In anticipation of Prime Re Academy's Solvency Week in October Markus Räder of Prime Re Services has asked a few questions to Karel Van Hulle and Frank Cuypers, who will run the workshops. We are happy to share their answers with you, and hope seeing you next month at one or several of the three modules.

Markus
The Prime Re Academy Workshops are typically attended by actuaries and other insurance technicians. What message do you intend to convey to them?

Karel:
Do not overlook the total picture.
Actuaries and other technicians have a tendency to loose themselves in the technical details for which they love to develop good technical solutions. However, these solutions might not fit the total picture. The model that is finally retained needs to be comprehensive and understandable for outsiders, i.e. management, supervisory authority and in the end also for those who have an interest in the undertaking.
Accept that things are not perfect.
Rome was not built in a day. Insurance is complex and although the adoption of a risk based approach is a major improvement, some issues will have to be dealt with differently when more experience has been acquired with this innovative approach. This is particularly true for the calibration of a number of risks but also for the valuation of long term liabilities.

Frank:
I could not agree more with Karel, and to my shame I must admit that sometimes I catch even myself having gone too far… This is also why in the Risk, Capital and Solvency Models workshop we shall insist on keeping things as simple as possible, but not any simpler.

Markus
You and Frank strongly agree about the principles and ultimate goals of Solvency II and risk-based regulation in general. However, your opinions tend to diverge with regards to the implementation in Europe. How will the workshop address this?

Frank:
I am very critical of the Solvency II standard formula and much of the regulatory framework, and I shall illustrate some of my critiques with concrete examples during the workshops. Nevertheless, I am conscious that not everybody shares my opinions, and I thought it will be advantageous bringing Karel on board, so that the participants may develop a more differentiated picture of the framework.

Karel:
An important difference between the Swiss Solvency Test and Solvency II is that the first regime was adopted for one single country whilst the other regime applies to several thousands of small, medium-sized and large insurers and reinsurers in many different countries, with diverging legal and supervisory cultures and experiences. Ensuring that all companies in the EU apply the new (in principle uniform) regime in the same way is quite a challenge. Although few options have been provided for member states and insurance undertakings, divergences have occurred and goldplating has been practiced. This is an important reason why the principle based Solvency II regime has developed into a very complex regulatory regime. Through its work on supervisory convergence, EIOPA has been trying to put all supervisory noses in the same direction. That has resulted in a large number of recommendations and guidelines which become in practice mandatory for insurance undertakings. It is my belief that we are still in a transitional phase: once the risk based culture will be more embedded in the minds of insurers and supervisors, it will be possible to relax some of the requirements. I therefore continue to stress the importance for both insurance undertakings and supervisors to concentrate on the principles: the more rules, the less likely that they will all be correctly applied in practice.

Markus
The Swiss regulator used to favour and encourage a model diversification, with as a result more than half the Swiss insurance companies having implemented an internal model. What is your attitude towards internal models?

Karel:
Solvency II is a risk based solvency regime. For me, this automatically implies that a standard formula can only be a next to best solution. I have always been an enthusiastic supporter of internal models. They reflect much better the particular situation of an insurer. However, only few insurance undertakings and insurance groups in the EU have had their internal model approved by supervisory authorities. This has to do with a lack of experience that supervisors have had with internal models but also with the failure of many insurance undertakings to produce an internal model that was sufficiently credible and understandable to be approved by the supervisor. Many undertakings have therefore given preference to partial internal models as a first step in the direction of a full internal model. Here again, I believe that we need to have patience and that all parties concerned will feel more comfortable when they have gathered experience. On the other hand, one must admit that the existence of a detailed standard model has its advantage, particularly for small and medium-sized insurers, but also for supervisors.

Frank:
I'd actually go even further than Karel: particularly small and medium-sized insurers should develop an internal model, because given their simple corporate structures their internal models remain totally straightforward and manageable. After all, let's not kid ourselves: Solvency is not rocket science!

Nevertheless, I find Karel's positive and encouraging attitude towards internal models very reassuring. I wish it was shared by more regulators, tough, and I completely fail to understand why the European Union has done so little to improve their resources and skills. In the light of the colossal systemic risk a standard formula introduces, the current dismissive attitude of most regulators towards internal models appears irresponsible.

Markus
Most European insurers have decided to adopt EIOPA's standard formula. However, they all must to some extent implement in parallel an internal model in order to perform their ORSA, which should be used to help steering the company. What is your advice if the ORSA indicates one strategy to follow, while the standard formula penalizes this solution and grants a capital reduction for the opposite?

Karel:
The standard formula is not an "EIOPA formula". It was indeed developed by EIOPA, but it has become a legal document that has received the approval of both the Council and the European Parliament. This standard formula is mandatory. It is the basis for the definition of the SCR. The ORSA is something different. The ORSA was introduced to ensure that management does not hide behind the standard formula. The ORSA is not an additional capital requirement. It is there to ensure that an insurance undertaking does not engage in business for which it does not have the right amount of capital. The ORSA follows a forward looking approach. That is different from the one year time horizon which is the basis for the SCR. The ORSA is not there to punish the undertaking if its analysis leads to the conclusion that the undertaking needs more capital. The undertaking can perfectly take the measures needed to ensure that it will still respect the SCR in the future, for instance by no longer offering certain products or by improving its risk management. There is a lot of misunderstanding about the meaning of the SCR. Many insurance undertakings believe that their SCR has to be more than 100% and some supervisors seem to require undertakings to have an amount of capital that is well above 100%. I disagree with this because the SCR is a target and not an absolute number. In the same way, the ORSA cannot be used as another capital requirement in addition to the SCR.

Frank:
Unfortunately, already now almost everybody focuses solely on the solvency ratio: starting with the regulators, but also the analysts and the rating agencies. And as a result the use-test is largely forgotten. This is why we will use the toy internal model, which we shall develop during the Risk, Capital and Solvency Models workshop, in portfolio planning and reinsurance optimization exercises.

Prof. Karel Van Hulle
lectures at the Economics and Business Faculty of the KU Leuven (Belgium) and at the Economics Faculty of the Goethe University in Frankfurt where he is attached to the International Centre for Insurance Regulation. He is a member of the Insurance and Reinsurance Stakeholder Group of EIOPA and served as Head of Insurance and Pensions at the European Commission until 1 March 2013, where his main task was the development of Solvency II. He was a member of the Technical Committee of the International Association of Insurance Supervisors, of which he was nominated Distinguished Fellow in 2013. He was closely involved in the negotiations which lead to the equivalence decisions of the European Commission for Switzerland and for a number of other countries. He is a regular speaker at insurance and pension conferences around the world and is Honorary Fellow of the UK Institute and Faculty of Actuaries.

Dr Frank Cuypers
has led numerous actuarial engineering and modeling courses and workshops in Europe and Latin America. He comes with a vast lecturing experience and a prominent scientific track-record in modeling complex systems. As a Swiss Re Executive and Chief Actuary at the former Zurich Re in Cologne, he has wide experience in most actuarial disciplines and lines of business, which he has deployed at KPMG and PwC to advise leading providers of financial services and Government Agencies. He is a fully qualified member of the German and Swiss Actuarial Associations (DAV and SAV), which he has served on numerous committees.