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Solvency II demands businesses' documentation is up to scratch

KENT ULYATT and PETER JONES consider the importance of proper documentation

THE CHALLENGES of Solvency II should be embraced as an opportunity to put controls into insurance businesses that allow better evaluation of risk and give enhanced documented processes for all business functions.

Documented processes should be in place to guarantee accurate data is inputted throughout the organisation, with controls and validation in place to ensure the output from the internal model is reliable for making business decisions and mitigating business risk. Failure to achieve this as part of the Solvency II programme will result in the compliance requirements of Solvency II not being adhered to.

When we talk about documentation, we mean the processes undertaken by an insurance business to achieve the requirements of Solvency II are fully documented, as a transparent record of actions that have been taken – and will be taken – and the reasons for those actions.

When preparing for Solvency II, there are a number of considerations to be taken into account, including strategic business plans, the project programme, resources, skills, data quality, governance, the capital model and risk management. To account for these considerations properly, it is vital to create a framework supported by accurate data and documented in detail, with plans in place for monitoring, validating and change control management.

As Solvency II requires these high levels of data accuracy and documentation as part of the corporate governance requirements, we believe the importance of documentation and data should not be underestimated and should provide consistency with the way business is conducted within an organisation. PRO Insurance recognise it is crucial to ensure a detailed, end-to-end process is addressed and effective risk management embedded in the business and, as a result, has embedded a programme for ensuring this is achieved and maintained.

Documentation should be sufficiently comprehensive to allow all business processes to be understood by knowledgeable third parties. It should be possible for a new team to come into a business and, on the basis of existing documentation, carry on seamlessly. The three main areas where this is vital are: data; capital model; and risk management

Data

Documenting data input, management and controls is imperative to the quality and credibility of the processes behind the capital model. Procedural documentation must be in place that provides sufficient visibility showing the data used to develop, validate and operate the internal model is accurate and appropriate.

Documentation needs to be dynamic. It needs to have the flexibility to react to changes within a business and to be instrumental in guiding strategic decisions.

PRO Insurance places a change control system at the heart of its clients' process management, encompassing both the quantitative and qualitative elements.

Capital model

Documentation of a capital model requires sufficient level of detail to evidence the capital model incorporates appropriate risk drivers, the philosophy governing it is theoretically and practically valid and the mathematics of the model are robust. Documentation should show a holistic view of the process for those using the model for business decisions and for those operating, designing and running a capital model requiring more detailed individual calculations and assumptions. Inputs need to be defined and outputs need to be explained.

Documentation should show a model's sensitivity to specific risks. Stress testing showing the most likely events that could lead to an insurance business not having sufficient funds should be well documented. There should also be an assessment of how the model captures changes to the business environment, acquisitions and commutations, and incorporating external factors such as the economy and financial markets. PRO Insurance puts strong importance on the asset as well as the liability aspect of the capital model. On the asset side of the equation, this must include weight given to liquidity and market risk. Documentation about the liabilities must include discussion and explanation concerning all areas of reserving risk, underwriting risk, counterparty credit risk, operational risks and risks that cannot be captured within the model itself.

Risk management

At PRO Insurance, a separate documentation regime is applied to operational risk to capture the range of probabilities and events. Good risk management requires senior management is involved in the validation process and management needs to review the outputs from the model and record how the internal model results are used in business decisions. A comprehensive validation report should outline the gaps in the firm's existing validation activities and give recommendations for improvement in terms of methodology, system development, control processes and data-related procedures.

Documentation needs to be a continually evolving process seeking to achieve best practice, which explains what is done, how and why. These processes and documentation will help support the business and control its risks, as well as ensuring full Solvency II compliance.

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