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This article was
published by
Lending Strategy,
March 2010

A holistic approach to solvency

Forgive me if I don't jump for joy at the news that the UK has just crossed the line in coming out of recession at the end of January. Growth of just 0.1 percent provides precious little to cheer about particularly as many economists have warned that the country could slide straight back into recession.

Without appearing pessimistic, I think the fact that the Bank of England remains cautious over the UK's growth prospects serves to highlight the fact that a business's ability to use the various tools at their disposal to ride the economic storms has never been more important. In my book, that makes the practical use of an integrated risk management approach to decision making fundamental to the future success of any firm.

In difficult economic conditions, it is all too easy to become internally focused. The temptation is to simply focus on identifying and mitigating your own organisation's risks relative to its appetite, moreover, the adequacy of your systems and controls. However, as I discussed last month, it is also essential to look beyond your own four walls. A firm must understand the impact of the decisions it makes with regards to the business partners it works with. Failure to properly identify and understand the risks that your business relationships present to you and you to them could have significant consequences on your own firm's performance and reputation.

Lenders and insurers have worked hand-in-hand for many years. Our core activities complement one another. We've enjoyed mutually beneficial relationships – although naturally some have fallen down along the way and some lenders have chosen to replace insurers with their own captives. I wonder, however, whether the advent of Solvency

II is going to cause a review of existing relationships and if so, how important a factor will an insurer's approach to the new regime be?

Solvency II is really all about ensuring that an insurer can effectively manage the risks it undertakes relative to its appetite for a given risk and the corresponding capital required to support that strategy be it, geographic, product or channel. There is not much contained within the new regime that a firm wouldn't want to do in order to build a sustainable, profitable business that consistently meets shareholder returns over time. Like Basel II, it has three key pillars, capital resources, risk management framework and governance, and disclosure. The key decision for insurers is whether to adopt the standard formula to be dictated by the EU or take the opportunity to fully embrace the ambitions of Solvency II, and take a holistic, long-term view in creating its own internal model for driving sound economic business decisions.

I believe that an organisation that chooses to develop their own internal models under the Solvency II directive will by definition have more sophisticated systems and controls and an optimal capital structure. It will offer greater economic stability, be more transparent and react and respond far more efficiently to changing market conditions. Ultimately, it will offer greater stability to its business partners. While it might represent a less painful approach and take a whole lot less work, a business that simply chooses the standard approach is missing the opportunity to truly understand how it can use risk management to drive better business decisions, make more effective use of its capital, and ultimately offer its business partners a competitive proposition.

The effective and practical application of risk management tools will have a positive impact on calculating an insurer's capital position.

For example, as part of the internal modelling process, an insurer will have to ask itself whether it has the right balance of products in its portfolio and question the volatility of each line. If you write a large book of business such as personal property protection with a stable loss ratio, it will still deliver a solid return even in an extreme trading environment and therefore has a lower capital requirement. A more volatile book of business such as credit insurance, however, is likely to experience poorer returns in extreme market conditions and therefore

has a higher capital requirement. Balancing out the portfolio will enable the insurer to blend its capital requirement and achieve the desired returns while continuing to write the more volatile lines of its portfolio.

Reinsurance is another tool that can be employed to provide a smoother path in the tougher years, but clearly there are costs associated with this. The risk modelling process should result in a business determining its appetite for risk and whether reinsurance is appropriate, and if so, how much it is willing to pay. Would it prefer to avoid the cost of reinsurance and experience an ROE of 20% over say, a three year period, and risk seeing that drop dramatically in a tough environment or is a lower but stable annual ROE more desirable with the comfort of having transferred some of the risk off the balance sheet via reinsurance? An internal risk model can test reinsurance options, and determine whether they are likely to change as the business appetite for risk changes.

Failure to implement Solvency II effectively could have a negative impact on a company's attractiveness to existing and future business partners. If it fails to demonstrate that its data is of sufficient quality, its procedures and policies are documented accurately, and that it uses its model to drive business decisions, it still runs the risk of having further capital requirements placed on it. Not only that, the cumulative effect of these failures will only result in instability which ultimately impacts both its business partners and their customers.

The holistic approach involves greater commitment from a business for sure, but the benefits to an insurer and its business partners, I believe, will more than compensate the effort. By optimising the use of its capital, an insurer will be in a better position to deliver more competitive propositions to its business partners. It will have a more efficient decision making process enabling it to quickly react and respond to changing market conditions. The quality of information available to share with its partners should also assist in improving the management of the partner's portfolio.

Sound risk management forms the bedrock of future stability for lenders and insurers alike, and stability is something that we're all looking for particularly in today's challenging environment.