Lessons learnt from Solvency II

Christopher Critchlow, Head of Professional Services at OAC, draws upon OAC's experience of the 2016 year-end process for the new Solvency II regime. OAC provides the actuarial function for a number of UK insurers, so the following article explores the common issues that firms faced and how they can address the key challenges for next year.

The 2016 year-end valuation process has been one of the most challenging I can remember. The new Solvency II regulatory regime, new reporting processes and the impact of audit reviews on new systems and processes all combined to test those working in the industry to the limit. So, now that we all emerge from this year's inaugural process, a period of evaluation will be important so improvements can be made for the 2017 year-end which will be all too soon upon us.

The key themes we have identified are:

- Audits are more intrusive and have a much greater impact.
- Reporting requirements are significantly more onerous.
- Knowledge base for all aspects of Solvency II is much greater.
- Need for firms to get a better handle on the dynamics of the Solvency II balance sheet.

Audits

The impact of audits should not be underestimated. Auditors are now required to treat Solvency II firms as "public interest entities" ("PIEs") which places a significant burden on audit firms to ensure they approach audits in an appropriately thorough manner with staff who properly understand the full requirements of Solvency II.

Due to the complexity of the new Solvency rules and because this was the first time the numbers were subject to full review, audit firms approached similar problems in different ways and often had different interpretations or requirements. It may take 2-3 years for these differences to be ironed out and there will be inevitable frustrations within actuarial functions and insurers' senior management teams as any changes need to feed through to the numbers.

Historically, the primary person taking responsibility for the valuation of an insurer's liabilities was the actuary appointed to the role of actuarial function-holder ("AFH"), now Chief Actuary in Solvency II and ultimately the insurance company Board. However, there is a risk that the more insistent auditors become in imposing their own standards and interpretations of the rules that these lines of responsibility become blurred. If something were to go wrong, could the insurer claim as a legitimate defence that they changed their approach in light of audit firms' requirements? We need to be careful that policies and interpretations of the rules do not become so rigid that they fail to reflect the specifics of each business. Clearly, a robust challenge is an essential part of the audit process but ultimate responsibility must rest with the insurer.

Another interesting approach some audit firms seemed to take was that they reviewed the entirety of the Solvency and Financial Condition Report ("SFCR") when in practice their review should have been limited to sections D and E (valuation and capital management). This extension of scope clearly impacted on the valuation process.

Reporting requirements

Despite the preparations undertaken before the year-end, the reporting requirements proved to be very time-consuming. Not only was the amount of information required much more significant than had to be reported before, but the specific reporting requirements were only finalised within a few weeks before the reporting deadlines.

A key issue also was just how much detail firms needed to provide within the SFCR and the RSR. Inevitably, firms will be reviewing competing firms' disclosures and no doubt some degree of consistency will be reached over the next 2-3 years.

Knowledge base and resourcing

The requirements of Solvency II are significantly more onerous than anything under the Solvency I regime to the point where it is almost impossible for any one individual to have a firm grasp of all the intricacies of the new standards.

This can make it harder for smaller actuarial functions to operate effectively without additional support.

This makes it so important that actuarial functions are appropriately resourced with technically knowledgeable staff, with each having competencies in key areas of the new regime. Inevitably these demands for greater breadth and depth means that teams need to be larger and, coupled with the extra work needed, means that actuarial functions are not likely to become any cheaper.

Understanding the Solvency II balance sheet

As with any new rules, there will often be unexpected and potentially unintended consequences. One example of that was the very significant fall in yields over 2016 leading to many firms' risk margin amount increasing materially.

Additionally, the valuation approach exposes considerable interactions eg lower interest rates may make the duration of the business longer and hence more exposed to the risk of lapses.

This can make the balance sheet more volatile and it can make it much harder to predict how a business may develop in the light of changing economic and demographic conditions. This makes the stress and scenario testing element of the Solvency II regime so important so that management can focus on the materially significant risks (or a combination of risks) to which it is exposed.

What can firms do to make the valuation process easier?

Adequate resourcing
I am assuming that resourcing is a "given", although I would note the need to ensure that the firm has sufficient breadth and depth to its actuarial function to ensure that it is capable of delivering a proper well-rounded service to the business. This may well need firms to review their functions and internal operations to ensure they are focused on delivering what the business really needs in the new environment.

Better project management and planning
Actuaries are not known to be the best project managers but it is an essential skill to ensure that the work is properly planned, resourced and monitored to ensure all relevant parties are kept informed of progress, issues addressed and ultimately that the regulatory returns are filed properly and on time.

Subject matter experts
To have staff within firms who can take responsibility for being the source of all knowledge on their given area eg documentation, technical provisions, SCRs and model development.

Develop the relationship with your auditors
Close liaison with the auditors is essential to ensure a smooth valuation. Ways in which this can be done include:

- Advance discussions of issues with auditors of their expectations and requirements.
- Good standards of documentation.
- Review approach on key matters arising in the valuation.
- Regular updates to issues arising.
- Active maintenance of issues logs.

Conclusion

Needless to say, Solvency II has seen a huge impact on the insurance industry and represents a significant cost for firms. Unfortunately, the cost of maintaining such a regime for firms is likely to be a continuing factor. For many firms, nothing quite prepares them for the actual experience of meeting the new demands, especially when multiple relationships are dependent on a smooth process, both internally and externally. As I have explained, it may take 2-3 years for the new regime to become more "settled".

Indeed, OAC will be investing further in ensuring we meet our clients' requirements, especially as more firms have turned to us to provide their actuarial functions following their experience of the 2016 year-end valuation process. I am proud of the way that the OAC actuarial team have stepped up to face these new demands and challenges. Development is continual and we are always striving to make sure we can do things better and more efficiently.

OAC is delighted to be invited to speak at a number of industry events this year to highlight the lessons learnt from Solvency II and how firms can overcome their challenges.

How can OAC help?

If you would like help with reviewing your processes for Solvency II then please get in contact today to speak to one of our experts.

For more information

Christopher Critchlow
Director | Head of Professional Services
christopher.critchlow@oacplc.com
07768 604400

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