

# Run-off: the highway or the by-way?

**Although it is clear that Solvency II will apply to the vast majority of run-off businesses, there may still be a temptation by some to take the 'path of least resistance'. Steve Mathews warns against taking the easier option without first considering the implications for both policyholders and shareholders.**

## Introduction

Faced with a choice between one of the four methods for calculating the Solvency Capital Requirement (SCR) under Solvency II, the 'standard formula' may seem an obvious choice for run-off organisations. Certainly, its relative simplicity compared to the other methods and the time commitment involved is attractive.

However, the run-off sector has some very specific characteristics that the standard formula does not readily accommodate. Notably, Lloyd's has already taken the decision that all its agents and syndicates, including those with run-off books, will be required to develop an internal model which will feed into the central Lloyd's model that will go for approval by the FSA.

The SCR calculation choice for each firm will depend on a number of different factors so there is no single right way. But our analysis shows that the standard formula is likely to lead to higher capital requirements for run-off companies which will, in turn, restrict repatriating profit to shareholders.

Closer examination of the pros and cons of the options from a run-off perspective certainly seems warranted.

## The four SCR options

For those relatively new to Solvency II, or to recap for those that are not, the SCR is the central plank of the quantitative (Pillar 1) requirements.

Pillar 2 covers the qualitative measures, notably the Own Risk Solvency Assessment (ORSA) and Pillar 3 deals with disclosure. This paper touches upon these but concentrates on the quantitative options and the issues that may arise from each.

The four options for arriving at a company's SCR are:

- The standard formula
- The standard formula, but using historical data to set some undertaking specific parameters
- A partial internal model
- A full internal model

## The standard formula

Almost by definition, the standard formula is not designed to reflect the risk profile of a particular organisation. It's worth bearing in mind that neither Solvency II nor the standard formula component were designed with the run-off sector in mind.

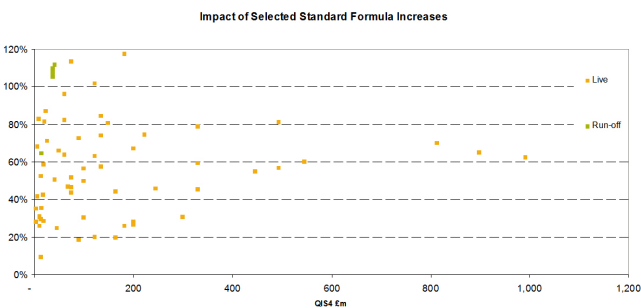
Many run-off books contain elements of risks such as asbestos, pollution, health hazard, LMX, WTC and so on. These risks were not included to any meaningful extent in the parameterisation of the standard formula - which was mainly focussed on business written in the last 10 years. As such, it is far from clear that the standard formula is appropriate for run-off companies.

So, probably the first thing run-off companies have to think about is whether the standard model is appropriate to quantify the risks within their organisation and, after that, whether they can convince a regulator of that fact. If the regulator doesn't agree with an assessment of appropriateness, it can insist that the business creates an internal model anyway. Alternatively, the regulator may choose to delve much more deeply into your ORSA - more of which later.

The second consideration with the standard formula is what it will do to the amount of regulatory capital run-off companies have to hold?

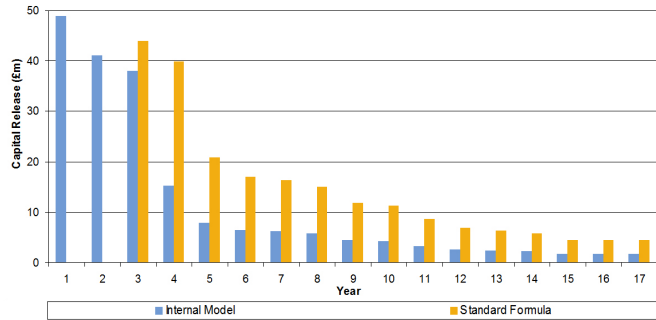
EMB research has shown the significant impact of changes made by CEIOPS to the standard formula calculation parameters since QIS4 (which was broadly in line with the ICA). The study included around 70 insurance entities with a QIS capitalisation of over £8 billion, including five run-off companies.

The market average increase was over 60% but figure 1 below shows the range of increases, with run-off groups highlighted in green. This shows that in four out of five cases, the capital requirement for run-off organisations more than doubled. The latest adjustments to the parameters in April 2010 have caused some mitigation of



these effects, but on a relatively minor scale. Although many parts of the insurance industry are still engaged in feverish lobbying to limit the need to raise new capital it is hard to see CEIOPS dispensing completely with the prudent standard formula calibration measures that would seem, in part, designed to push more insurance companies towards internal models. Ultimately, this may not be such an issue for traditional insurers anyway, many of whom maintain a large capital buffer for specific purposes such as maintaining a superior rating with rating agencies.

This is not the case in the run-off sector where one of the main objectives is to repatriate capital as quickly as possible. Therefore, capital levels have historically been a lot closer to the regulatory minimum. As figure 2 (above right) shows, the need to retain excess capital to meet a regulatory requirement (at the levels found in our study) could cause significant delays in releasing capital. In this case, the entity would be unable to release any profit to shareholders in the first two years after Solvency II.



So, if the standard formula is starting to look less attractive, what are the additional pluses and minuses of the alternatives?

### Undertaking specific parameters

CEIOPS currently offers three prescribed methods for a company to use its own or pooled data to estimate parameters that are relevant to the organisation. Unfortunately, we consider that only one of these methods is likely to be appropriate for run-off business. This is quite a basic model with some unintuitive features and it is not particularly helpful in that it still leaves no room for judgement.

### Partial internal model

While companies have to be able to demonstrate the rationale for their decisions to regulators, the partial internal model allows companies to use a model for some parts of the capital calculation and the standard formula for the remainder. Since much of the capital in the run-off sector is allocated for reserving risk, this would be an obvious area for inclusion in a partial model.

The effect of having a model, albeit only covering part of the operations, should be to reduce the capital requirement. This addresses the issue of being able to release capital back to the shareholders.

Securing regulatory approval for a model, however, comes with associated management responsibilities. There is also a need for action in 2010 as the FSA has already kicked off a pre-application process for those companies that want to have a model ready and approved for the inception of Solvency II in 2012.

Primary among these responsibilities is the need to demonstrate compliance with the 'use test'. This requires companies to prove the model is embedded within its business culture and is used to make strategic decisions. There are also extensive requirements for the governance and documentation of the model which, when combined, make this far from an easy option.

The business benefits accruing to a firm which is able to successfully implement an internal model, along with the likely reduction in capital requirements means that we would expect the partial internal model route to be the preferred route for most run-off companies with a proactive run-off exit strategy.

#### Full internal model

The same requirements apply to a full internal model, with the addition of the extra work required to get a model approved to calculate a company's entire SCR.

Arguably, however, this is the level at which run-off consolidators should be operating in order to achieve efficiencies when taking on new books of business, to demonstrate credibility to their counterparties. A full internal model also enables a consolidator to better reflect diversification and to measure the true economic value of transactions.

#### Pillars 2 and 3

When making a choice about the best option for them, run-off companies need to remember that they will have to complete the ORSA anyway, regardless of which path they opt for. The ORSA is where a firm supplies its own assessment of risk management, measurement and mitigation in order to forecast its capital requirement for residual risks.

In terms of workload, this is the equivalent of an ICA+, in that it takes the material required for a best practice ICA submission up a further notch.

Due to the potential issues already highlighted about the appropriateness of the standard formula for run-off companies, the ORSA is likely to come under close examination from regulators. This will be the case particularly where there is a discrepancy between the standard formula SCR result and the ORSA.

#### Conclusion

There are clearly limitations for run-off companies in using the standard formula to calculate their SCR under Solvency II. First and foremost, there is widespread market belief, confirmed by EMB's research, that regulatory capital will be higher, delaying run-off companies' ability to return capital to their shareholders.

That being said, it is true to say that the alternatives of creating a partial or full internal model are not straightforward. For companies that aren't already progressing down this route, there is a lot of work to do in a relatively short time.

Whichever way they choose to go, run-off companies need to consider the wider consequences - so that they take the highway or by-way to Solvency II with their eyes open.

#### Steve Mathews is a director at EMB

Steve is a Fellow of the Institute of Actuaries and provides reserving, ICA and strategic advice to a number of Lloyd's Syndicates and London Market companies. He holds the Lloyd's Syndicates Practising Certificate and is a member of the London Market Actuaries Group. He is actively involved in assisting his clients in preparing for Solvency II, providing pricing advice to a number of London Market entities and in advising companies on latent claims issues.

For further information, please contact [steve.mathews@emb.com](mailto:steve.mathews@emb.com)



# EMB Worldwide

For more information contact your local EMB office or email us at [solvency-2@emb.com](mailto:solvency-2@emb.com).

## Europe

United Kingdom,  
Epsom  
Cambridge  
London  
+44 (0)1372 751060  
[info-uk@emb.com](mailto:info-uk@emb.com)

Germany,  
Cologne  
+49 221 356626-0  
[info-de@emb.com](mailto:info-de@emb.com)

France,  
Paris  
+33 (0)1 42 68 52 23  
[info-fr@emb.com](mailto:info-fr@emb.com)

Norway,  
Bergen  
+47 93 00 88 50  
[info-no@emb.com](mailto:info-no@emb.com)

The Netherlands,  
Amsterdam  
+31 (0)20 820 00 60  
[info-nl@emb.com](mailto:info-nl@emb.com)

Spain,  
Madrid  
+ 34 91 791 29 34  
[info-es@emb.com](mailto:info-es@emb.com)

## North America

San Diego, CA  
+1 858 793 1425  
[info-us@emb.com](mailto:info-us@emb.com)

San Antonio, TX  
+1 210 826 2878  
[info-us@emb.com](mailto:info-us@emb.com)

Chicago, IL  
+1 312 986 1425  
[info-us@emb.com](mailto:info-us@emb.com)

Chagrin Falls, OH  
+1 440 725 6204  
[info-us@emb.com](mailto:info-us@emb.com)

Hollywood, MD  
+1 312 261 9631  
[info-us@emb.com](mailto:info-us@emb.com)

Stamford, CT  
+1 203 604 2930  
[info-us@emb.com](mailto:info-us@emb.com)

## Latin America

Brazil,  
Sao Paulo  
+55 11 2711 1500  
[info-br@emb.com](mailto:info-br@emb.com)

## Africa

South Africa,  
Johannesburg  
+27 11 728 7651  
[info-za@emb.com](mailto:info-za@emb.com)

## Asia-Pacific

Japan,  
Tokyo  
+81 3 5942 5901  
[info-jp@emb.com](mailto:info-jp@emb.com)

India,  
New Delhi  
+91 124 410 1018  
[info-in@emb.com](mailto:info-in@emb.com)

Australia,  
Sydney  
(The Quantium Group)  
+61 2 9292 6400  
[info@quantium.com.au](mailto:info@quantium.com.au)

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