business practices.

Secondly the focus of Solvency II on more proactive risk management will, as its impact beds in, undoubtedly lead to new assessments of business models.

As things stand today, most European insurers are focused on embedding the new requirements, which cover capital requirements, governance and controls as well as regulatory reporting.

However it is inevitable that once the requirements are embedded, company boards will move onto what it means for their businesses – in many insurers this is already happening. Solvency II will reward well managed diversified businesses. Inevitably this will be accompanied by a drive for greater focus on capital management.

We may see new European players attracted to the Asian markets, both as a diversification of their European businesses and for the profits that can be generated in Asia.

At the same time, however, other players may take the view that they can manage risk better with a smaller range of businesses and downsize back towards their home markets.

What is clear though is that solvency II will be the new backdrop in front of which capital allocation decisions are taken.

And finally, the approach taken by Europe's regulators was not to amend any existing laws and regulations but to start with a new, fresh regulation system from scratch.

Arguably this has created a "State of the Art" regulatory framework which I am sure will influence the thinking of other regulators around the world -including in this region.

I am not so arrogant to expect other countries to adopt Europe's rules and regulations directly - but I do over time expect to see elements of the regime adopted elsewhere. There is evidence of this in Bermuda and South Africa already –and we are already seeing much more demand for actuaries working on Solvency II that are centred in and around Hong Kong, where many life companies base their regional headquarters.

The European Insurance Industry/ scope of solvency II

Before diving into the detail of the new regulation, I thought it might be worth giving a few statistics about the European Insurance Industry -for those that are less familiar with it.

There are over 5,000 insurance companies into which over 1,000bn euro or 41% of the world's insurance premiums are paid.

Europe's 500million people are some of the most insured in the world - reflecting both the success of the European insurance industry and the desire of individuals to protect things that are dear to them.

The 27 countries in the EU are dedicated to a Financial Services Action Plan aiming to create a single wholesale market and an open and secure retail market.

The original Solvency I regime was the initial attempt to bring the insurance codes of each of these countries together. It tidied up the existing rules -but had a formula based approach to capital and was below the bar already being set by many of the member states.

The nature of the Solvency II initiative has been summarised as "a fundamental review of the solvency and risk management standards for the European insurance industry aiming to strengthen the prudential regulation of the insurance sector".

The principle objectives behind it are a desire to harmonise policyholder protection across the EU - with a strengthened regime that should reduce the possibility of consumer loss or market disruption in insurance, and at the same time harmonising regulations. This should give well run insurers a competitive advantage they can use across the different markets.

What is solvency II?

So what is Solvency II and how does it seek to regulate the European insurance industry?

The first part is a comparison of an insurer's assets and liabilities.

But as well as this quantative assessment, there is a second pillar which is the insurer's processes for managing and controlling risks.

This recognises that solvency, or ability to meet claims and commitments to policyholders is a function both of the capital held **and** the quality of risk management in a firm. The final pillar covers the disclosures and publication of quantitative and qualitative information to markets and regulators. By publicising information in a consistent way, the market should reward well managed firms who amongst other things should find they can raise capital more cheaply.

So step one is a market consistent valuation of a firm's assets and liabilities. This calculation is on a market value basis, or for liabilities that are not able to be valued at market value, a best estimate basis, that is the discounted mean value.

To this must be added a risk-based assessment of regulatory capital. This means that the regulatory capital number will respond to changes in the risk profile of an insurer.

The basis is of the regulatory capital assessment is that the insurer must have sufficient capital to survive over the next year in 99.5% of cases. The sum of these two amounts is then compared to a market consistent valuation of the assets of the insurer, and allowance is made for the quality and location of capital when comparing free assets with the regulatory capital.

The risk-based assessment of regulatory capital is one of the most interesting and potentially technically challenging areas of the new rules.

One of the aims of the Solvency II initiative is that well run firms should have an advantage. There is a standard formula to calculate the regulatory capital number, which reflects as far as possible a typical European insurance company, and is very

granular. Firms can, with permission from their regulator, use the standard formula with some firm specific parameters or develop their own internal model (which must be signed off by the regulator).

In practice most large firms have opted to apply for the internal model approach and are currently working through the difficult tasks of developing and calibrating these models and meeting with their regulators to agree them.

On its own the implementation of these new rules for the Quantative Capital Requirements would be a major undertaking for the European insurance industry. Building the necessary models is a task that is ascribed to the risk function, with significant actuarial involvement. As firms have upgraded their existing reserving work it has created a significant demand for actuaries.

In this work many firms are developing stochastic internal models in order to assess the capital required to meet the solvency test.

Actuaries have been at the forefront of this work and in the process many are developing their modelling skills further.

But Solvency II also covers two other areas which are sometimes referred to as pillar 2 and pillar 3. Pillar two is the qualitative element of the regime, but no less stretching for that.

This means that each company will need to have in place processes for managing risk and internal controls. The company will have to document these, and then submit to the regulator information about them as part of regular reporting,

It is likely that companies with good risk management and diversified business models will benefit from a reduction in the amount of regulatory capital they need to hold. However, it seems obvious to me that any company that understands the risks it faces, has good governance, in the sense that decisions are made well, and good controls, is going to be at a competitive advantage.

Solvency II requires certain functions to be performed in the risk and actuarial areas. This places risk management and actuarial thinking at the centre of the regime, and recognises the importance of actuarial science in the soundness of the insurance industry. Solvency II does not require the actuarial function to be performed by an actuary, but the European actuarial profession is developing education and standards to give qualified actuaries an edge in this area.

Actuaries have many of the analytical and modelling skills that will be needed to run an insurance company under Solvency II -and many will expect to be able to find employment in the risk function.

The key requirements here will be an ability to keep an open mind to risks, becoming more risk focused, developing an understanding of decision making in their firm, thinking more widely than just the models or numbers and being able to communicate well.

The actuarial function and risk function will have important interdependencies. Actuaries on both sides of the fence will play a vital role in communicating and building understanding. The firms that do this well will be rewarded with lower capital requirements, which will in turn give them a competitive advantage. In fact, the key to success in Solvency II is good communication across an insurer, so that the underwriters talk to the reserving people who talk to the claims people and who in turn talk to the executive.

The third pillar is the discipline the market will bring to bear from the information that is disclosed.

The companies that are able to explain their business models clearly so that the capital markets understand them and the risks implicit within them, are likely to get better ratings from the rating agencies and cheaper access to those capital markets.

Again there will be actuaries both sides of this fence supplying information and using it to advise on investment strategies or who to place business with. For example actuaries involved in deciding who to place reinsurance business with will want to consider the market disclosures of any potential reinsurance partner.

What are the implications of solvency II for actuaries?

Now that I have spoken a little bit about the principles of the new regulations, I want to say something about what Solvency II means for us as actuaries.

As I have outlined, the actuarial function is responsible for the calculation of the technical provisions, the largest item on the balance sheet and a key source of risk.

To some extent this is an area which will be familiar territory to many.

Solvency II together with the guidance being put in place by local regulatory authorities will ensure a consistent and high standard to the actuarial work implicit in these calculations.

All actuaries working in reserving will need to bring their work up to these minimum standards and ensure that their calculations reflect market consistency -and can assess the probabilities of various events so as to calculate the capital required.

In building the new ‘Internal Models’ the actuarial profession is building a richer and deeper understanding stochastic modelling for capital assessment.

The software is already developed and actuaries are using it.

The debates have now moved on to some of the trickier areas such as how to model management actions and account for the risk management practices of the company within these models.

In addition the actuarial profession needs to engage with language of financial economists. What does 'market consistent' mean when referring to a portfolio of insurance contracts?

Solvency II has brought these concepts into the heart of the actuarial profession.

But as I have explained this is only part of the story in Solvency II.

In assessing the capital, actuaries will need to do more than build models.

Solvency II is also about helping companies better understand, and manage, the risks within a business. It covers the entirety of running an insurer.

The relationship between the actuarial function and the risk function is critical. It will require actuaries to utilise some of their softer skills, learning from and building relationships with other professionals.

With its emphasis on risk identification and management, Solvency II links well to actuarial thinking and presents opportunities for the profession as a whole –wherever you are. It will drive opportunities for further research and further actuarial science.

It also brings risk control and management more explicitly to the centre of the business - which will give actuaries opportunities to influence and adopt key roles in the business.

CERA

With this in mind, and remembering that 'capturing opportunities' is a central theme of this conference, I would like to spend a moment on the benefits that actuaries who are prepared to invest efforts in achieving the new global Chartered Enterprise Risk Analyst qualification could bring to this equation.

I came across this article in a recent issue of the UK. While it talks about the impact of Solvency II in the asia region, it highlights the opportunities it can present for actuaries.

Many actuaries are directly involved in risk management as an integral part of their routine activities, but often in relatively narrow defined areas. Solvency II, with its central focus on enterprise risk management, provides just one of several cues for ambitious actuaries to broaden their risk management skills and add value to their employers and clients in a wider business context.

The Institute and Faculty of Actuaries is working alongside 12 other national associations to build a strong foundation for the CERA qualification and establish this as a brand that stands for excellence in Enterprise Risk Management.

CERA qualified actuaries have demonstrated that they have a strong understanding of ERM concepts and processes, an ability to categorise risks, expertise in risk modelling, aggregation and risk measurement, an understanding of economic capital models and familiarity with risk management tools and techniques. A pretty powerful combination, I hope you will agree. And one which should open up a whole range of career opportunities for those who take on the challenge.

I want to show you a short video clip which features some recent CERA qualifiers. They explain why they decided to take the qualification and what they see as the benefits now they have it.

While the clip has been produced by the UK Actuarial Profession and is aimed at promoting the qualification to our members, I should point out that CERA is a *joint* initiative developed by twelve national associations.
http://www.actuaries.org.uk/content/cera-chartered-enterprise-risk-actuary-qualification-may-2011

While Solvency II is specifically directed at the insurance industry, the concepts that underpin it are also embedded in the regulation of other parts of the financial system - and indeed the wider economy.

So opportunities will also exist outside of the insurance industry for actuaries to use the skills developed in implementing Solvency II.

This is one of the reasons why, within the Institute and Faculty of Actuaries, we are adopting the strategy we are, as we look to define the distinctive contribution that actuaries provide as practical, mathematically skilled, rigorous and regulated risk professionals.

Conclusion

In conclusion, I would like to end by saying that good regulation is important because it ensures companies can meet their promises -and are there for policyholders when they need them.

Solvency II is modernising the regulation of European insurance companies and bringing in some new concepts actuaries will need to be proficient in.

My own view is that this will, over time, lead to a stronger European insurance industry.

I would urge those of you who work for regulators, and those of you who work for the companies they regulate - to take an interest in the Solvency II development.

It is based on a sound set of concepts at the cutting edge of regulatory development. I am sure that many of the concepts and much of the thinking that underpins Solvency II will also be relevant in your markets and may well be adopted in the developing regulation.

Worldwide, the actuarial profession has an important public interest role to play in helping the development of good regulation. Our role as practical, mathematically skilled, rigorous risk professionals operating within a regulated environment and professional codes - enable us to contribute positively to these debates.

However, we will need to continually refresh our skills in order that we continue to contribute positively, in tandem with other professions and the needs of the market.

Thank you.