

Insurance

Bridging risk and capital*

Countdown to Solvency II

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01



Solvency II on the radar:
Insurers' views on the
challenges ahead

02



Solvency II takes shape:
Emerging blueprint for
implementation

03



Winning over key
stakeholders: The Own Risk
and Solvency Assessment

04



In the best light:
Making the most of Pillar 3

05



Contacts

Foreword

Welcome to the fifth edition of Countdown to Solvency II, PricewaterhouseCoopers¹ newsletter examining the latest developments in the forthcoming reform of prudential regulation for European insurers.

A formal agreement has now been reached between the European Commission, Parliament and Council of Ministers on Solvency II, which will pave the way for the passing of the Framework Directive into law later in the year.

Securing the final go-ahead for Solvency II has required a considerable measure of compromise, not least on the controversial issues of group support and the treatment of equity risk.

Group support has been removed from the directive for now, though its possible re-inclusion will be reviewed a few years after initial implementation. The absence of group support may make it more difficult for groups made up of a network of locally incorporated subsidiaries to realise the full capital benefits of risk diversification. The alternative of a branch structure may have benefits, though as we discuss in this edition of Countdown, there are a number of factors to consider before deciding whether and how to follow this option.

In relation to equity risk, countries can in some circumstances maintain their current approach to valuation for clearly defined life products sold solely within their borders. However, this option only applies to portfolios with average liabilities of more than 15 years and the contracts must be ring-fenced from other areas of the business, with no possibility of transfer.

Even with the final compromises, the directive is set to have a transformational impact on the European insurance market in areas ranging from strategic planning and capital allocation to front office operations and market communications. As the focus of Solvency II shifts from legislation to the practicalities of implementation (a first wave of CEIOPS consultation papers has been published and more are due later in the year), this edition examines how companies can get their preparations on track and optimise the competitive benefits of their investment.

A key issue to note is that the scope of the companies covered by the directive is significantly broadened from Solvency I. Few exclusions remain. For example, a company will fall within the ambit of the directive if it has annual gross written premiums of more than €5 million or has technical provisions of more than €25 million or conducts any sort of credit or liability insurance business. With many more companies now likely to be subject to the directive, it is clearly important that they and others who have yet to get started begin their preparations as soon as possible.

As part of its response to the current financial crisis, the European Commission is looking at harmonising more closely some of the potentially conflicting national legislation that can make centralised group regulation and other aspects of the single market harder to introduce and apply. This includes insolvency and winding up procedures. In addition, a proposal for EU-wide insurance guarantee schemes is expected in Autumn 2009 which is expected to be implemented at the same time as Solvency II.

We hope that this and future editions provide insights that can help insurers to assess the implications of the directive and assist them in preparing for the changes ahead. The subjects covered are based on feedback from our clients. If you have any comments or if there are any issues you would like to see covered in future editions, please let me know.



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¹ 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

01

Solvency II on the radar: Insurers' views on the challenges ahead

A poll of insurance professionals carried by PricewaterhouseCoopers at the end of last year shows that Solvency II is now firmly on the Board agenda. Yet as Jim Bichard and Jan-Huug Lobregt report, many firms are concerned that their ability to meet key implementation deadlines and realise the business benefits of their investment may be impeded by potential project overload and lack of available talent.



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The QIS4¹ results indicate that the insurance industry is broadly supportive of the direction of Solvency II. As the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) noted 'the basic architecture of Solvency II seems to be well received'. CEIOPS also welcomed 'the impressive participation rate by industry [in QIS4], especially of smaller insurers and groups'², suggesting that the directive is now on the radar of many European insurers. Less evident at this stage, however, is whether these companies have a clear view of the implementation challenges involved and the likely costs, as well as the possibly significant competitive opportunities to be seized.

Increasingly, we are asked by our clients 'what are my peers doing?' and 'am I keeping pace'? So in November 2008, when over 60 industry professionals came together at a seminar hosted by PricewaterhouseCoopers in London, we took the opportunity to conduct a poll, posing some of the more pressing questions we had been asked. Respondents included representatives from a broad range of UK-based and international groups.

Given the timing of the seminar, several questions focused on the Financial Services Authority's (FSA) then recent outline of the 'actions that insurers should presently be undertaking'³, including gap analyses and the nomination and appointment of an individual responsible for the implementation of Solvency II. Both are key qualification criteria for participating in the FSA's internal model 'dry-runs', which are running through the summer of 2009 (see Countdown to Solvency II, Edition 4). That said, the answers to these, and other questions, provided revealing insights into insurers' broader perspectives on the directive, which

should interest companies across the European Union.

A business issue

Nearly three-quarters of the respondents said their 'nominated individual' is or would be a member of the executive Board (CFO (45%), CRO (27%) and even CEO (2%)), rather than the 'chief actuary' (9%). This marks a significant shift in attitude and underlines that Solvency II is increasingly seen as a business issue, rather than an elaborate actuarial exercise. As a result, the focus of implementation is moving away from the quantitative technicalities of Pillar 1 to the more demanding qualitative requirements of Pillar 2.

This is a positive development. Two of the most critical lessons from Basel II implementation were first, the importance of early senior management engagement and second, the need to ensure the effectiveness of risk management practices and their integration into the business (see article on pages 14–17).

Of course, Solvency II goes a step further than Basel II, stipulating not only an effective risk management framework, but the demonstrable overall coherence of any internal models used within risk management and decision making processes (the 'use test'). Interestingly, insurers at our seminar saw the use test as the toughest compliance challenge. They also saw this as the principal difference between Solvency II and the UK's Individual Capital Adequacy Standards (ICAS), which suggests that many models may not yet be embedded into decision making processes within the business, even though the ICAS regime has been in operation for several years. Their concerns are well-founded as the change management challenges of the

Solvency II is increasingly seen as a business issue rather than an elaborate actuarial exercise.

1, 2 The fourth Quantitative Impact Study run by the CEIOPS for the European Commission in preparation for the Level 2 implementing measures, the results of which were published in November 2008.

use test is likely to be considerable depending on the internal models used since it could impact all aspects of the organisation. If any internal models, full or partial, are used for any aspect of the business, these need to be visible as an integral and reliable driver of decision making throughout the organisation.

Managing pervasive change

The change management challenge presented by Solvency II is much broader than passing the use test. As mentioned above, the poll demonstrated that many are coming to realise that its implementation is not just a technical exercise, but requires a marked change in organisational behaviour. People will have to operate within the established risk management framework at all times, which means risk considerations underpinning all business decisions and extensive co-operation between risk, actuarial and finance professionals and business teams. They will need to

develop a common language and work together to a far greater extent than they have before. Effective training will be indispensable in addressing these challenges and bringing about the required change in behaviour.

Realising the benefits

The poll showed that most companies want to optimise business benefits through their investment in implementation. Respondents felt the most valuable prizes were better-informed decision making and the better use of capital. On the flip side, a combination of cost, potential project overload and pressures on limited resources were seen as principal obstacles to reaping the rewards.

Estimating the costs

While respondents anticipated that the expense of implementing Solvency II would be significant, their expectations on the actual cost for each company varied considerably. A majority felt that overall it would be less than 1% of gross written premiums (GWP) with 25% estimating between 1% and 0.5%, and 30% believing it would be less than 0.5%. However, nearly 20% believed the bill would be more than 2% of GWP (8% between 2 and 3 percent; 9% over 3%).

The investment required will depend on the nature, scale and complexity of the business and the organisation's level of ambition for Solvency II. Some companies will simply aim to comply with the directive, while others see Solvency II as an opportunity to strengthen operational efficiency and enhance business decisions. In this context, it was interesting that only 60% of respondents said that their organisations would definitely be seeking pre-approval for the use of an internal model and that less than 20%

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felt this decision was influenced by the FSA's accelerated timetable.

Avoiding project overload

Basel II showed that the risk of project overload is high. Failure to meet key milestones on time not only exacerbated the difficulties in achieving project objectives overall, but significantly increased costs.

It was therefore somewhat surprising that, given respondents' recognition of this risk, less than 20% had at that stage mapped out what needs to be done by performing a detailed gap analysis. Gap analyses provide a sound basis for project planning (which is why the FSA has indicated that a gap analysis has to be undertaken to qualify for its internal model dry run) and we would have expected a much higher proportion to have completed them by November 2008. Quite a few though will doubtless have done so in the subsequent months.

Talent shortage

The lack of available talent was seen as the most potentially problematic resource issue. This included not only actuarial, risk management and other professionals needed to ensure effective implementation within the industry, but also the perceived capabilities and readiness of the regulator. Less than 20% of respondents felt that the FSA has sufficient resources and expertise to enable internal model pre-approval to be achieved on a timely basis. In response, the FSA highlighted the additional £3.2 million being invested in new personnel over the coming year and also emphasised that the impact on its actuarial resources is likely to be less marked than some suppose.

The poll carried out in November reflected the perspectives of UK insurers. However, we have seen similar developments and views in other EU countries. Clearly, in the UK there is increasing awareness at Board level and Solvency II is a component of most 2009 budget allocations. The accelerated timetable set by the FSA for internal model pre-approval may seem exacting, but really only reflects the time and resources needed to upgrade systems and integrate them into governance and business planning in time for 2012.

Leading the way

Our work with clients across Europe indicates that a number of leading companies have already nominated an executive sponsor and carried out their gap analyses. Building on this foundation, they are now seeking to promote organisational engagement through embedding related measures into performance management and compensation. They are also looking at how to align Solvency II with associated initiatives, such as strengthening financial reporting and investor and rating agency disclosure. Six months down the line, we would expect them to have key project teams in place and a clear view of the timing and sequencing of implementation activities in areas ranging from training to data and validation.

We are seeing this in the market more generally, but the poll highlighted the importance of starting the Solvency II project as early as possible in order to use all the time available. With the Framework Directive now agreed, the implementation deadline of 31 October 2012 is fixed.

Success will not only be measured in terms of compliance, but also in the competitive advantages of more efficient use of capital and strengthened market confidence. While the technical changes are substantial, firms cannot afford to lose sight of the sizeable organisational change and management challenges, meeting which will depend both on talent and engagement.

Many companies have not yet started their Solvency II projects. This is particularly true for smaller insurers on the Continent, but is also the case for some larger groups. With the intense negotiations over the directive's text, many believed that the project might be delayed or even shelved. This is clearly not the case. The countdown to a new Solvency II world has now begun in earnest and any further delay could prove both needlessly costly and disruptive.

02

Solvency II takes shape: Emerging blueprint for implementation

With the launch of significant new supervisory guidance and overhaul of risk management regulations in Germany in anticipation of Solvency II Pillar 2, a clearer picture of how the principles of the new directive are likely to be put into practice is beginning to emerge. Mark Batten and Julia Schüller discuss what regulators are likely to expect and the resulting implications for insurers.



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Politics, as Bismarck said, is the ‘art of the attainable’. The Framework Directive for Solvency II has been approved by the European Parliament, following an agreement between MEPs, the European Commission and Council of Ministers, and will be formally passed into law later in the year. This required a compromise in which group support, the main point of contention, has been dropped from the directive, though its possible reinclusion will be reconsidered at a later date.

Many within the insurance industry may be disappointed by the withdrawal of group support, as this may make it harder to realise the diversification benefits of a consolidated group-wide solvency calculation. However, failure to reach an agreement ahead of the forthcoming European elections could have led to serious delays and even the derailing of the Solvency II project. The shelving of Solvency II would have led to an even more complex and fractured regulatory system within the EU, in which individual states adopt their own different interpretations of risk-based prudential supervision.

The Framework Directive that is now in place is still likely to have a transformational impact on the insurance industry. The precise implications depend on how the broad principles set out in the Framework Directive (‘Level 1’) are translated into detailed guidelines for practical implementation (‘Level 2’) and consistent application by different supervisors across the EU (‘Level 3’) – see Figure 1 for an explanation of the enactment process. Key considerations for insurers include the likely cost, the impact on strategy and operations and how regulators will enforce compliance. Naturally, companies will also be looking at how best to realise the business benefits of their investment.



Countries such as Denmark have set the scene for Solvency II through the introduction of interim risk-based capital requirements, (commonly known as ‘Solvency 1½’). A key feature of the Danish Individual Solvency Requirement and Adequate Capital is the emphasis on Board level oversight and accountability.

As we outline in this article, some further pointers to how Solvency II will be put into practice come from the German Federal Financial Supervisory Authority’s (BaFin) launch of new Minimum Requirements for Risk Management by Insurance Undertakings (MaRisk VA).

Recent months have also seen the publication of draft guidelines for the application and supervision of Solvency II by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), which is the lead adviser to the European Commission on the implementation measures for the directive. Further CEIOPS consultative papers will follow during the course of the year. Related guidance has come from the International Association of Insurance Supervisors (IAIS), which develops standards for supervisory best practice and co-operation around the world and is keen to promote a risk-based approach to prudential regulation.¹

Germany takes the lead

Introduced in January 2009, MaRisk VA² seeks to provide a stepping stone to Solvency II.³ MaRisk VA applies the regulations outlined in the German Insurance Supervisory Act, under which insurers and predominantly insurance-focused financial conglomerates should adopt appropriate risk management systems. This includes requiring companies to develop a risk strategy, gauge their risk-bearing capacity, decide on capital allocation and build this into their key business decisions. The design and application of MaRisk VA is of particular relevance to insurers across the EU, as one of its chief architects, Dr Thomas Steffen, Chief Executive Director for Insurance Supervision at BaFin, is also Chairman of CEIOPS.

MaRisk VA requires an 'economic' evaluation of assets and liabilities for the purpose of risk quantification, which is likely to accelerate the data and modelling challenges presented by Solvency II, especially in a market used to operating with the cushion of prudence margins. However, like Solvency II, MaRisk VA is far more than

just a technical challenge. Senior management will be expected to define a risk strategy and allocate capital for individual businesses in line with the overall risk appetite and business strategy of the enterprise. The risk strategy should include the risk bearing capacity of the enterprise, underpinned by tolerances for particular risks. These guidelines should be aligned with key aspects of the business, including compensation, and be continually reviewed and revised by the management board to take account of any changes in the risk profile, business objectives and prevailing market conditions. The review should be both quantitative and qualitative. A 'strategy audit' should draw on input from the internal audit function or the supervisory board, especially in the context of strategic risks.

The insurer should determine its ability to cover all material risks, based on its risk profile and risk-bearing capacity. This exercise provides the basis for allocating capital and risk limits in line with the risk and business strategy.

BaFin has also set out what kind of operational and organisational framework will be needed to facilitate this more systematic and integrated approach to risk and strategic management. This includes comprehensive risk identification, assessment and classification, covering all current and emerging risks inherent in relevant business processes. Subsequently, all material risks should be quantified using prescribed, fully documented valuation standards (potential loss, probability of loss occurrence and correlation).

The framework should also define clear structures for the oversight and control of business processes with significant inherent risks, including underwriting calculation of technical reserves, asset

1 IAIS media release 'IAIS issues key guidance papers on solvency assessment', 22.10.07.

2 Pension funds in legal form of mutual insurance associations, insurance companies in terms of section 53 para. 1 of German Insurance Supervisory Act, funeral expenses funds are excepted.

3 BaFin Quarterly Q2/08.



management (including asset-liability management) and the management of retrocession/ reinsurance. Duties should be segregated, where appropriate, for example separating oversight from direct control. Firms also need to demonstrate that the people assigned to monitor or manage risk within the business have appropriate knowledge and independence.

For the first time, German regulation includes clear stipulations on the work and structure of internal audit and business process outsourcing. To ensure this is a dynamic rather than a static process, all stakeholders will be expected to focus on how the assessment and design of their risk management systems could be improved, quantitatively, qualitatively and operationally. The frequency and scope of supervisory reviews are based on an assessment of the entity's risk profile, the nature and volume of underwriting, and the complexity of the business model.

Foundations for implementation

In 2008, CEIOPS published a series of related issues papers on governance, supervisory review and an insurer's Own Risk and Solvency Assessment (ORSA) – the latter is the focus of a separate article on pages 14–17.

While key aspects of the CEIOPS' proposals are comparable to MaRisk VA, they go further in both detail and substance in a number of important areas. Both MaRisk VA and CEIOPS require clear, precise and documented guidelines. CEIOPS explicitly stresses this for decision making procedures. It also insists that members of the administrative or management body must 'possess sufficient professional

qualifications, knowledge and experience...to provide a sound and prudent management of the undertaking',⁴ while MaRisk VA requires appropriate staffing and training of staff in general. To support this, corporate governance should be underpinned by an effective framework of reporting and co-operation, which covers all aspects of the business rather than just the communication of significant risks as specified in MaRisk VA. Risk reporting should also be tailored to the requirements of the management body to ensure a 'solid and reliable basis for the necessary management decisions'.⁵ In practice, training, explanation and distillation of critical information will be required to ensure Boards can understand and respond to what may be complex and unfamiliar risk data under both the CEIOPS and MaRisk VA requirements. It is also important to consider how these developments will affect the culture of the enterprise.

Operationally, CEIOPS specifies the need for a separate actuarial function and a compliance plan that takes account of each activity's susceptibility to regulatory risk. It also requires documented policies and procedures to ensure that people within the key functions of compliance, actuarial and internal audit are suitably 'fit and proper'. Within MaRisk VA, these stipulations are confined to risk management, though the circular does provide more detail on the obligations of internal audit than CEIOPS has done to date.

CEIOPS has set out detailed guidelines for the supervisory review process (SRP) as part of its plans for the harmonised interpretation and application of Solvency II across the various jurisdictions of the EU. Under the risk-based approach, the level and frequency of scrutiny should be

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⁴ 'Implementing measures on systems of governance', issues paper published by CEIOPS on 03.10.08.

⁵ 'Implementing measures on systems of governance', issues paper published by CEIOPS on 03.10.08.

proportionate to the nature, scale and complexity of the business and the effectiveness of its governance, risk monitoring and control. The onus will be on firms themselves to demonstrate that the business is properly managed and that appropriate safeguards are in place. For example, firms that conduct scenario analysis to gauge the relative impact of emerging risks and can document how this information will be communicated and acted upon are likely to benefit from a lighter touch SRP than those that do not. Regulators are also encouraged to look out for evidence of loose controls, poor quality management or crude underwriting strategies as early warning signs of a possible breach of solvency requirements, even if there is no immediate indication of financial distress.

CEIOPS is due to publish its advice to the European Commission on the implementation measures in the summer of 2009, followed by consultations and planned adoption in the autumn.

Solvency II goes global

In October 2008, the IAIS published a series of supervisory papers aimed at 'improving transparency, comparability and convergence of the assessment of insurers' solvency internationally'.⁶ The guidelines have close parallels with the principles of Solvency II and could thus provide the basis for the directive's application as a global standard for insurance regulation. This includes setting control levels for supervisory intervention,⁷ ensuring that enterprise risk management is integrated into the governance and business planning of the company⁸ and carrying out a regular ORSA that encompasses 'all material and reasonably foreseeable risks'.⁹ The IAIS also supports the use of an internal model as an alternative to standard

solvency evaluation as long as it meets appropriate statistical quality, calibration and use test standards.¹⁰

Of particular note is the IAIS' strong endorsement of the need for group-wide supervision. Its principles include the assessment of capital adequacy and internal controls on a group-wide basis, along with ensuring the necessary co-operation and exchange of information to allow efficient and effective group-wide scrutiny.¹¹ These principles echo the recommendations of a recent report by the High Level Expert Group on financial supervision in the EU ('the de Larosière report'), which calls for 'a balanced group support regime, coupled with sufficient safeguards for host member states, a binding mediation process between supervisors and the setting up of harmonised insurance guarantee schemes'.¹² A recent report by the UK Financial Services Authority ('the Turner review') has also called for a stronger role for colleges of supervisors as part of a 'much more unified approach to global financial supervision'.¹³

However, the IAIS accepts that group supervision is one of the least developed areas of regulatory practice and sets no timetable for mandatory implementation. It offers alternative approaches to calculating capital requirements within a group, with a consolidated single entity basis on one side and a legal entity method on the other. In addition to exploring these options further, the IAIS is committed to developing a framework for greater co-ordination and mutual recognition among supervisors. It believes that 'enhanced information sharing among supervisors resulting from supervisory recognition would reduce the risk of regulatory arbitrage and encourage effective risk management and measurement'.¹⁴ The IAIS believes that

6 IAIS media release 'IAIS issues supervisory papers on solvency assessment', 17.10.08.

7 'Guidance paper on the structure of regulatory capital requirements', published by the IAIS on 17.10.08.

8 'Guidance on ERM for capital adequacy and solvency purposes', published by the IAIS on 17.10.08.

9 'Guidance paper on the structure of regulatory capital requirements', published by the IAIS on 17.10.08.

10 'Guidance paper on the use of internal models for regulatory capital purposes', published by the IAIS on 17.10.08.

11 'Principles on group-wide supervision', published by the IAIS on 17.10.08.

12 'The High Level Expert Group on financial supervision in the EU', 25.02.09. The group of experts was brought together by the EU to 'strengthen European supervisory arrangements' in the wake of the financial crisis.

13 'Turner review: A regulatory response to the global banking crisis,' published by the UK FSA on 17.03.09.

14 'Guidance paper on the mutual recognition of reinsurance supervision', published by the IAIS on 17.10.08.



Those that delay or cut corners could actually end up facing higher compliance costs...

recognition does not necessarily require a formal agreement or regulatory equivalence as long as supervisory practices are suitably competent and transparent.¹⁵ Where appropriate, this may include further development of supervisory colleges.¹⁶ Under the guidelines for colleges of supervisors published by CEIOPS and the Committee of European Banking Supervisors (CEBS), the group supervisor would be responsible for setting a work programme and co-ordinating the operations of the college.¹⁷

Accelerating momentum

With the formal enactment of the Framework Directive now imminent, the preparations for Solvency II can begin in earnest. The European Commission, CEIOPS and the industry itself all need to play a part in developing a workable and beneficial framework for implementation and ensuring that it is applied consistently across the EU.

The developments outlined in this article provide further clarification about what supervisors are likely to expect. They highlight the extent of the work needed to integrate risk management into the governance and decision making of the business and develop the frameworks of control, oversight and documentation needed to demonstrate that this is the case.

Companies that ensure their preparations are timely and thorough are likely to face a less onerous regulatory burden in the long run. They will also be in a better position to realise the benefits of more effective control, more efficient processes and more informed decision making. Those that delay or cut corners could actually end up facing higher compliance costs and potential disruption, as any weaknesses may heighten regulatory scrutiny and the need for rapid remediation.

¹⁵ 'Guidance paper on the mutual recognition of reinsurance supervision', published by the IAIS on 17.10.08.

¹⁶ 'Principles on group-wide supervision', published by the IAIS on 17.10.08.

¹⁷ 'Colleges of supervisors – Ten common principles', published by CEBS and CEIOPS on 27.01.09.

03

Winning over key stakeholders: The Own Risk and Solvency Assessment

The Own Risk and Solvency Assessment (ORSA) is an opportunity to showcase the firm's risk management capabilities and demonstrate how risk and capital management is used to support decision making and ultimately create value. Farid Bonawiede, Erica Nicholson and Immy Pandor examine why the ORSA is set to be such an important regulatory mechanism under the new regime and how it will provide firms with an opportunity to extract real business value from their Solvency II investment.



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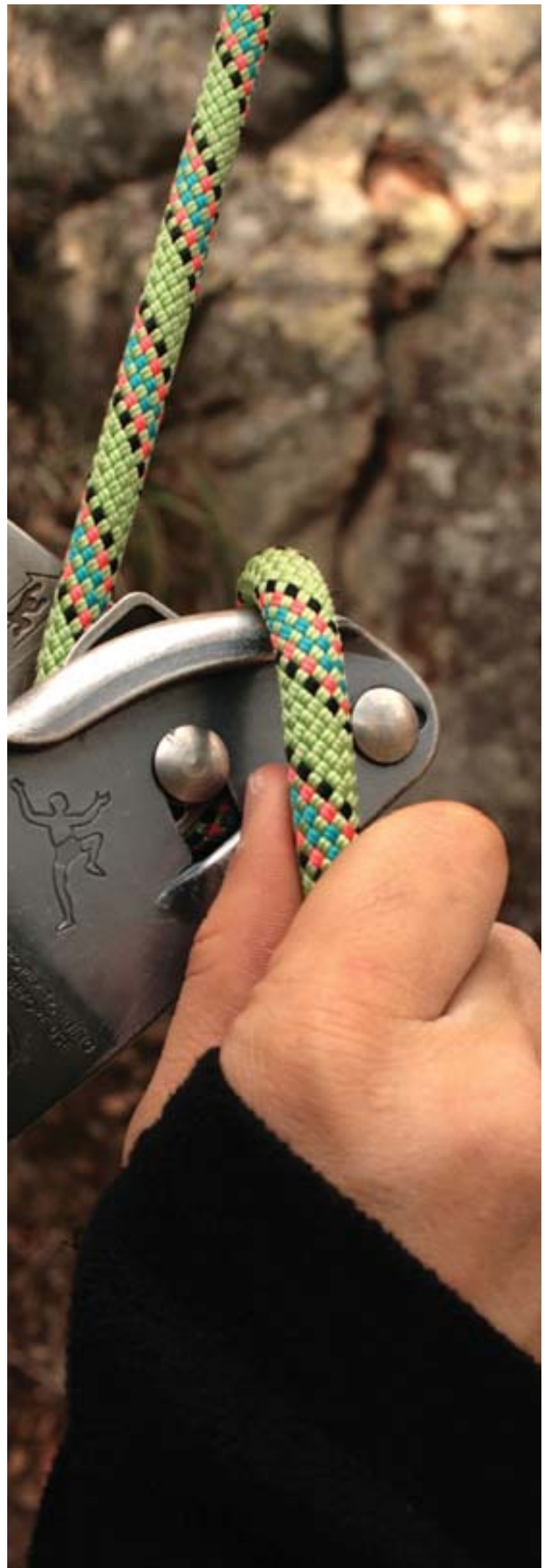
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The ORSA only occupies a few lines in the Solvency II Framework Directive (Article 44). Yet the ORSA process is set to be a key driver for embedding enterprise risk management (ERM) into the business and the resulting reports are likely to be one of the most important aspects of supervisory review under the new regime.

According to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), a key adviser to the European Commission on the implementation of Solvency II, the ORSA 'aims at enhancing awareness of the interrelationships between the risks an undertaking is currently exposed to, or may face in the long term, and the internal capital needs that follow from this risk exposure'.¹ As a 'management tool', it is designed to instil risk awareness in the culture and decision making of the company, forming 'an integral part of the overall business strategy' and helping the firm to 'obtain a real and practical understanding of the risks it is assuming'.²

Companies' assessments should ensure that they can 'continuously meet the regulatory capital requirements, as well as the internal capital targets they set themselves'³ in the face of changes in their risk profile and business plans, as well as the impact of developments in the external environment. The ORSA should include a 'forward-looking perspective' through a combination of risk, capital and solvency projections and, stress and scenario testing, and help create contingency and mitigation plans that set out the firm's options for managing and maintaining its capital and solvency position in line with its desired risk appetite. The required scope, frequency and detail of these evaluations are likely to be extensive in the wake of the financial crisis.

Ultimate responsibility rests with the Board, with all the components of the ORSA to be captured in a report signed off by the 'administrative body' and presented to supervisors for review. The financial crisis has raised questions about some executives' appreciation of the nature and extent of the risks being assumed by their frontline teams. From a supervisory perspective, the ORSA will therefore play an important role in ensuring that the Board maintains appropriate understanding and oversight of the entity's risk exposures. From the company's perspective, the ORSA can provide senior management with the information and assurance it needs to strike a sustainable balance between risk and reward and, not least, to avoid damaging surprises.

Showcase for ERM

Solvency II is set to provide further impetus for the development of ERM by requiring insurers to create a competent firm-wide risk management framework and integrate this into their governance and business planning processes. Companies are also facing regulatory pressure to ensure that their remuneration policies are consistent with sound risk management. Organisations with effective ERM capabilities and a strong culture of risk awareness will find it much easier to demonstrate the necessary risk understanding and control through the ORSA process. This assurance should enhance regulatory confidence and reduce the level of scrutiny and potential for any additional capital to be applied by supervisors.

If minimum Solvency II compliance is the first hurdle, rating agencies are setting a higher bar, which encourages insurers to manage risk and capital in a way that enhances the quality of earnings. This includes helping to

sharpen balance sheet management and optimise the risk/reward profile in areas ranging from product design and pricing through to actively managing the firm's in-force portfolio. According to AM Best, 'an insurer that can demonstrate strong risk management practices integrated into its core operating processes, and effectively execute its business plan, will maintain favourable ratings in an increasingly dynamic operating environment'.⁴

By pulling together the risk appetite, risk-based capital requirements and overall business strategy, a robust ORSA report offers a compelling basis to communicate the strength of the company's solvency position and the embedding of ERM in the organisation. Key aspects of the report could be shared with rating agencies, along with other stakeholders such as joint venture partners. A well-prepared ORSA will be particularly beneficial in enabling firms to demonstrate how ERM supports capital efficiency, the management of emerging risks and the articulation/application of the risk appetite within the organisation, aspects of management which now form a critical part of rating agency financial strength evaluations. The ORSA report can also help to facilitate broader discussions in areas such as business development, the thinking behind risk management and response to possible future scenarios.

1, 2, 3 'Own Risk and Solvency Assessment', issues paper published by CEIOPS on 27.05.08.

4 'Risk management and the rating process for insurance companies', published by AM Best on 25.01.08.

Figure 1: A best in class ORSA report can be expected to cover a number of specific items

<p>1. The ORSA report process A description of the governance (challenge, discussion and debate) process surrounding the submission of the report</p>	<p>5. Risk appetite The firm's risk appetite statement, process for managing within desired parameters and the firm's current profile</p>	<p>9. Stress and scenario testing The firm's future capital/solvency position under a number of reasonably plausible (downside) stress tests and scenarios</p>
<p>2. Context and scene setting A summary of the firm's legal and management structure, its core business and the market environment in which it operates</p>	<p>6. Risk identification and assessment An overview of the firm's processes and procedures for identifying, assessing and prioritising its key risks</p>	<p>10. Capital plan The firm's capital plan under the base case and under downside stress tests and scenarios</p>
<p>3. Risk management philosophy An outline of the firm's risk management philosophy (i.e. how the risk dimension is used in the business)</p>	<p>7. Point-in-time capital and solvency position The firm's point-in-time capital and solvency position along regulatory and economic dimensions</p>	<p>11. Use test An overview of how the firm's risk and capital management activities are fully integrated into the management process and operations</p>
<p>4. Risk governance An outline of the firm's risk governance, risk control processes, procedures and policies</p>	<p>8. Forecast capital and solvency position The firm's projected capital and solvency position over the plan period (3 to 5 year outlook)</p>	<p>12. Ad-hoc ORSA re-runs Formal presentation of ad-hoc 'event driven' risk, capital and solvency assessments during the reporting period</p>

Although much of the ORSA will be confidential between the firm and its supervisor and probably more detailed than would be required under Pillar 3 market disclosure, elements could be adapted for the required solvency and financial condition reports (see article on pages 18–23). At a time when capital is severely constrained, the results of the ORSA report could help to send a clear and credible message to the markets that this is a firm that can target capital efficiently and react quickly and decisively to opportunities, while operating within strict and well-informed risk tolerances. Enhanced market confidence can, in turn, increase the capital-raising potential as and when required.

Practical implementation

The key aims of an effective ORSA are now reasonably clear – an ongoing 'business as usual' process through which the Board and the regulator is kept apprised of the firm's current and future

anticipated risk, capital and solvency position and is provided with the means to assess the efficacy of its risk management framework. However, there is less certainty about the detailed application. While further implementation guidance may be forthcoming following the strong call made by insurers for greater clarity, we do not anticipate Level 2 implementation measures or Level 3 national legislation to be detailed and/or prescriptive as this will detract from the process being a firm's own assessment of its risks and solvency. Consequently, insurers will still have a considerable amount of discretion in what is a principles-based process.

Based on our work with clients and discussions with regulators and rating agencies, Figure 1 outlines what we believe will be the key components of the ORSA report. The precise focus and level of detail will need to be tailored to the specific characteristics of the business and be proportionate to its scale, nature and complexity.

Given the comprehensive nature of the ORSA report it is important that firms begin to define their ambition for the ORSA process if they have not done so already. This includes the scope of the evaluations, what will be reported and who are the key recipients. It is also important to assess their state of readiness, identify any material gaps that will need to be filled and carry out the cost/benefit analysis before embarking on the ORSA journey. Firms which have not developed sophisticated ERM and related risk-modelling capabilities may wish to confine their ORSA to demonstrating the competence of their risk management and alignment with business planning needed for minimum Solvency II compliance. Companies with a more developed framework may naturally want to secure some of the payback from their investment by using their ORSA to display their strengths and enhance stakeholder confidence.



Firms should seek to explain their risk management philosophy, including how risk considerations affect strategic decisions; the metrics used to measure risk and reward and how capital management is aligned to risk-bearing capacity. The risk appetite defines how this philosophy is applied within the business. It is therefore important to show how the risk appetite is translated into underwriting limits and is supported by appropriate monitoring and enforcement.

The capital plan should include a forecast of how any anticipated changes in the underwriting strategy and/or risk profile would affect the solvency position and a projection of the impact and response to a range of possible stresses and scenarios. Although the assessment itself does not have to be continuous, the ORSA should be updated regularly enough to ensure that compliance with solvency requirements is continuous. A company should also be ready to assess its risk, capital and solvency position 'without any delay' following a significant change to its risk profile.⁵ Triggers for updating the ORSA might include an acquisition, a new product launch or significant market events.

Validation is clearly critical. This includes checking the rationale for key assumptions against actual outcomes, and explaining the thinking behind any subsequent adjustments. The risk management framework and its operation should also be regularly reviewed by internal audit. In addition, it may be useful to benchmark the ORSA against peers and evolving best practice.

To demonstrate the integration of ERM into decision making it is important to tie the assessment and its results to the allocation of capital within the business. A further indication that risk awareness is genuinely embedded into the business is the alignment of performance objectives and related incentives to risk-adjusted measures.

What this comes down to is ensuring that the ERM programme is working as intended and that risk considerations genuinely influence key decisions. Companies with effective ERM programmes are likely to have most of the necessary systems and procedures in place. The additional challenge presented by the ORSA is ensuring that these are operated in a systematic, consistent and forward-looking way and underpinned by appropriate governance, validation and documentation. This could be quite onerous, and experience of comparable risk and capital assessments under Basel II suggests that firms should begin preparing now if they have not already done so.

The suggested format for the Basel II Internal Capital Adequacy Assessment Process (ICAAP) documents in the UK provides a useful benchmark for the presentation of the ORSA report. It is notable that while the Financial Services Authority (FSA) accepts that 'the ICAAP may be based on existing internal documentation, the FSA will clearly find it helpful to have a bespoke summary prepared to communicate the key results and issues to it at a senior level'. The FSA's guidance notes on the ICAAP states that the ICAAP report should be in a 'format that can be easily understood at a high level and contain all the relevant information that is necessary for the firm and FSA to make an informed judgement and decision as to the appropriate capital level and risk management approach'. Above all, this is a management tool rather than a technical risk report. 'Where appropriate, technical information on risk measurement methodologies, capital models and all other works carried out to validate the approach (e.g. Board papers and minutes, internal or external reviews) could be contained in appendixes'.⁶

Our experience of working with banks and supervisors in relation to the ICAAP has underlined its importance in

effectively demonstrating compliance with Pillar 2 requirements. It is also particularly useful in helping non-executive directors to understand the ERM process and communicate this to regulators. We would expect the ORSA to serve similar functions.

Up to scratch

By requiring companies to develop a holistic view of their risk profile and understand how risks affect their future solvency position, the ORSA can provide a useful aid to effective management. Firms would not only be prepared for the worst, but also better equipped to capitalise on opportunities than less well-informed and well-managed competitors. Companies will also be able to convey the strength of their risk control, the depth of their risk understanding and the efficiency of their capital management to key stakeholders. Although developing the necessary structures may be time-consuming, there is no need to create an additional layer of bureaucracy and compliance. The benefits of the ORSA can best be realised by embedding it into existing business processes and creating a report that is intelligible and meaningful for executives, rating agencies and other stakeholder groups. Indeed, many of the larger insurance groups have already invested heavily to develop their risk management capabilities. The risk dimension has formally been elevated to become a Board level topic with the equivalent of an ORSA being a regular standing agenda item. Solvency II will ensure that the rest of the insurance industry catches up.

⁵ 'Own Risk and Solvency Assessment', issues paper published by CEIOPS on 27.05.08.

⁶ 'ICAAP submission – suggested format', updated version published by the UK FSA on 22.11.07.

04

In the best light: Making the most of Pillar 3

Many banks' Pillar 3 disclosures have been limited to basic compliance, offering little insight into how risk is managed or how it influences strategy. With the demand for transparency increasing in the wake of the financial crisis, could this minimalist approach be missing a valuable opportunity to demonstrate the strength of risk and capital management and its value to the business? Richard Barfield, Christophe Cadiou and Donald Seto examine what can be learned from banks' approach to Pillar 3, the disclosure challenges facing insurers under Solvency II, and how effective risk reporting could be turned into a source of competitive advantage.



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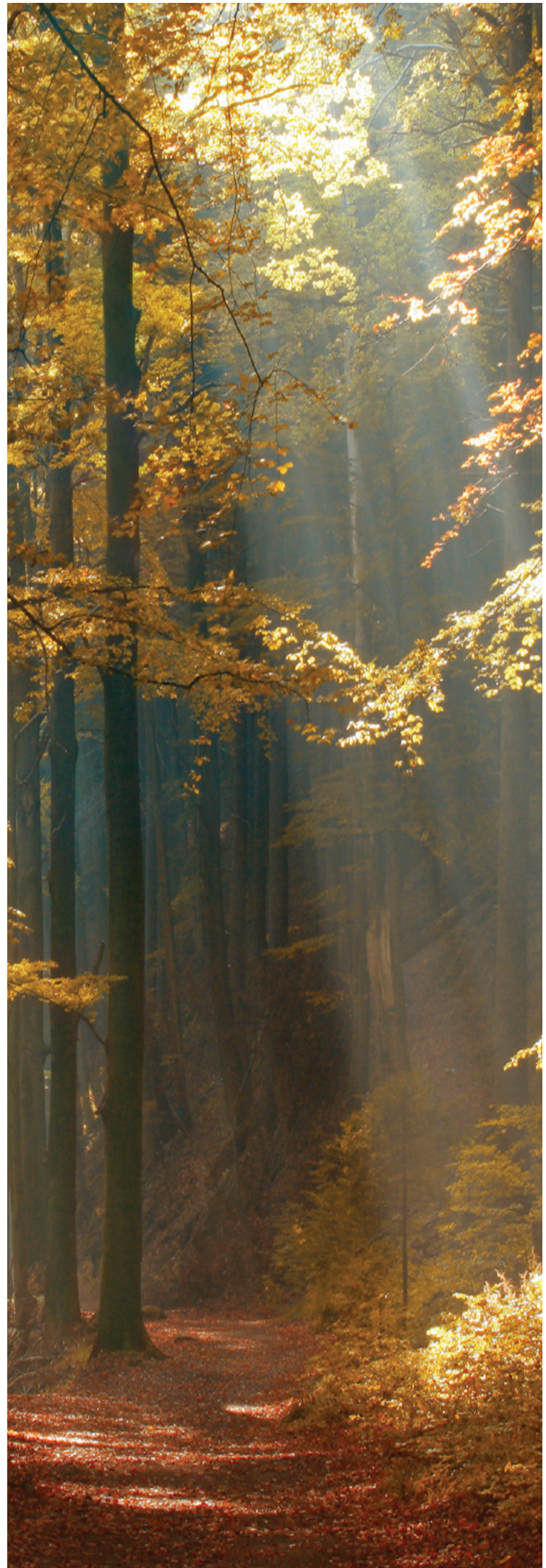
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‘Nothing is swifter than rumour,’ said the Roman poet Horace and, as his friend and fellow poet Virgil pointed out, ‘rumour grows as it goes’.

The turmoil in the financial markets has created fertile ground for rumour. Some banks and indeed some insurers have seen billions wiped off their share values in the wake of rumours about undeclared risks or possible capital weaknesses. In many cases, the whispers circulating around the dealing rooms have proved exaggerated and even unfounded. In these uncertain times, however, a lack of transparency could lead some analysts and regulators to believe the worst, even if the company’s understanding and management of its risks are actually quite sound. As such, what a business itself may believe is sufficient disclosure may no longer be enough to meet stakeholders’ increasingly exacting expectations.

Basel II Pillar 3, the forerunner of the comparable disclosure requirements under Solvency II, is designed to provide a catalyst for greater transparency by opening up risk and capital management to the discipline of market scrutiny. The minimum requirements combine quantitative information about the risk position and related capital adequacy with a description of key risk assessment processes. Under the principles-based approach, institutions are also encouraged, but not necessarily required, to explain their perceptions of the risks they face; the assumptions underlying risk valuation; their priorities for risk management and how risk considerations influence strategy.

Short of the mark

In reality, the first year of Pillar 3 reporting has been far less insightful than the drafters of Basel II might have hoped, with many companies focusing on narrow compliance with the rules rather than the broader, principles-based spirit of the Accord. In particular, our analysis of the disclosure shows that while the core quantitative data requirements have been reasonably well covered by most institutions, the qualitative information has been confined largely to generic descriptions of risk management techniques. Any analyst looking to ‘get under the skin’ of the business is therefore likely to have been disappointed.

Many of the Pillar 3 disclosures have also lacked sufficient clarity and accessibility. Indeed, in some reports it is very difficult to see the wood for the trees amid a deluge of unfiltered and poorly explained data. To increase the transparency and usefulness of reporting, it will therefore be important to devote as much attention to clarity and accessibility as to its contents.

Missed opportunity

There are a number of possible reasons for the limitations of banks’ Pillar 3 disclosure. Some banks may have wanted to concentrate on getting over the initial compliance hurdle and then build on this in future years’ reporting. The speed with which the bad news escalated in 2008 may have made other organisations reluctant to say too much in case their communications were soon superseded by developments. Some of the information about risk and capital may also have been reported in the IAS 1 and IFRS 7 financial statements.¹ However, in many cases it would appear that the limited scope and detail of the

¹ PricewaterhouseCoopers analysis of how banks have addressed IFRS 7 is available in ‘Accounting for change: Transparency in the midst of turmoil: A survey of banks’ 2007 annual reports’ (www.pwc.com/banking) and how insurers have addressed IFRS 7 in ‘Called to account: A survey of 2007 IFRS 7 insurance reports’ (www.pwc.com/insurance).

Pillar 3 disclosure owed most to it simply being behind Pillars 1 and 2 in the queue for attention and resources. Was this an opportunity missed? Pillar 3 disclosure is a demanding and, in some respects, novel undertaking. However, it is also an opportunity to convey the strengths of the business and the risk-reward rationale for key decisions, which could be critical in sustaining investor confidence in a challenging market environment.

The Basel II disclosure requirements are being reviewed in the wake of the financial crisis. There is a particular recognition within the banking industry (and demand from investors and politicians) for greater transparency in relation to securitisation and complex products. As a result, the Capital Requirements Directive is being revised. The higher bar for disclosure will inevitably extend to insurers.

Pillar 3 for insurers

Under Solvency II Pillar 3, insurers will be required to provide annual, publicly available reports on their solvency and financial condition. The disclosure should include:

- Nature of the business and external environment, objectives, strategies and performance;
- Governance structures, responsibilities of the Board, senior management and key committees;
- Risk profile and risk management approach for each category of risk;
- Valuation bases for assets and liabilities including technical provisions, with explanation of any major differences to the bases used in the financial statements;

- Capital management including minimum capital requirement (MCR), solvency capital requirement (SCR) and quality/structure of solvency reserves; and
- Any breaches in MCR or SCR or capital add-ons imposed by supervisors (jurisdictions can choose to waive the requirement to disclose capital add-ons for up to five years).

While much of the quantitative information may already have been disclosed as part of IAS 1, IFRS 4 and IFRS 7, many of the qualitative demands will either be new or go some way beyond the IFRS requirements. In line with Basel II, insurers have the discretion to augment basic compliance with further quantitative and qualitative analysis of their risks and their implications. Implementing measures, drafts of which are due to be published during the course of 2009, will provide more detail about what information must be disclosed and how.

Assessing the implications

The first Solvency II reports will not be due until at least 2012, and therefore some companies may see them as a distant concern. However, the immediate relevance of such risk and capital disclosure is increasing as stakeholders' concerns over write-downs and underlying solvency continue to spread from the banking to the insurance industry. The heightened market scrutiny of insurers' risk and capital management in the current market conditions can be seen in the increasing focus on risk-adjusted metrics such as economic capital and economic profit, rather than just profit measures such as embedded value.



Although the Solvency II Pillar 3 requirements are conceptually comparable to Basel II, the insurance directive is likely to go much further than its banking counterpart, and therefore the implementation and investor relations challenges for insurers will be greater. Unlike banks, for example, insurers will be required to disclose capital breaches and the regulatory view of their Pillar 2 capital demands. Unlike Basel II, Solvency II also requires insurers to disclose how information from the internal capital model is integrated into the day-to-day running of the business.

Making it happen

The first clear lesson from Basel II is to address Pillar 3 alongside the other Pillars rather than leaving it until last. Insurers' disclosure will draw heavily on the information gathered for Pillar 1 and the Own Risk and Solvency Assessments (ORSA) carried out as part of Pillar 2 (please see article on pages 14–17 for more details about the ORSA and its implications). However, companies may fail to consider Pillar 3 when preparing for the other Pillars and therefore find the information is not always available in a way that can be easily retrieved and organised for public disclosure. Insurers will also need to take a considerable amount of complex actuarial data, much of which may only have been for internal use up until now, and bring it up to a credible and intelligible standard for public disclosure.

The market-consistent approach to valuation under the planned new IFRS for insurance contracts will bring regulatory and financial reporting further into line. This could provide a spur for closer co-operation between the risk and finance functions and open up cost-saving synergies in areas such as data reconciliation and investor relations.

However, convergence also creates challenges. In particular, companies will need to ensure that IFRS and Solvency II reporting is consistent and, if not, explain any differences in their solvency and financial condition report. One key area of departure is the fact that IFRS deals with the contract and Solvency II with the entity, so policies that may not be designated as insurance under IFRS, such as investment plans, would still fall under Solvency II. There could also be differences in the calibration of assumptions and the treatment of certain liabilities.

Increased disclosure will inevitably open insurers up to more probing enquiry from analysts and investors. Addressing this will require timely education and explanation for stakeholders, who may be unfamiliar with the Solvency II valuation bases and assumptions. It is also important to recognise the considerable weight that analysts and investors attach to market presentations and other briefings from management, rather than just the disclosures in annual reports. Insurers should therefore seek to identify and convey their principal risks and how they are being addressed in a clear and consistent way across all points of disclosure, be they regulatory, financial or analyst presentations. A valuable basis for this would be the key qualitative points emerging from the ORSA. A number of banks have been able to do this to great effect as part of the Internal Capital Adequacy Assessment Process (ICAAP).

The underlying challenge is how to establish a robust governance structure around the disclosure process. With so many areas of the business involved, production of the solvency and financial condition report could be disrupted or delayed by a lack of ownership, the late involvement of key stakeholders and inconsistencies in data sources.

Increased disclosure will inevitably open insurers up to more probing enquiry from analysts and investors.

Under Basel II, successful Pillar 3 implementation projects have typically been sponsored by the CFO, and brought together the following units from the outset to ensure that all inputs are considered and responsibilities are clearly defined:

- Board of directors (must approve the formal disclosure policy);
- Finance and accounting;
- Actuarial;
- Risk management (which would usually own much of the data that needs to be disclosed under Pillar 3);
- IT (responsible for the design and maintenance of data collection);
- Internal/external auditors (includes looking at what can be drawn from financial statements and assessing consistency between regulatory and financial reporting); and
- Investor relations (define the overall communication strategy around risk management and ensure consistency of messages between all aspects of market reporting).

Realising the opportunities

Pillar 3 could help insurers to demonstrate the stability, efficiency and capital strength of the business. For the first time, companies will also be able to convey a 'single version of the truth', in which both regulatory and financial reporting reflects the way the business is run. In our view, the key to realising these opportunities is a strategic approach to disclosure that looks beyond basic compliance to provide a real insight into the prospects of the business:

Leadership: There is no established template for Pillar 3 disclosure. Leading firms therefore have an opportunity to set the competitive benchmark for the scope, nature and quality of reporting. This benchmark includes what information is disclosed above and beyond narrow compliance, along with the coherence and accessibility of its presentation.

Meeting expectations: Liaise with investors and rating agencies to find out what information they want and ensure that they do not misunderstand the contents of Pillar 3 reporting.

Management's eye view: Explain how risk is perceived and managed. This might include the basis for evaluating business options and the approach used to determine and manage all potential exposures. It might also include explaining the interaction between different risks and how individual underwriting decisions are aligned with the overall risk appetite.

Clarity: Avoid deluging external stakeholders with a torrent of unintelligible data. Ensure risk and capital information is clear, concise and coherently structured and underpinned by appropriate explanation and corroboration.

Scrutiny: The solvency and financial condition reports will highlight capital-intensive areas of the portfolio such as guaranteed or run-off business. Can you justify the capital charge to analysts and, if not, is there a case for withdrawal or divestment?

Comparability: Some of the information included in the solvency and financial condition report will be comparable against peers. It is important to assess both the numbers and the underlying assumptions, as both will be compared.

In our view, the key to realising these opportunities is a strategic approach to disclosure that looks beyond basic compliance to provide a real insight into the prospects of the business.



Discretion: Some insurers may naturally conclude that certain voluntary disclosures are inappropriate, for reasons of commercial confidentiality or any perceived deficiencies they may portray. However, companies should assess whether saying nothing may actually create uncertainties in analysts' minds, especially if competitors provide the relevant information.

Next steps

The planned risk and capital management disclosures under Pillar 3 have never been more relevant than they are today. Although details of the Pillar 3 implementation measures have yet to be published, regulators are likely to set a high bar for the scope and quality of reporting in the wake of the financial crisis. Further pressure to augment basic compliance with additional voluntary disclosures is likely to come from analysts, rating agencies and regulators and the precedents set by leading competitors.

Although the first Pillar 3 disclosures are some way off, the growing market scrutiny of insurers' solvency positions means that greater transparency about risk and capital management is already a pressing concern. Discerning and presenting a consistent management's eye view of the company's key risks, how they are tackled, and how their capital implications are managed, could help to satisfy immediate market demands and lay a firm foundation for Pillar 3 implementation.

Making the most of Pillar 3 will also require a clear strategic vision about how to present the organisation's approach and rationale for risk management in the most coherent and compelling way. From the outset, it is important to establish the necessary executive direction, organisational

co-operation and close alignment with other market communications. Above all, the demands of Pillar 3 should not be underestimated or left until last. Our experience would suggest that the following are key steps along the way:

- Set up a separate project structure under a committed executive sponsor;
- Ensure that Pillar 1 data vehicles are capable of delivering the Pillar 3 requirements;
- Check what information will be needed in addition to Pillar 1 data, looking in particular at qualitative requirements;
- Decide what voluntary disclosures should be included;
- Check for overlaps with other publicly disclosed risk and capital management information (e.g. IFRS 7);
- Source required data from existing systems and identify data gaps;
- Define an IT architecture for data gathering, reconciliation and reporting;
- Establish a validation process around Pillar 3 disclosures; and
- Define a communication strategy and involve the investor relations team at an early stage.

05

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