

Solvency II: Pop QIS

QIS5 looms. The industry is gaining clarity on how Solvency II will impact individual businesses and business lines. A diversification benefit is back on the table. This will have a negative impact on small, niche businesses unless it is handled with care.

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Pop[ular music] has more to do with the insurance industry than might meet the eye. Not only does the Lloyds market insure many individual stars and their essential body parts, but also lurking among the industry executives are a few of the stars from yesteryear. It is not quite the case that John Bonham faked his death to fulfil his long term ambition to be an insurance executive and now runs Axis Capital, but if you know what the BRAVE partners know – you would be surprised.

QIS5

Almost as popular as the Led Zeppelin reunion – QIS5. Regulators are keen for this to be a broad test of the current proposals.

“Diversification in an event driven portfolio is not about correlation.”

Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

A lot of progress seems to have been made following the industry consultation post QIS4. In most cases, industry concerns appear to have been taken into account – in particular illiquidity premiums, an essential point for annuity blocks, the winding up gap and the treatment of future premiums.

Diversity

The controversial issue of diversification is back on the table. At the outset, Solvency II was rumoured to favour larger insurance companies through providing capital benefits for diversified business models. The early implementations did not incorporate the diversification element, but now it is back with QIS5.

Measuring diversification

BRAVE partner, Christopher Cloke-Browne, has long experience in modelling and measuring diversification in event driven portfolios. Diversification in an event driven portfolio is not about correlation. As the collapse of synthetic CDO trading has shown, correlation is simply the wrong measure. In this market, which has produced some substantial losses in trading books, the implied correlation on CDO tranches has often exceeded 100%. Mathematically this should not be possible.

Condos on Mars

BRAVE Partners has already commented on the issues surrounding building diversification into Solvency II models in commentary such as: "[Don't build a condo on Mars](#)". The point is that correlation is a spurious measure of co-occurrence risk – the risk that several negative events occur at the same time – or that one event has many negative impacts.

BRAVE Partners approach

The BRAVE partners have developed sophisticated, yet simple to implement technology to model the diversification benefit of event driven risks.

Interactive examples of the technology are available on the BRAVE Partners website at:

<http://www.bravepartners.com/BRAVE%20RiskAnalytics.php>

BRAVE Partners services

BRAVE Partners can advise insurers on the construction and parameterisation of their Solvency II models in order to accurately reflect the true diversification benefits of their business. This might be particularly useful for a small, specialised insurer where the diversification is greater than might be immediately apparent.

Interaction

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- QIS5 puts diversification firmly back onto the Solvency II agenda.
- Diversification favours large firms over small ones.
- BRAVE Partners can assist insurers to build a Solvency II model that will fully capture diversification benefits, even for smaller insurers.
- This would assist smaller, niche insurers in remaining competitive post Solvency II.

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