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Briefing note

Appropriateness of standard formula for SCR

It isn't news to firms that they have to understand and explain the differences between their own risk profile and the underlying assumptions of their Solvency Capital Requirement (SCR), to demonstrate appropriateness, but it is one aspect of Solvency II preparation that may have sat on the backburner until now.

> "Firms must first identify where there are deviations between their risk profile and the standard formula assumptions and then assess the significance of any deviations."

Until recently much Prudential Regulation Authority (PRA) resource has been dedicated to larger and Internal Model Approval Process (IMAP) insurers. However, with IMAP underway, it seems that the PRA has now started to direct more focus towards smaller standard formula firms.

For standard formula firms this appropriateness exercise is particularly pertinent as they have very limited control over the assumptions that are used and a key message from the PRA's Solvency II update, in October 2014, was that firms are required to demonstrate that the standard formula is appropriate for them. This was also a hot topic at the 2014 Institute and Faculty of Actuaries Life Conference.

Regardless of whether the PRA has specifically requested the assessment, given the approaching Solvency II deadline, it is now time for firms to consider the practicalities of carrying it out. The exercise will ultimately form part of the Own Risk and Solvency Assessment (ORSA) for all firms and, for threshold firms, will be required as part of their 2015 Forward Looking Assessment of Own Risks (FLAOR) submission.

How standard are you?

Unsurprisingly, the standard formula approach, for calculating the SCR, is named as such as it has been developed by European Insurance and Occupational Pensions Authority (EIOPA) to cover the material quantifiable risks that most undertakings are exposed to. However, it is unlikely that it perfectly represents all the risks of all non-IMAP firms:

- Some material risks a firm is exposed to may not be covered; or
- For risks that are covered, the underlying assumptions may not reflect the firm's risk profile.

Firms must first identify where there are deviations between their risk profile and the standard formula assumptions and then assess the significance of any deviations.

The PRA's message at their Solvency II update was that a significant proportion of UK insurers should fit within the standard formula framework. The upside of this for firms is that most are not expected to have to go down an internal model route, saving considerable time, effort and cost. However, the challenge for firms is to come up with a practical approach for demonstrating that the standard formula is appropriate.

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> It is not acceptable to simply compare the overall solvency needs under the ORSA with the SCR to determine whether the risk profile deviates significantly from the SCR assumptions.

Assessing the appropriateness of the standard formula

EIOPA has stated that it will not prescribe:

- An approach for assessing the significance of the deviation;
- The circumstances under which it would be appropriate for a firm to consider possible deviations of its risk profile from the standard formula assumptions; or
- What should be taken into account in the assessment.

So what help is out there for firms?

EIOPA's draft guidelines on ORSA include some explanatory text that outlines what should be included in the assessment:

1. An analysis of the risk profile and an assessment of the reasons why the standard formula is appropriate, including a ranking of risks;
2. An analysis of the sensitivity of the standard formula to changes in the risk profile, including the influence of reinsurance arrangements, diversification effects and the effects of other risk mitigation techniques;
3. An assessment of the sensitivities of the SCR to the main parameters, including undertaking-specific parameters;
4. An elaboration on the appropriateness of the parameters of the standard formula or of undertaking-specific parameters;
5. An explanation as to why the nature, scale and complexity of the risks justify any simplifications used; and
6. An analysis of how the results of the standard formula are used in the decision making process

In July 2014, EIOPA released a paper describing the underlying assumptions in the *standard formula calculation*. This is a likely starting point for firms although it is questionable whether there is enough detail in the paper to ascertain what exactly the standard firm is and to give a sufficient base against which to compare.

So what are the dos and don'ts? First, the don'ts then, more helpfully, the dos…

Don't: put off considering this assessment any longer

Whilst, as with all aspects of Solvency II, materiality and proportionality should be central considerations when designing the approach to assessing the appropriateness of the standard formula, time does need to be set aside to develop an acceptable approach.

Don't: simply compare the overall solvency needs under the ORSA with the SCR

It is not acceptable to simply compare the overall solvency needs under the ORSA with the SCR to determine whether the risk profile deviates significantly from the SCR assumptions. The overall solvency needs and SCR may be calculated on different bases and include different items. Similarly, a comparison with the Individual Capital Assessment (ICA) is not sufficient.

> A qualitative assessment is permitted in the first instance, to consider the significance of the deviation between the actual risk profile and the risks assumed in each of the modules of the standard formula.

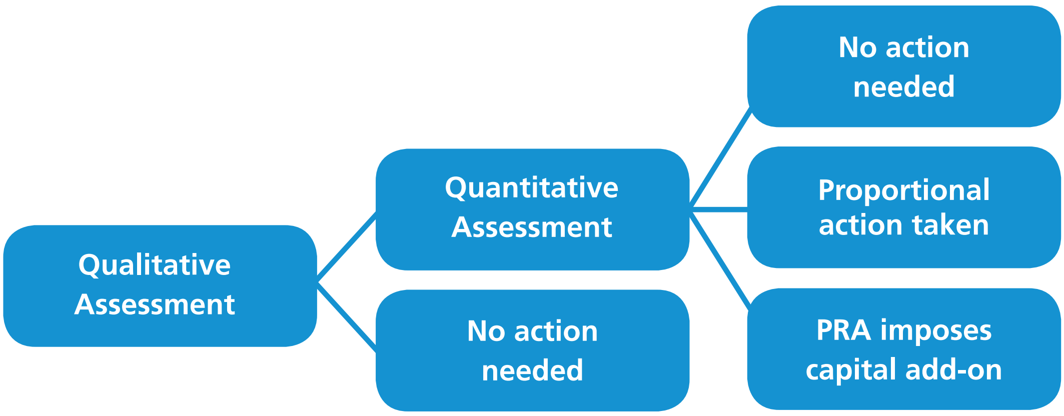
Do: use the ORSA

The ORSA is an important starting point for identifying where there may be differences. The risks, assumptions, stresses and correlations underlying the ORSA should all be considered.

Do: start with a qualitative assessment

A qualitative assessment is permitted in the first instance, to consider the significance of the deviation between the actual risk profile and the risks assumed in each of the modules of the standard formula. The correlations between the modules should also be considered.

Where the deviations are considered to be significant then a quantitative assessment is required.



It is during these qualitative and quantitative assessments that EIOPA's assumptions paper will be required. This paper does however lack some depth. For example, without knowing the fund structure underlying the equity stress, it is difficult to assess whether the stress is appropriate to the firm's equity portfolio. Further, the paper outlines some shortfalls of the standard formula approach, for example, it does not account for equity volatility, a risk faced by many firms who would consider themselves standard. It is also well known that the standard formula doesn't sufficiently cover catastrophe risk for general insurance firms.

Do: consider the implications of the assessment and what action is needed

Despite basing the standard formula on a typical insurance profile, it is accepted that there is no one-size-fits-all and some deviations are expected. One of the major areas for concern in the standard formula is operational risk. Operational risk is notoriously difficult to quantify and a risk that varies widely between firms. In this case, the standard formula may over simplify the process to manage operational risk.

Where material deviations occur, firms need to consider whether additional actions may be required:

- Establish a suitable governance system that adequately manages the risks faced, especially those risks that cannot be properly addressed by quantitative requirements reflected in the SCR.

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> The ultimate questions that need to be answered are whether the decision taken will add value to stakeholders and if any additional cost is justified by increased policyholder protection, otherwise it goes against the key aim of the regime.

- Align the risk profile to the standard formula, removing any non-standard risks. This approach has implications for the future in terms of product offerings. It is possible that firms using the standard formula will be discouraged from creating new and innovative or non-standard products that might make the profile of their business non-standard.
- Applying for underwriting specific parameters, if these are appropriate.
- Developing a partial or full internal model, a costly and resource-heavy option. The materiality concept suggests that this is an option if the standard formula significantly mis-states the SCR and the PRA has cautioned that firms should only go down this route if the standard formula is not a good fit. There would seem to be a balancing act for firms to struggle with – how inappropriate must the standard formula approach be before an internal model approach is appropriate?

Proportionality should be considered when deciding on the most appropriate course of action. The ultimate questions that need to be answered are whether the decision taken will add value to stakeholders and if any additional cost is justified by increased policyholder protection, otherwise it goes against the key aim of the regime.

Do: provide the PRA with an adequate analysis

It is important to demonstrate an adequate understanding of the assumptions and correlations underlying the standard formula and that, where these are materially inappropriate for the given risk profile, satisfactory actions have been taken to resolve these.

If the PRA considers such actions to be insufficient and the firm is required to hold the risk, capital add-ons may be applied, although the PRA has advised that this should not be a permanent solution.

Conclusions

The PRA will be expecting standard formula firms to make progress with their assessments over the coming months and the impending Solvency II deadline should also act as a stimulus. Firms should be aware of the challenges that they may face in undertaking such an assessment and in taking action upon obtaining the results.

Could it be possible we will see a rise in the number of firms applying for full or partial internal models in the future?

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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