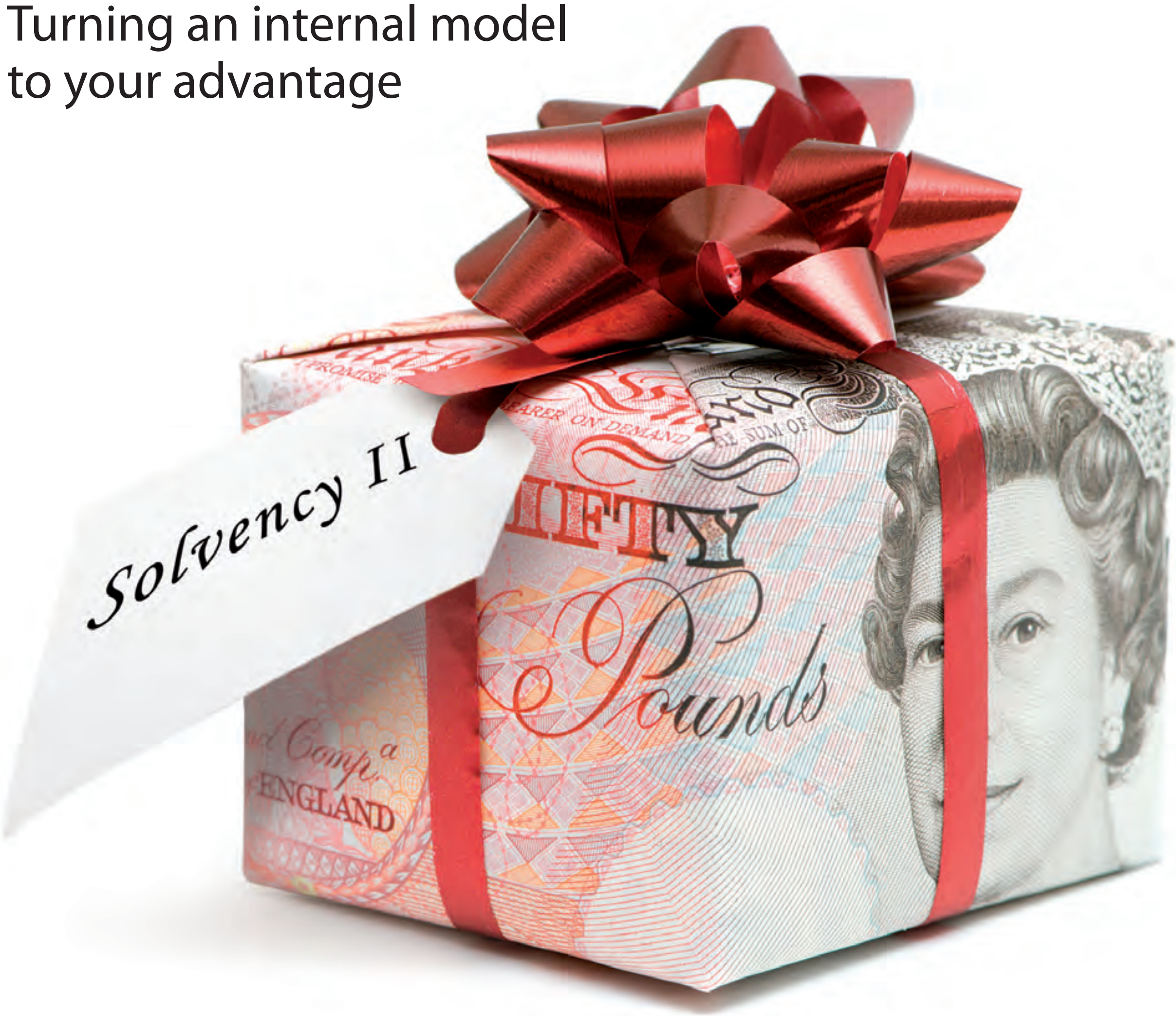
LONDON
ONE HUNDRED
WHITE PAPER

September 2011

Solvency smart

Turning an internal model to your advantage



Brought to you by
ERNST & YOUNG
Quality In Everything We Do

ERNST & YOUNG

Quality In Everything We Do

1. The positive side of Solvency II

CEOs across the London market have long been asking whether there will be sufficient benefits associated with Solvency II and the internal model to justify its considerable costs.

While every situation is different, the companies that are taking a positive view of Solvency II and fully embracing the implementation of the associated processes and disciplines are already seeing real commercial benefits.

The insurance industry has been so focused on meeting the regulatory requirements of Solvency II that the commercial benefits that could arise have so far been largely overlooked.

We believe a well-embedded internal model can provide more insightful management information and fundamentally change the way companies do business for the better. Businesses can create real competitive advantage from their internal models, thus realising significant commercial gains from the costs incurred. Here's how…

2. Genuine commercial benefits

2.1 An improved understanding of risk

Significant commercial benefits can be gained from an accurate understanding of the risks in your business. This understanding enables management to more efficiently target and address those risks (e.g. from a resource allocation perspective).

The internal model gives a consistent view of the interaction between risk, capital and value across different types of businesses and geographies and, using economic capital, allows companies to quantify risk so as to form a better understanding of their capital utilisation.

An internal model can be a valuable tool in developing a strategy that increases profitability while also reducing risk. It provides an opportunity to apply a common currency to the measurement of risk, value and capital across the entire business and gives an objective measure for evaluating business decisions.

2.2 Better strategic decision-making

The internal model will make it easier for companies to identify strategies that increase diversification.

This will allow them to reduce capital requirements or to address capital-intensive classes of business in order to release capital for other profitable risk-taking activities. This may reduce the overall cost of holding such capital. A company may also consider reducing a risk exposure via reinsurance, securitisation or hedging arrangements.

Broadly, the internal model can improve decision-making with respect to the following strategic functions:

- Mergers and acquisitions
- Expanding business or exiting lines of business
- Capital allocation
- Legal entity restructuring
- Product and pricing strategy
- Investment strategy
- Reinsurance purchasing
- Maintaining credit ratings

The internal model will also assist in allocating the costs and benefits of a reinsurance programme, as well as investment-related items (such as a risk-free return and investment-related fees and expenses) and group overheads across lines of business. This delivers a more accurate understanding of the economic profitability of lines of business for strategic decision-making purposes.

2.3 Better management information and communication

Companies should carefully consider the management information being prepared for strategic functions to ensure that it draws on the most relevant data from the model and its underlying systems.

This exercise will be covered to some extent by the work associated with the Own Risk and Solvency Assessment, but the more relevant and accurate the information, the greater the likelihood of improved decision-making.

Information should be targeted at the correct risk drivers and should provide insights into areas such as the sensitivity of the business to movements resulting from the last quarter's activity.

The more robust and commercially relevant the management information prepared from the model is, the greater the organisation's ability to communicate effectively with all of its stakeholders, including:

- Investors
- Debt providers
- Rating agencies
- Underwriters and staff
- Reinsurers
- Brokers/distribution agents
- Co-insurers
- Clients

Improved communication with stakeholders could potentially facilitate improved understanding of the business's performance, leading to enhanced stakeholder confidence and ultimately improved credit ratings, valuation or even business terms.

2.4 Smoother credit rating assessments

Standard & Poor's and AM Best have recently introduced new measures into their global rating assessment processes that include a review of a company's internal modelling capabilities.

Where a firm relies on a credit rating, the internal model should be built to meet rating agency needs, as well as those required for Solvency II.

3. Time to change

Insurance companies moving to a more risk-based underwriting strategy are finding risk and capital becoming increasingly central to underwriting decisions.

The status quo is being challenged, with

more questions being asked about the implications of certain lines of business.

One of the key requirements under Solvency II is the need to satisfy the "Use Test", where the onus is on management to demonstrate that the internal model is embedded into the decision-making process.

As well as compliance with the Use Test, CEOs and their management teams need to use the internal modelling process to generate data that facilitates more informal decisions, such as those around:

- Where to deploy capital
- Whether to acquire businesses or teams
- Which parts of the existing business are non-core and should be disposed of
- What is the group's risk/return appetite?
- How the group's strategy should evolve

In order to achieve some of these value-added benefits from the Solvency II internal modelling process, CEOs should challenge their management teams to deliver a potentially greater level of detail.

For example, the quality of the responses to the questions set out below will be driven by the degree to which the internal model has been embedded in the organisation, and the robustness of the management information generated by it and other systems.

- How does capital currently affect strategic decision-making and how will this change as we improve the information available to our management team?
- What metrics will we use to measure capital efficiency and how do they interact with other goals (such as profitability, franchise building, cash flow and competitive positioning)?
- What is the marginal impact on capital of writing certain lines of business, and how does it impact diversification?
- Where are there capital inefficiencies in our structure, or risks that we can pass onto the markets for a lower cost than the cost of capital?
- What is our tolerance to specific events, and are there areas in our risk appetite where we could accumulate risk?
- What are the major drivers of capital usage in the business and what, therefore, should we look to mitigate?
- What are the key sensitivities in the results in terms of decisions related to calibration and modelling techniques? How robust are these and how materially would alternatives affect results?
- What are our five most significant risks and how do they compare to market benchmarks and our key competitors? What does this mean for the relative competitiveness and attractiveness of risks?
- What sources of capital would be most effective in absorbing losses, and what are the relative costs of these?

Underlying all of these questions is the need to be clear which performance measures the business is trying to optimise. Solvency II will provide a capital measure and, if implemented effectively, an enhanced level of data to support this, but it will be down to management to assess the relevant risk/return metric.

4. How to realise the potential

Companies should not overlook the limitations of the internal model, as these issues will affect the quality of decision-making and must be addressed if potential benefits are to be maximised. The following steps will need to be taken to mitigate the model's limitations:

4.1 Tackle complexity

Part of the reason that Solvency II compliance is so costly is that the questions addressed are inherently complex. While the benefits outlined above provide a source of advantage for businesses, they rely on overcoming the complexity of model output to leverage the information contained in that output. Technical capability and appropriate training will clearly allow some management teams to realise benefits more than others.

4.2 Invest in data quality

Management will need to provide the capabilities to allow data from the model to be produced on a real time basis, so as to enhance the accuracy of decisions. Consequently, management should consider the following in relation to timely management information:

- What is the most appropriate method of long-term solvency monitoring?
- What is the correct balance between roll forward and approximation against full hard close?
- What is the process to update and robustly challenge the assumptions on a timely basis, given volatility in market conditions?
- What is the process for identifying those assumptions that are key for timely updates?
- To what extent does the internal modelling process simply amplify the existing problem of inherently poor data quality (e.g. for specific lines of business)?

It is vitally important that data is produced from one source – that being the internal model – and is of sufficient quality (i.e. robust and complete) to ensure consistency with all the other measures in the business (e.g. the International Financial Reporting Standards) in order to avoid creating a misleading picture.

Stress and scenario testing is required to ensure that the outcomes of the internal model make sense in realistic stress scenarios.

Reverse testing should also be performed to identify what events, or sequences thereof, would lead to failure of the business or of its critical support functions (e.g. debt covenants, credit rating etc).

5. Model example

Having invested in sophisticated capital models, management are able to refine their capital allocation decisions more precisely. A logical next step in the use of these models is developing management information systems to provide insight into returns on capital employed by portfolio.

Such information would not just highlight performing or underperforming lines of business, but allow management

the opportunity to consider how to develop positively performing lines of business or create strategies for dealing with underperforming lines. This increased focus can only be of benefit to shareholders and will demonstrate an active management of each business line.

Such analysis may lead to a splitting of the business between ongoing and discontinued business lines and the creation of exit strategies for non-core or underperforming portfolios that are incapable of being turned around. This same analysis can be expanded across legal entities and geographical borders.

One such area for consideration may be where an insurer has a presence in both the Lloyd's and company market; it may be worth considering which "paper" is best for performing portfolios and creating the appropriate strategies for expanding business on an efficient capital platform.

Decisions obviously need to be made on operational and commercial aspects. In particular, when assessing the options for the underperforming portfolios there may be:

- Commercial reasons for continuing to write such business e.g. it is part of a combined policy that needs to be written to support better-performing lines of business;
- Client requirements, where part of a wider business relationship;
- Strategic reasons for writing the business, such as entering new markets; or
- Macroeconomic reasons for underperformance that are being seen across the sector, which are regarded by management as a temporary phenomenon.

Portfolios that are incapable of remedy and hold no commercial purpose can be considered for placing into run-off, and would then need to be actively managed to conclusion to protect value. Grouping a number of discontinued books together would provide management focus and generate possible economies.

Discontinued lines can also be sold into the buoyant run-off acquisition market, which can provide attractive value for vendors, enabling them to quickly free up capital for redeployment on expanding positively performing business and growth markets.

6. A call to action

The internal model can clearly deliver overwhelming commercial benefits that, if capitalised on, can result in improved profitability and returns on capital. In addition to increasing a company's value through enhanced profitability, we believe the additional data the internal models will produce on an annual basis can allow companies to improve financial disclosure to investors.

With such improved disclosure increasing the transparency of the business, new investors will be attracted, ultimately resulting in a positive effect on the company's valuation. Proper development of the internal model can turn what has been widely regarded as a negative drain on resources into a positive competitive advantage. Now is the time to act if your company is to be one of the beneficiaries.

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential. For more information, please visit www.ey.com

Richard Battersby Partner | EMEIA Financial Services – Transaction Advisory Services
+44 20 7951 4471 | rbattersby@uk.ey.com

Mike Barkham Partner | European Actuarial Services
+44 20 7951 1516 | mbarkham@uk.ey.com

Tim Leggett Partner | EMEIA Financial Services – Insurance
+44 20 7951 1877 | tleggett@uk.ey.com

Simon Burtwell Partner | EMEIA Financial Services – Insurance
+44 20 7951 0532 | sburtwell@uk.ey.com

Kevin Gill Partner | EMEIA Financial Services – Transaction Advisory Services
+44 20 7951 9362 | kgill@uk.ey.com