

Solvency II: Insure against insolvency, too

January 30, 2010

Consultants EMB are predicting a 62% uplift in capital requirements for the UK P&C insurance industry. These figures are based on post QIS4 changes to the rules. Sensational figures make people (including the BRAVE partners) read stories. The real story is that all firms - even small ones - should look to build an internal model. BRAVE Partners outlines how.

Regulatory incentives

Basel II was no different. With Solvency II the regulators are seeking to create incentives for all insurance companies to build internal risk models. Those incentives have become clear with the study undertaken by EMB consultants. Firms that choose the standard formulas for Solvency II capital will require, on average, 62% more capital. The range was vast – with a 10% increase at the bottom end and 120% at the top end – but a certain increase across the board.

The modelling task

Building internal models often appears to be an Herculean task, with an expense to match. At BRAVE Partners we believe not. The firm has, for some time, been advocating a sophisticated, yet straightforward and transparent, approach to risk modelling for Solvency II. The approach is outlined on the [BRAVE Partners website](#) and there is even an [interactive demo tailored to Solvency II](#).

Data is the key

The central element in the implementation of Solvency II is data. An insurer will face data capture, cleaning and management, regardless of whether it chooses the standardised, or internal model based approach. Risk measuring and monitoring relies on good data. This piece of the puzzle will consume resource, but it has an overall benefit to the business.

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From data to model

Once the data has been gathered, the step to an internal model is not vast. The data feed the internal model much as they would the standardised formula. Ultimately the standardised formula is just a simplified model.

The embedding challenge

The main challenge facing smaller insurers is the task of embedding the model into the governance and management of the business. An internal model must be both understood by the firm's management, including the board, and used in their decision making process. BRAVE Partners has heard murmurings that at least one of the major consultancy firms is establishing a huge team to provide senior managers in the insurance industry with training on risk models and modeling. So, one solution to the Solvency II requirements is for senior management to attend night classes on complex mathematics.

BRAVE Partners has observed frequently that that can be a tall order for some modelling approaches – the reasons why are outlined in a number of commentary pieces, such as [“Don't build a Condo on Mars”](#).

The key to an embedded model

Most models are built in a vacuum and then the business leaders are asked for bizarre inputs, such as the correlation between hurricanes in the NE USA and the Gulf of Mexico. However, BRAVE Partners believes that the key to an embedding is to build a model from the business decision process. BRAVE Partners' approach is driven by this philosophy. The end result is a transparent model that can be constructed with minimum effort.

BRAVE Partners services

BRAVE Partners can assist clients to develop a Solvency II framework that becomes an asset of the business that can place a firm among the leaders in the business.

It is now clear that firms that do successfully go down the modeling path will have a distinct business advantage over those that do not. Using the risk techniques and approaches, it is straightforward to construct a transparent, embedded risk model.

BRAVE Partners can advise on the best modeling techniques and frameworks to build a compliant Solvency II internal model.

- Regulators seem to be using Solvency II as an incentive framework for insurance companies to build internal risk models.
- Those companies that do not comply with the regulators' agenda will find themselves capital constrained compared with their peers and therefore less competitive.
- BRAVE Partners can assist insurers to build a Solvency II framework and a detailed capital plan as an asset for the business.
- Insurers that follow a model embedding program will emerge stronger than their competitors that do not.

Interaction

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