



INSURANCE

Solvency II Briefing

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Foreword

Welcome back for the second edition of our Solvency II Briefing.

As expected, the last few months have been hectic in the Solvency II world. CEIOPS¹ has circulated five consultation papers (CPs), the results of QIS 2 and, of course, we are about to enter into QIS 3. Needless to say, there is much to debate at the moment!

We start this issue with a challenge to the industry – asking is Solvency II requiring firms to undertake actions which are transformational, aggressive and urgent? We then look at some of the implications of QIS 2 and the recent CPs in a set of articles considering Pillar 1 and Pillar 2 issues, before revisiting the data challenges that we touched on in the last edition.

We then consider how Basel II and Solvency II differ and what insurers can learn from the banking experience – you may be surprised by some of the conclusions.

We have really appreciated the positive feedback we received in respect of the first edition. Please continue to tell us what you like and don't like. We are always happy to take on board new ideas. To that end, we finish this issue with a round up of some shorter 'news clippings' from the Solvency II world.

¹ The Committee of European Insurance and Occupational Pensions Supervisors

Solvency II

Transformational, aggressive, urgent?

This article takes an overall look at Solvency II and concludes that its introduction will have a transformational impact on the insurance industry.

The implementation date for Solvency II is 2011, a date which might be regarded as somewhat off. However, the article argues that rating, regulatory and business drivers will lead most firms to commence their Solvency II programmes as a matter of urgency.

Of course Solvency II is not yet fully specified – this article uses the CEIOPS consultation papers up to and including CP20 as the basis for its arguments and recommendations. There is much detail outstanding, but many of the key features are clear. It is these, together with existing regulatory and rating initiatives, which help drive forward the case for urgent commencement of Solvency II programmes.

An overview of Solvency II

Pillar 1

Solvency II remains organised in three pillars similar to Basel II. A key difference to Basel II is that Solvency II intends to address most material risk areas in Pillar 1 so that the discretionary regulatory overlay (Pillar 2) is expected to have a much smaller role.

The Minimum Capital Requirement (MCR) is a new concept for regulators in that it establishes a formal intervention level effectively requiring closure, restructuring or sale of an insurance business on breach of that capital level (see Figure 1). The recent QIS 2 Calibration Study demonstrated problems, with some firms reporting an MCR greater than their SCR. Redefinition of the MCR is one of the key outstanding points of Solvency II.

At the 'standard level', Solvency II sets out the Solvency Capital Requirement (SCR) calculation in risk modules with a defined correlation matrix. (see Figure 2.)

As at the time of writing, neither the module structure, correlation matrices or methods for computing module level SCR numbers are finally determined. However, the concepts are reasonably clear:

- A conservative formulaic calculation for each risk module.

- A defined conservative, correlation structure which recognises some diversification.

This compares with the internal models approach (which may be applied partially) in which 'anything goes' providing a firm meets the standards set out in Section 6.449 of CP20:

- The use test: 'is the actuarial model genuinely relevant for and used within risk management'.
- The calibration test: 'is the SCR calculated by the undertaking an unbiased estimate of the risk and measured by the common SCR target criteria'.
- The statistical quality test: 'are the data and methodology underlying both internal and intend and regulatory applications sound and sufficiently reliable to support both satisfactorily'.

CP20 distinguishes between risk ranking and risk calibration and proposes a minimum standard for the former of first-order stochastic dominance.

Pillar 2

At the overall capital requirements level three important principles apply:

- 1) The consideration of any important risk areas not fully included in Pillar 1: in the UK, for example, this is

covered by the guidance areas GENPRU 1.2.30(2) (Firm-wide Risk Management) and GENPRU 1.2.42 (Stress and Scenario Testing).

- 2) Proportionality regulatory expectations of a firm will depend on the complexity of its business and the risks that it poses to regulatory objectives.
- 3) The general Pillar 2 requirements in internal risk management and capital assessment for all firms should be the same as the 'use test' standard for firms using internal models (see article page 9).

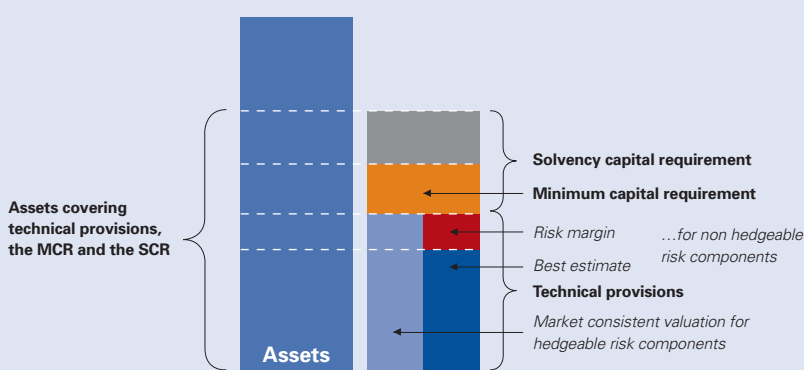
The net impact on insurance firms

Capital is generally a scarce resource within insurance firms. The net impact of the existing regulatory regime is to create the following key anomalies:

- Light capital requirements for catastrophe and liability non-life business lines.
- High capital requirements for life business lines, particularly unitised investment products with low levels of life cover.

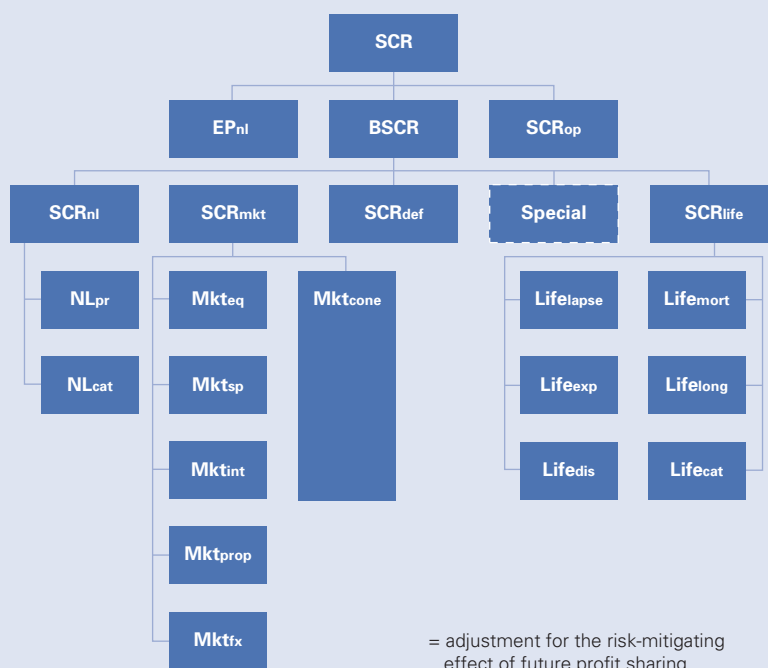
Broadly speaking a standardised approach to Solvency II can help reduce these anomalies and internal models should lead to a risk-based capital requirements system.

Figure 1 The make up of Pillar 1



Source: CEIOPS – CP – 04/06 Draft Consultation Paper no.16 – further advice on Pillar I issues

Figure 2 Risk modules proposed by CEIOPS CP20



Source: KPMG International, 2007

At this point there may be an objection on behalf of non-life catastrophe and liability firms. They are typically capital constrained and would regard their key constraint as being rating led rather than regulatory led.

Rating vs regulatory capital consideration

Several rating agencies have expertise in the insurance firm arena. In this section, we will use Standard & Poors notation for simplicity but the opinions raised apply across all rating agencies.

In theory, overall regulatory requirements are established at the 'BBB' rating level, whereas most insurance firms feel that they must operate at a minimum 'A' level, 3 'notches' above. Large re-insurance firms typically operate at a minimum 'AA' level.

It is easy to see the argument that rating agencies represent the binding capital constraint. In practice, however, this is rarely true. Figure 3 shows a schematic for capital management.

Business plan capital is the capital required to meet business plans 'agreed' with the regulator, net of capital raising potential. It is additional to 'enforce' regulatory capital requirements for most firms open to new business.

Figure 3 Capital Management



Source: KPMG International, 2007

Risk Capital is the additional capital which a firm itself believes that it needs to operate the business, net of management actions in extremis and prospective work.

Risk Capital can be set at different levels according to the risk appetite of the firm and the sophistication of its risk measurement tools.

It is easy to see that a low level of additional Risk Capital would place an insurance firm at higher risk of extreme regulatory intervention or even losing control of their firm in time of adverse experience.

For many firms the sum of regulatory, business plan and Risk Capital requirements will exceed that needed to achieve a target credit rating.

In any case, for almost all firms, investment in firm wide risk measurement/management will reduce the 'premium' that rating agencies require from them to achieve a given rating. The recent trend towards the formal 'Enterprise Risk Management' assessment of rating agencies creates a helpful transparency.

Transformational, aggressive, urgent?

Insurance firms price and pool risks to create a diversified business portfolio with a high expectation of profit and a low risk of extreme loss (but only in respect of identified and measured risk). Effective risk pricing (and understanding) is paramount and, at comparable cost/premium levels, offers a strong offensive weapon against which it is extremely difficult to compete except on the same terms.

In a capital scarce environment, business rating and regulatory drivers make it inevitable that all significant insurance firms will move quickly towards the internal model approach. The arguments are as follows:

- The standardised approach will be calibrated conservatively, so that firms using it will stand at a competitive disadvantage.
- All firms will be expected to implement internal risk measurement/management capability equivalent to the 'minimum

Addressing the urgent need to develop better risk management/pricing capability represents a major logistical challenge for insurance firms large and small

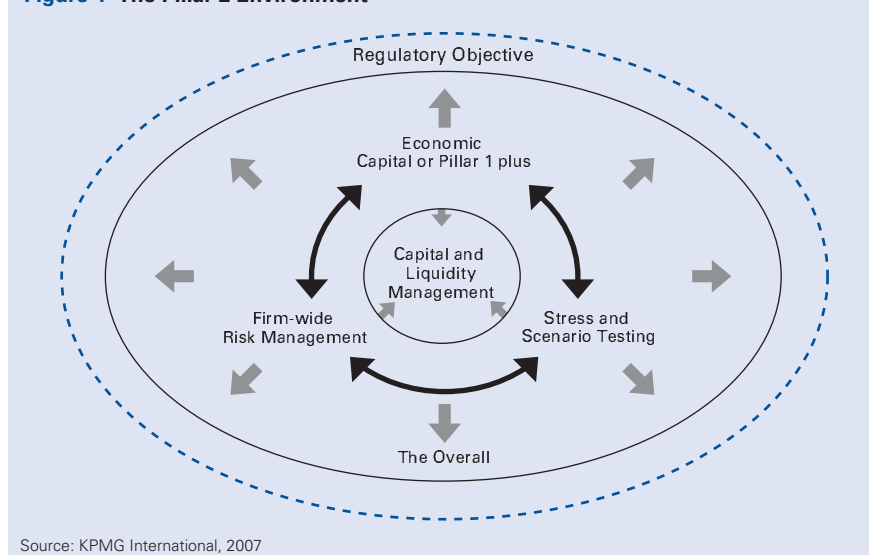
standards' implied by the 'use test' of the internal models SCR approach.

- Firms writing higher risk business under the standardised regime will face additional capital requirement, under Pillar 2. It is inconceivable that the application of Pillar 2 will not be conservative in most countries.
- The risk models required to meet the internal models standard will inevitably increase the profitability of business written in comparison to firms using less capable risk pricing tools – through better risk discrimination, better risk pricing and price-volume optimisation.
- The first businesses to introduce the next generation of risk models will have a significant competitive advantage (at least in comparison to firms with similar market access and cost/income structures).

If this reasoning is correct, an inevitable consequence is transformation of the insurance industry towards an improved risk rating/pricing models based on a predictive analysis of policy perils. Solvency II will also force firms to consider and extrapolate historical data trends in greater detail.

The transformation will be aggressive in the sense that early movers can achieve a significant competitive advantage whilst later followers may suffer significant adverse business selection.

Figure 4 The Pillar 2 Environment



It follows that the need to address risk models and to commence Solvency II programmes should be an urgent priority.

The target environment is set by Solvency II: Pillar 2 (see Figure 4) – albeit many firms will choose to address the issues arising within their Pillar 1 environment.

The challenge

Addressing the urgent need to develop better risk management/pricing capability represents a major logistical challenge for insurance firms large and small, for direct and indirect writers, for life and non-life business lines.

If the arguments set out in this article are correct, the Solvency II internal model standard should soon represent the minimum competitive position for many firms.

To address these issues, firms need to increase their Solvency II efforts soon.

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QIS 2

Implications for balance sheet restatement and calibration

As preparations are being made for the third round of quantitative impact studies (QIS 3) which will take place during the second quarter of 2007, it is a good time to reflect on the experiences from the QIS 2 exercise undertaken last year. Specifically we will be looking at the potential implications for balance sheets of insurers and highlight areas where QIS 3 needs to focus to help ensure the final calibration of the Solvency II framework is appropriate.

Before going too far, it is appropriate to point out that QIS 2 was not intended to be an attempt to calibrate the parameters but rather test the Solvency framework and it is important that the results are viewed in this context. Indeed many in the industry feel that CEIOPS may now be placing too much emphasis on the actual results from QIS 2. However, QIS 2 does provide indications where further work may be required on calibration.

Objectives of QIS 2

It is worth covering briefly what the objectives of QIS 2 were. Firstly it was to look at the potential impact on individual entities of a possible overall Solvency II framework, i.e. technical provisions, Minimum Capital Requirements (MCR) and Solvency Capital Requirements (SCR).

The various items considered were:

- the practicability of the calculations themselves
- resource implications
- the potential effect on level of capital needed by firms
- testing the suitability of different approaches for establishing capital requirements.

Secondly, the information would be used to assist in further development

and calibration of SCR and MCR. In Figure 5 the key differences in the balance sheet between the current Solvency I framework and under a risk-based economic framework are shown. It can be clearly seen that Solvency II is likely to radically change the appearance of an insurer's balance sheet. In the next sections we will consider the implications and potential issues raised by QIS 2 on specific sections of the balance sheet.



Figure 5 Current Framework vs Risk-based Economic Framework

	Current Framework	Risk-based Economic Framework
Valuation of Assets	Market / book value subject to admissibility	Market consistent
Valuation of Liabilities	Prudential margins included in technical provisions	Market consistent
Available Capital	Partial recognition	Adopt total balance sheet – based on economic ability to absorb shock
Diversification	No	Yes
Risk Mitigation	Partially	Yes
Solvency Control Levels	Only single control level – supplemented by various national rules	SCR important target, MCR hard limit
Group Issues	Partially recognised	Fully recognised
Calibration	Subjective	Economic basis using market / historical data and actual experience – more objective

Source: KPMG International, 2007

Technical provisions

CEIOPS has stated the methodology for calculating technical provisions should be transparent in the valuation of insurance liabilities. The resultant provision should cover the expected present value of the liability cash flows ('best estimate'), given current insights at the time of calculation, plus an explicit risk margin (set at an appropriately prudent level). When establishing this best estimate the company is expected to take into account expected demographic, legal, medical, technological, social or economic developments. This is by no means a simple task and some of the experiences from QIS 2 have indicated this. For example, the best estimate liability is usually the mean, discounted value of liabilities. In the

absence of guarantees or other features that make the relationship between liability and investment return asymmetrical, the calculation is relatively straightforward. However, in some cases the relationship between assumptions and the liability is not symmetrical, this can be particularly true when guarantees apply.

There are also challenges regarding the appropriate approaches to quantifying the appropriate risk margin that is then added to these best estimates to calculate the total technical provisions. QIS 2 highlighted issues with the practicality and suitability of both the cost of capital and the percentile approaches. The resultant technical provisions are intended to be market-consistent although there is no clear and agreed

definition and there is ongoing issue of consistency or otherwise with IFRS.

Participating business

QIS 2 has raised the particular challenges in determining the correct approach in technical provisions to participating life business. It appears that IFRS may require provisions which will not include future discretionary benefits. However, many believe that regulatory technical provisions should include expected future discretionary benefits. It may be the case that no simple harmonised solution is possible given that different jurisdictions have different issues in relation to nature of backing assets and the form of commitment to customers.

MCR

The MCR in QIS 2 was of a formulaic construction and the calibration was very provisional. There were specific issues in relation to the ratio between the MCR and SCR in the results. In particular for life business there was inadequate reflection of the profit-sharing nature of participating business and for non-life business there was no adjustment for the expected profitability of the business.

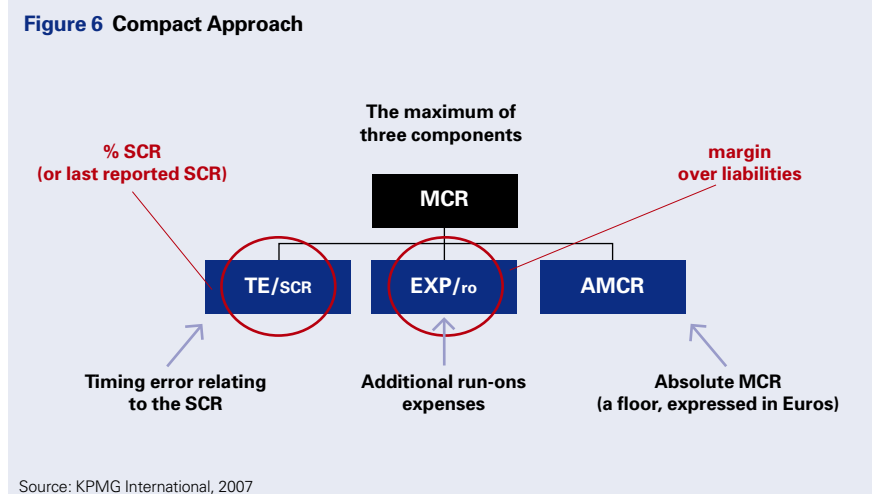
Two alternative approaches have since been proposed in response to these issues;

- a simplified modular approach; or
- what has been referred to as the compact approach as shown in Figure 6.

SCR

Potentially the SCR was the most important element being tested in QIS 2. The combined approach of formulaic and scenario approach has indicated that not all risks can be reduced to simple fixed factors. Further consideration is required on stress testing, for example including both level and trend risks. It may be preferable to have a standard formula which is appropriately risk sensitive even though it will create additional calculation burdens.

More generally are the considerations around internal models and the 'use' test. A specific example is the concerns raised about the robustness of the K factor approach for participating business. A possible way that has



been put forward is to provide for approval of a 'participation model' reflecting the interaction of assets and liabilities according to contract law or regulation in each separate jurisdiction.

Assessment of impact and areas for future focus on calibration

Under QIS 2 there was a general reduction in Solvency ratios across the EU but most entities would still be well above 100 percent. The largest impacts, and therefore also where further work on calibration and/or methodologies may be required, were:

- With-profit life business
- Non-life commercial and reinsurance business
- Monoline insurers
- Linked life business

In terms of the various risk categories there was a very large deviation between the lowest and highest impacts when compared to the current regime. This was especially

true for the life underwriting module. However, as mentioned previously these results should be viewed in the context that the calibration for QIS 2 was very provisional.

Notwithstanding this, QIS 2 proved to be a useful exercise. It has allowed the industry and the supervisors to understand where further thought is required to help ensure that Solvency II eventually results in a robustly calibrated framework. There is still much work to be done and QIS 3 should hopefully be a key opportunity for the industry to ensure this occurs. Having said that, one thing that does appear to be certain is that an insurer's balance sheet will look very different from the current regime.

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What about the qualitative requirements for Pillar 2?

Most of the recent discussions around Solvency II have been on modelling issues. This has been largely the result of the content of Consultation Papers such as CP20 and the QIS 3 specifications. This focus will almost certainly continue to be the case for a while, especially considering the fact that even Pillar 2 discussions seem to be biased towards capital and the nature of the SCR add-on.

However, Pillar 2 deals with far more than just regulatory add-ons and the supervisory review process. There will be qualitative requirements for risk management in insurance companies in Pillar 2. So far details are lacking as to what might be required, other than what was in the EU Commission's First Wave of Calls for Advice dating back to 2005. These clearly set out the requirement for an independent risk management function. However, there are national developments (e.g. in Germany) which possibly provide a preview for Pillar 2 in a more detailed way.

Considering the above it is tempting to ask:

1. what will the future Pillar 2 requirements for risk management look like; and
2. what kind of action insurance companies can initiate right now – without incurring too high a risk of doing things which will not really benefit them as soon as the final requirements are out?

At this stage it's tricky to answer the first question with any certainty, but the framework in Figure 7 highlights some initial ideas of what Pillar 2 might entail. According to this framework qualitative requirements will be based on three core strategic issues:

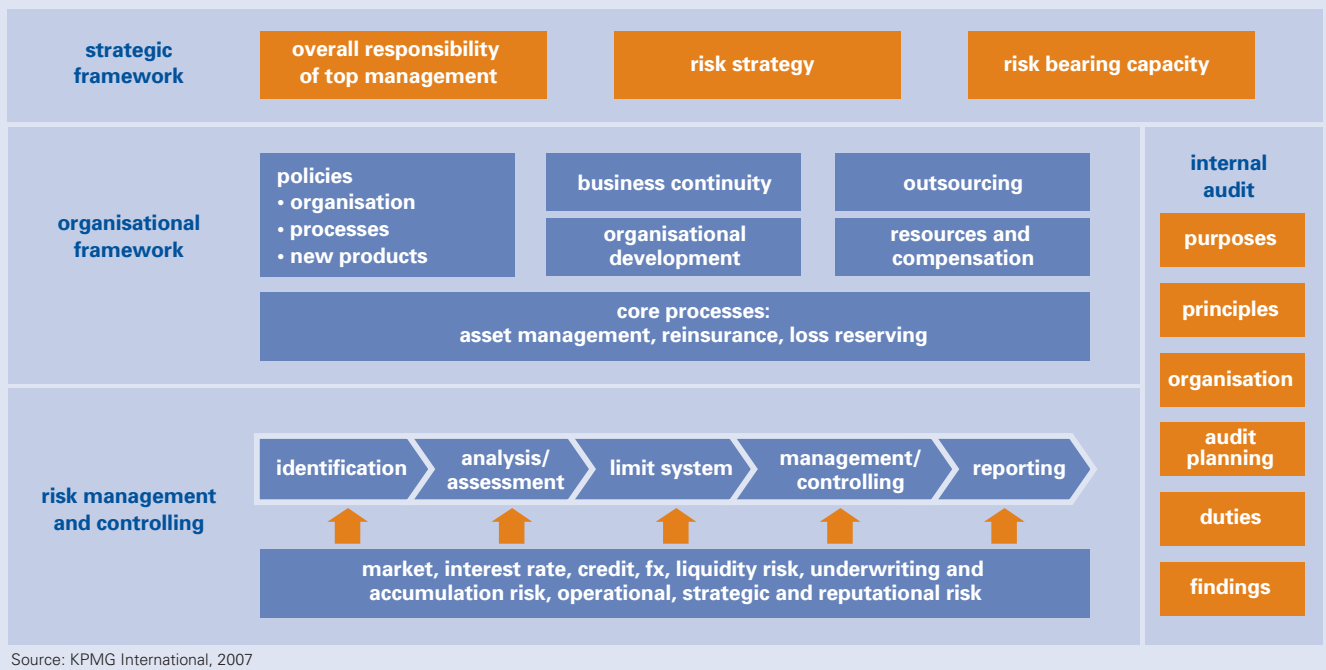
- an overall responsibility of leadership for risk management,
- a clearly defined risk strategy which is linked to the business strategy; and
- an ongoing management of the company's risk bearing capacity.

At the organisational level there will be various requirements. A key issue at this level will be requirements for core insurance processes, i.e. asset management, reinsurance management and loss reserving. This list might not be comprehensive, but if we take the importance of these processes for insurance companies into account then this would seem to be a reasonable assumption. Beyond the organisation of certain processes, internal audit is another area of development since all risk-related processes will be subject to the activities of internal audit, to ensure they are operating as intended.

Risk management will be another essential issue, and this is the area where Pillar 1 and Pillar 2 will really meet. It is important to note that at this point it may well be the case that Pillar 2 takes an even more general view on risk than Pillar 1 does, which might result in a more extensive list of risk categories to be covered than Pillar 1.



Figure 7 What Pillar 2 might entail.



Source: KPMG International, 2007

Time to move

Insurance companies are confronted with a double threat with qualitative requirements. In contrast to the quantitative set of requirements, there is much less public discussion about governance issues, organisational setup and qualitative issues of risk management. Additionally, the insurance industry is well aware of the experience banks have had with Basel II. In the banking industry similar regulations were introduced quite rapidly – so now might well be the right time to start the implementation of Pillar 2 improvements.

Under Pillar 2 of Solvency II it will not be sufficient for insurance companies to simply execute their core competency, i.e. manage their retained risk. The organisational setup and all the processes relating to risk management have to be documented and formalised in order to be communicated to a supervisory authority. From our firms' experience the following areas can frequently require improvement. This list is by no means exhaustive.

Governance, responsibilities and strategy

- Comprehensive documentation of the business strategy, e.g. within a long-ranging business plan, and a clear governance setup including a split of responsibilities between business operations, risk management and internal audit.
- Comprehensive documentation of a risk strategy which must be in line with the overarching business strategy. There will be requirements regarding the structure of a risk strategy document, its minimum contents and the level of concreteness of this strategy. A risk strategy must, as its core part, embrace statements concerning the strategic safety level a company intends to maintain, the kind of risks a company wants to hold within its own retention and the time horizon these risks are to be borne. In many of the cases, a risk strategy is a document too abstract to help in managing the day-to-day business. In this case it must be accompanied by additional documents making strategic issues operative, e.g. risk policies for the various business segments of a company.

- Almost every insurance company has inflowing risks which must be reinsured. If this is the case the risk strategy must also contain (or be accompanied by) a reinsurance strategy. This part of the risk strategy must specify which kinds of risks an insurance company wants to cede, which and how many reinsurers will act as counterparties, how the reinsurance contracts will be designed, and what implications reinsurance has for risk and return.
- Independent and objective risk management function.

Design of core processes

- Pillar 2 will surely result in an amendment of core insurance processes, as regards their transparency and formalisation. But also the alignment of certain processes will have to be improved, e.g. the links between risk reporting, risk management, the setting of risk limits and the management of risk transfers.
- Integration of risk controlling (both quantitative and qualitative) into the business management processes, and where possible also link to the management compensation system

Under Pillar 2 of Solvency II it will not be sufficient for insurance companies to simply execute their core competency

(in terms of a value based management which relies on risk capital allocation to managed units).

- Alignment of activities of internal audit to the newly built functions and update of the audit plans. This also refers to systematically building up knowledge within the particular audit function in order to maintain appropriate capabilities.

Link to quantitative issues from Pillar 1

- Align methods of risk measurement and risk controlling. This refers to quantitative and qualitative aspects of risk measurement for those risks which are subject to Pillar 1 considerations, and it refers to qualitative aspects for all remaining risk categories. Perhaps most importantly there should be a comprehensive, overall view of risk within the company. This is important in order to be able to arrive at a risk strategy and a reinsurance strategy that fit in with the overall risk profile of the company, and it is explicitly mentioned as one core target of Solvency II.
- Development and documentation of a concept for the risk bearing

capacity of the firm. This means that quantitative and qualitative methods have to be aligned, and there must be a common view both on risk and the capital resources a company holds. This is the reality check for a firm's strategy, and it must be in line with the long-term risk considerations in the risk strategy.

Conclusions

It can be assumed that the intensity of discussion around Pillar 2 will significantly increase as soon as future requirements become clearer. National initiatives such as those in Germany will speed up the process, and such developments may well serve as a blueprint for future Solvency II regulations. It is reasonable to conclude that these national developments will practically impact other countries – just as the forerunning FSA regulations did in the UK.

Companies intending to ensure Pillar 2 compliance in a structured, target-oriented and efficient process should start to think about Pillar 2 right now. Transparency in risk management processes also has other potential benefits – it often helps companies

streamline and enhance their operations and may also improve relationships with external stakeholders such as rating agencies and investors. Firms should not wait for the detail of Solvency II before seeking to raise risk management standards.

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Data systems for Solvency II

Data challenges for Solvency II

In the first edition of the Solvency II Briefing series the article, 'Data – a big challenge for Solvency II' discussed new challenges for data collection as well as new types of data which will arise from the upcoming Solvency II regulation. In this article we seek to outline how data systems could be enhanced so that their architecture becomes aligned with the holistic approach of Solvency II (see Figure 8).

Efficient data management

One of the biggest challenges coming out of Solvency II will be the breadth and depth of data requirements. As an example, additional data will be

needed for the Solvency risk capital calculation. Data will come from varied sources and some of these data sets will have to be pre-processed using actuarial systems. It is certainly conceivable that low data quality may have direct regulatory consequences in the form of SCR adjustments. Data integrity will become ever more important as the high level of confidence chosen for Solvency II risk capital calculations would imply a high sensitivity to outliers. In particular a company striving for an internal model would require a data system which supports extensive sensitivity analysis.

These requirements can be satisfied through the introduction of a well designed central data warehouse.

Such a data warehouse would:

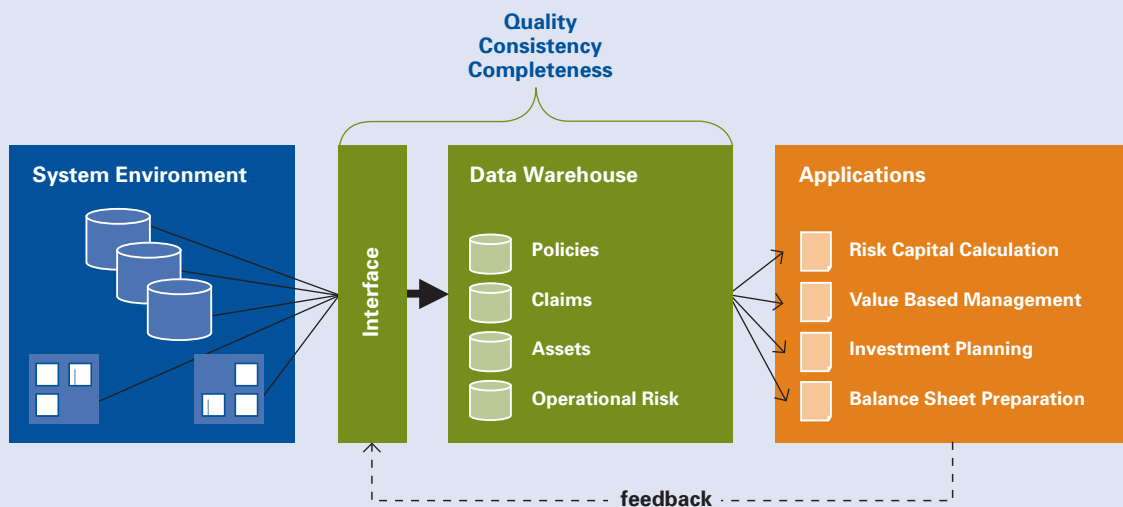
- mirror a corporate data model and;
- give assurance that these data sets are consistent and checked for quality.

Typically such a data warehouse will be accompanied by a dedicated interface which both controls quality of data and unifies data from several sources.

A step-by-step approach from legacy systems to a corporate data model

In the following we will assume that the business goals, which are to be addressed in the corporate data model, have already been defined. Efficient data collection needs a structured data

Figure 8 Architecture of a holistic data system.



Source: KPMG International, 2007

Efficient data collection needs a structured data basis and flexible reporting tools

basis and flexible reporting tools. The integration of existing legacy IT systems and data relevant for financial statement and management reporting is an important prerequisite for holistic and efficient data management. Examples of IT systems from which data would need to be collected, include:

- treaty – and claims systems
- provisions – and marketing systems
- asset management systems (including capital market data)
- accounting – and reporting systems.

In the following we outline the steps necessary for the introduction of a one-stop corporate data model (see Figure 9).

A) Analysis of legacy systems

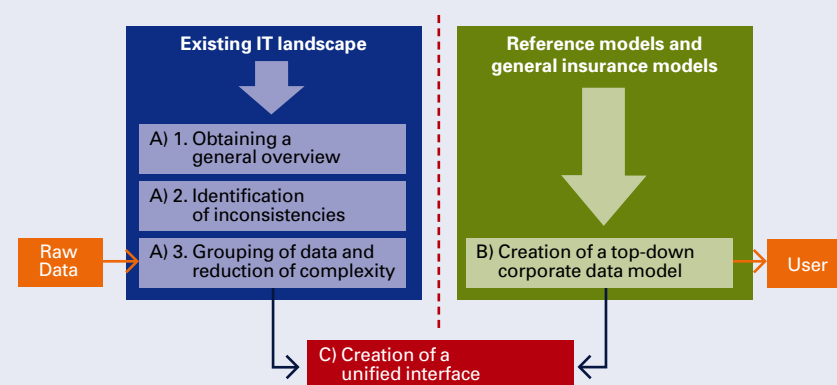
1) *Obtaining a general overview of the existing IT system*

A company would need to create an inventory of IT systems and existing data flows. These systems and data flows would be categorised according to their function in the business processes and their origin. This could result in a graphical work flow overview of the IT landscape which could help identify needs for optimisation and simplification of the IT architecture.

2) *Identification of inconsistencies*

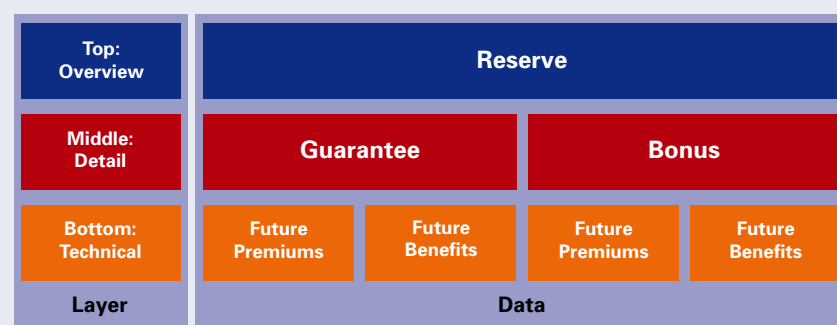
Having an overview of the IT landscape, it is now possible to investigate the various inputs for consistency. For instance, it could be possible that a projection tool

Figure 9 Transition from a legacy system to a corporate data model.



Source: KPMG International, 2007

Figure 10 A simple layer approach to reserve data for life insurance. In practice, one may choose a richer set of layers.



Source: KPMG International, 2007

would use statutory reserves for some product types and best estimate reserves for others. Another example would be cost parameters and best estimate probabilities which could be defined differently or updated at different times for different product generations. At this step one would also investigate whether the entire portfolio is covered by the data system.

3) *Grouping of data and reduction of complexity*

Even if the data system is consistent, it may be too complex for efficient use. For instance, technical reserves of complex life insurance products could be split into several components whose definitions are different from product to product and generation to generation. In order to use these data components one would need an intimate knowledge of the calculational details of each product. This could prove to be extremely difficult, as a life insurance contract typically has a duration spanning decades. On the other hand, the split into data components could be necessary for some automated administration tasks. In order to increase commonality and to reduce complexity one could define few generic components (such as the technical reserve for the guaranteed part, the technical reserve for the accumulated bonus etc.) which can more easily be understood and which cover all but a few specialist tasks.

B) Creation of a top-down corporate data model

In order to cater to a diversity of users, the corporate data model should mirror as closely as possible general business processes and actuarial dependencies. A good corporate data model would typically use a top down approach which incorporates several layers in a hierarchy of increasing detail and complexity. A layered structure would enable users to obtain consistent information at exactly the level of detail which is most suitable for their application (see Figure 10).

A corporate data model reflects the common processes and product types rather than the existing (legacy driven) data storage implementation. It would therefore be possible to support its design process through the study of reference models from the insurance industry. Such reference models could cover up to 70 percent of the corporate data model.

The results from step A)3 (see Figure 9) could help to incorporate the individual characteristics of the company into the corporate data model. These results would also have a bearing on the right depth of the various layers of the corporate data model.

A third input, which would be of special importance in this context, consists of the reporting requirements from Solvency II. Consultation Paper 15 (CEIOPS-CP-08/06) on supervisory reporting and public disclosure indicates that significantly higher data requirements are envisaged than in the present regulatory context. For instance, risk capital figures should be



Solvency II will necessitate further updates for IT systems and data flows



available for both group and solo-entity level. Remaining uncertainties about future Solvency II regulations indicate where the data model design should be especially flexible.

As an ultimate goal, all administrative and reporting systems as well as all projection tools would be able to access data exclusively through this corporate data model.

C) Creation of a unified interface

High data quality should be characterised by a unique data format and standardised data transfer procedures. Based on the inventory and the grouping of data of the legacy systems on the one hand, and the corporate data model on the other hand, the creation of a unified interface between the legacy systems and the corporate model would be a crucial task. As the physical data systems of the company evolve, this interface would be continuously updated. It would therefore need to be clearly documented and to include quality criteria and consistency checks.

Conclusion

Solvency II will necessitate further updates for IT systems and data flows. The introduction of flexible data warehouses as a basis of individual business solutions should address these enhanced data requirements. The introduction of a good data warehouse can be a demanding task and the need to comply with future Solvency II requirements adds to its complexity. While this may seem to be a daunting task, the silver lining on

the cloud is that it is possible to start now and have the system up and running by the 2010/2011 implementation deadline of Solvency II.

Insurance companies can also use Solvency II as a key driver for implementation of further business intelligence solutions for risk and economic capital calculation, performance and reporting management, and ultimately to increase company profitability.

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Capital management in the Solvency II world

As you can see from Consultation Papers 13 and 15, Risk and Capital Management will be at the heart of the Solvency II regime and much of the approach taken by insurers is likely to become discloseable. This increases the pressure on firms to have an efficient approach to capital management within the firm and a view of what their desired state is.

In recent years, insurers, in particular in the life sector, have tended to focus on increasing returns through new business volumes and operational efficiencies. But return on capital can also be dramatically increased through reducing the quantum and cost of capital. Many insurance businesses acknowledge that they are probably not making full use of the options available to reduce capital requirements. Various analysts have highlighted that there is a wide variance between the most and least efficient capital structures employed by insurers, and have commented that the level of disclosure about capital management could be enhanced.

As a result, insurance businesses are under ever-greater pressure to improve their risk and capital management framework. Companies have recognised the need for a more disciplined and focused approach to capital management as well as, providing adequate disclosure to explain their approach to stakeholders. Greater level of disclosure will indeed be a future regulatory requirement.

CEIOPS's (Committee of European Insurance and Occupational Pensions Supervisors) has outlined the type, nature and level of granularity of information that is likely to be a requirement for both supervisory reporting and public disclosure under Solvency II in Consultation Paper 15 titled, 'Draft Advice to the European Commission on Supervisory Reporting and Public Disclosure in the Framework of the Solvency II project'.

Improved capital measurement is an important development. Previously insurers focussed on reducing capital by reducing liabilities. More and more, industry best practice is seeking to use more sophisticated capital measurement tools and methodologies including focussing on asset and investment performance.

Acquisitions also present an excellent opportunity to take a fresh look at capital management practices – both in terms of delivering best value from the deal structure, and achieving better returns post-deal. Consolidation could help insurers to achieve the benefits of diversification as a group's capital requirement may be less than the sum of parts.

The question is – how can insurers satisfy stakeholders, including regulators, that they are approaching capital management in the most appropriate way for their business and achieving appropriate returns on the capital employed in the business?

The capital quiz – 5 questions for improved capital management

- Do you know the right level of capital for your business?
- Are you sure your organisation uses capital more effectively – essentially, how can you optimise capital requirements and maximise the efficiency of existing capital?
- Do your capital requirement and measures reflect your business risks?
- Do you use capital to drive performance?
- Do you have the right management information at a sufficiently granular level on capital adequacy to support business decisions?

Meeting the capital challenge

Getting the approach to capital management right can enhance returns: it makes clear commercial good sense. Firms who do not engage in the capital management debate and conundrum in the near future are likely to be left behind by their peers, who will have better information for strategic and business decision-making. And with Solvency II on the way, those that fail to implement rigorous risk and capital management on time face the imposition of much higher capital charge requirements. Regulators are explicitly focussing on the robustness of risk management and governance procedures in determining regulatory capital levels as can be gauged by Insurance

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undertaking's Internal Risk and Capital Assessment (IRCA) requirements detailed in CEIOPS's Consultation Paper 13.

Capital management presents a highly complex challenge for managers of insurers as the interaction between economic and regulatory capital is key to creating shareholder value and maximise return on capital. The two main reasons why Solvency Capital Requirement (SCR) under Solvency II may differ from the insurer's own assessment of internal capital (i.e. economic capital) are as follows:

- The Insurer may wish to hold additional capital for business purposes compared to the regulatory capital. For instance, it may choose to hold capital for rating purposes which represents a higher confidence level than that used to calibrate the SCR.
- The Insurer's risk profile may differ from the one implicit in the SCR. For instance, the insurer's assessment of the capital needed to back a particular risk might be different from the SCR's assessment. Or the insurer's risk profile might include risks which are not covered by the SCR.

From a regulatory perspective only the second type of difference is of concern and will guide supervisors in deciding whether the SCR might be deficient and hence the need to hold additional capital ('Pillar 2 capital add-



... the capital repatriators typically trade at a 15 percent premium to those threatening to raise capital, with the cash hoarders on a steady underperforming trend.

European Insurers – The Spade and Shovel, 4 October 2006

... market transparency and public disclosure in the area of capital management are an important part of the Solvency II framework...

Consultation Paper No 15, Draft Advice to the European Commission on Supervisory Reporting and Public Disclosure in the Framework of the Solvency II Project – CEIOPS, 6 November 2006

The opacity of insurance capital structures makes it almost impossible to identify excess capital and to hold management accountable for how it is deployed...

2006 Sector Outlook – 10 January 2006

As an integral part of the overall business strategy, insurance undertakings are required to have in place their own strategies for Solvency capital and all material risks to which they are exposed (such as underwriting, credit, market, liquidity and operational risks), as well as an appropriate policy for the use of risk mitigation and transfer arrangements (e.g. reinsurance, derivatives) that together manage and address overall Solvency. Insurance undertakings are required to have in place internal control mechanisms and processes that allow quantitative and qualitative measurement of each risk identified, including probability and impact on the risk profile of the insurance undertaking and the amount and quality of eligible capital which is relevant to the achievement of the undertaking's own goals. The IRCA shall be taken into account in the undertaking's strategic decisions.

Insurance undertaking's Internal Risk and Capital Assessment (IRCA) requirements – Consultation Paper 13

Insurers need to understand and take in to account both the type of differences and should aim to maximise returns on the level of economic capital

on' under Solvency II regulatory regime). However, Insurers need to understand and take in to account both the type of differences and should aim to maximise returns on the level of economic capital while at the same time seek to minimise levels of regulatory capital through improved capital measurement, robust risk management and enhanced governance procedures. As with any major task, the best approach is to have a plan.

1) Assessment: do you have clear objectives around capital, and are you meeting them? Are you satisfied that all key business decisions take capital impact into account? How confident are you that you are allocating capital effectively (i.e. where it is needed to meet higher volatility to achieve higher return)? What might you need to change in terms of structure and approach to achieve better returns?

2) Analysis: understand the benefits and costs of improvement and avoid risk-reward conjecture. For example, if you decide your operating or legal structure will make you more capital-efficient, what will be the business impact and how much would it cost you to change?

3) Implementation: develop a Target Capital Model, through a process of identifying the most effective way to allocating the right amount of capital for your business and optimise long term returns.

The capital management approach

Capital management touches on many different areas of an insurance business. Individuals within your organisation will have a thorough grasp of their own specialist areas, but they may need help in developing an understanding of their interdependencies. For example, in reviewing your capital objectives, an in-house team may develop a structure that minimises tax cost through long term tax planning – but it might not give you the flexibility or credit rating you need.

Developing a Target Capital Model (TCM) (see Figure 11) will enable you to take a holistic view of how capital fits into your business and highlight areas where you may need to change or improve.

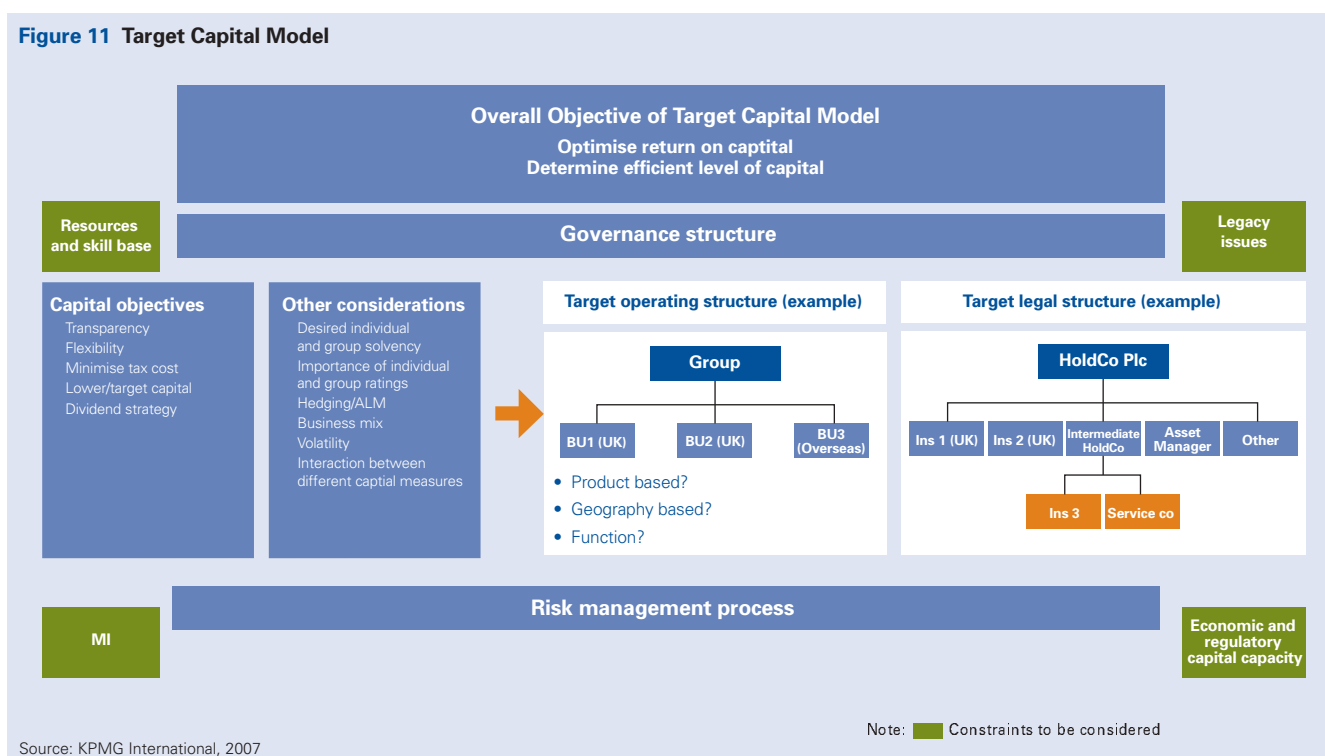
How the TCM process works

Every business is different and the approach will always depend on individual circumstances. Initially, key activities will include:

- Reviewing your business strategy and determining your position with the equity markets.

- Reviewing your governance structure and risk management processes.
- Agreeing your overall capital objectives and defining individual and group capital targets.
- Considering rating requirement taking into account pricing, reserving and dividend strategy of the insurer.
- Documenting and evaluating other considerations – like your business mix, group Solvency and the interaction between capital measures.
- Determining constraints – skills and resource requirements, legacy issues, regulatory requirements and MI.
- Considering interdependencies of accounting, tax, regulatory and actuarial requirements.
- Identifying options and diversification benefits.
- Determining your firm's target operating model and legal structure.
- Producing a high-level implementation plan and researching your options.
- Determining if there are any poorly performing portfolios/lines of business and consider exit or turnaround strategies.

Figure 11 Target Capital Model

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Potential Benefits of a Target Capital Model

- Aligns capital management with overall business strategy to optimise return on capital within defined risk appetite
- Enhances corporate structure and tax efficiency given stated strategic plans to reduce your cost of capital
- Embeds capital management in your risk management and governance structure
- Uses capital to understand and drive enhanced performance
- Achieves capital flexibility to release capital for strategic aims e.g. M&A, new business
- Releases capital from poorly performing portfolios/lines of business
- Assists in understanding the interdependencies between accounting, regulatory, tax and actuarial aspects of different capital measures (Regulatory, Economic Capital, EEV, ICA, IGD)
- Improves transparency for financial reporting and the forthcoming Solvency II disclosures
- Enhances management information with better processes to inform decision making

Solvency II – learning lessons from Basel II

Solvency II seems to be gathering pace. Final feedback on the last of the six consultation papers (CP15 to CP20) was submitted on January 19 and the draft Directive is promised for summer 2007. Solvency II is already breaking new ground and planning a path through to implementation of Solvency II won't be easy. There are, however, similarities with the international banking capital adequacy regime Basel II, which will complete its implementation this year. Whilst Solvency II must be specific to the insurance industry, nevertheless, insurers can draw some useful lessons from the Basel experience. Here we compare the two regimes and explore the likely implementation challenges for insurers.

Similar aims and approaches

Solvency II is a major initiative, and it's rare for projects like this to run without complications. However, the experience from Basel is helping to inform the industry debate. Solvency II takes the same three-Pillar approach as Basel and has the same broad objectives, which are:

- promoting a 'safe and sound' financial system
- firms will hold capital relevant to the risks in their business
- improved risk management and corporate governance
- improved global supervision and capital adequacy reporting.

Key areas of difference

Diversification is at the core of insurance business and can vary hugely across organisations. In Basel II, there is some implicit diversification, but wider diversification benefits providing a reduction to regulatory capital have to be very strongly justified. Solvency II aims to include recognition of diversification benefits more transparently and in a manner unique to each organisation. Under the proposed Pillar 1, the Solvency Capital Requirement (SCR) would take account of diversification effects across risks. CP20 notes that 'insurance undertakings should be permitted to recognise dependencies within broad risk categories as well as



The experience from Basel is helping to inform the industry debate

across broad risk categories.’ In addition insurers should be ‘permitted to fully recognise the effect of risk mitigation techniques in their actuarial model as long as counterparty credit and other risks are properly captured.’ There is ongoing debate as to whether diversification benefits might be restricted, as inferred by CP20 but this is strongly opposed by many in the industry.

Range of risks included. Basel II included credit, operational and market risks under Pillar 1. Solvency II has chosen to include all of these, plus a wider group of risks under Pillar 1 including insurance and liquidity risk. This is considered necessary as the range of risk exposures varies more across insurance companies than across banks. However, measurement of these additional risks brings additional challenges, and debates about how to include some risks in Pillar 1 may still have a long way to go. Ultimately, some may end up in the ‘too hard’ category, and have to be moved to Pillar 2 – as has happened with other risks in Basel II.

Supervisory approach: Basel II European supervisors took a largely harmonious approach and had the advantage of starting from a common platform including an agreed model approval mechanism. The Solvency II supervisors are much more disparate, and are currently trying to align a number of different interests and conflicting views. It is possible that Pillar 1 rules under Solvency II may need to be more comprehensive than those for Basel II to achieve maximum harmonisation.

IFRS compatibility was rather side-stepped by Basel II, with core numbers coming from the risk, rather than the accounting systems. However, given the inter-dependency of overall insurer Solvency with balance sheet valuation, IFRS is expected to have a key influence on Solvency II. The intention is to have consistency in valuation with IASB principles. However, the recent CP20 has highlighted some areas of disagreement. The IASB and CEIOPS are seeking to reconcile their views wherever possible, but their slightly different objectives will inevitably give rise to some differences.

Pro-cyclicality is a significant issue for Basel II. As risk perception increases (for example as a recession approaches and people default on loans), so Basel II capital requirements increase, causing banks to reign back on lending, and possibly deepening the recession. For Solvency II, pro-cyclicality is an emerging issue and similar effects could be predicted on the pricing cycle.

Other Solvency II issues under discussion

Minimum Capital Requirement (MCR): Banks do not have an equivalent for MCR under Basel II, so this is virgin territory and the subject of a Solvency II Consultation Paper. Basel II is something of a leap of faith for the banking supervisors. For those who have the equivalent of a modelling approach for the SCR, the regulators will rely on this completely. There is no other measure or backstop. It means the regulators

really have to take the models seriously, and believe in them as an appropriate risk measure. The current Solvency II debate centres on how the MCR should be calculated and CEIOPS discussed two potential approaches in CP20 being:

- a modular approach – reflecting the main risk modules of the SCR in a simplified way
- a compact approach – a percentage of Solvency Capital Requirement (SCR).

In its supplementary advice CEIOPS opts for the modular approach though the latter compact method is favoured by industry. How this will conclude remains to be seen.

Partial modelling: Basel offers full and partial modelling options to quantify risk, so firms can mix and match according to what will provide a cost-effective overall risk assessment. Solvency II will also allow this – but under strict conditions. However, the term means different things. In Basel a partial model applies to the whole business but the regulators supply some of the factors. In Solvency II a partial model can be applied to risk modules and risk taking units. In general the industry supports companies being allowed to move to internal and partial models on an incremental basis rather than the fixed approach recommended by CEIOPS. The Basel experience would suggest that partial modelling is very popular – and seen by many as a pragmatic stepping stone to full models.

The key management decision to be made is which type of model to choose

Disclosures: Solvency II introduces major new disclosure requirements and expectations which are outlined in CP15, Public Disclosures. Basel has similar disclosure requirements, and the impact of these was perhaps underestimated at the start of the Basel II debates. One of the Basel II requirements is to disclose the approach being used for regulatory capital – whether standardised, partial, or full modelling. Understandably, no firm wants to be seen to be taking a less sophisticated approach than its peers, and there was an undeniable influence on the decisions some firms took as to whether to use a modelling approach or not. In addition, information for many of the Basel disclosures comes from product and risk systems, and is not always reconcilable to the accounts and general ledger – yet this information will be in the public domain.

Implementation challenges

Technical

Building a highly robust, reliable model to calculate capital requirements presents firms with a big technical challenge, not least because of the complexity of the range of risks involved. Many Basel implementers have commented that if they were to do Basel again, they would invest in more technical specialists who understand IT, to bridge the gap

between complex, highly technical and statistical specifications, and pragmatic IT implementation. Legacy systems provide a further challenge. The extent of data requirements is another major issue, and one which has been causing problems for banks under Basel II. Insurance loss close-out times are typically longer, and data less consistently held. So there are challenges ensuring that the information fed into the model is clean, complete and consistent with business planning and financial reporting data, and the model result is stable.

Management

The key management decision to be made is which type of model to choose – standard, internal, or partial modelling using a mix of both. What's most important is to get senior management involved in the business case early, to ensure they understand the implications for legislation and what the regulators are looking for – and have faith in the model that is ultimately chosen. Identifying the team is the next major decision, and availability and quality of resources could well be an issue for some firms. Putting together a project like this requires a broad range of specialist skills – in actuarial modelling, project management and risk management. Don't forget that firms will all be approaching this together – at critical

stages of Basel implementation, banks found that the market for specialists completely dried up due to the high demand. Those left without when the music stopped faced delays to their programmes.

Getting the risk management framework right is very important. The regulators are not simply asking firms to come up with a number: they are looking for a properly defined, independent, objective risk function, with a proper separation of roles between the front line, the risk managers and Internal Audit. They will also be looking for the right level of documentary support (in terms of policy documents and business plans).

One final thing firms will have to brace themselves for is working to continually changing and developing requirements. Whilst the draft text is due out this summer, the detailed implementation requirements will come later. If firms go too fast, there is a risk that some may have to backtrack, which could result in wasted time and expense. Yet many banks expecting to reach the Basel II finishing line this year started implementation in earnest four or so years ago, and firms can't afford to wait until all the regulations are finalised before starting. Getting the timing and programme flexibility right will be important.



One of the most important lessons from Basel for insurers right now is to get engaged in the debate early

Key lessons: make your voice heard and focus on the business benefits

While Solvency II is often called 'Basel for insurers', the truth is more subtle. The fundamental aims are common, but the supervisors are taking care to reflect the structural differences between insurance and banking in the Solvency II regime, and reflecting the lessons learned from the Basel experience. When the draft Directive hits the streets this year, it probably won't be entirely familiar to the banking industry, despite the common framework.

One of the most important lessons from Basel for insurers right now is to get engaged in the debate early. Make your voice heard, and wield all the influence you can: regulators are highly skilled, but unless they hear your input, they may not design a regime that suits your business needs. Sectors of the banking community which were earliest to the debating table on Basel seem to have gained most – and those late to enter debate, lost most when the dust has settled. It's not possible to be definitive about the extent to which debate and outcome are linked, but with hindsight it's a risk most wouldn't want to take.

Insurers are keenly aware of the investment required to meet the Solvency II regulatory requirements.

Basel implementation costs have been estimated at nine figure sums for large diversified banks. Bearing in mind this investment, it's critical that firms focus on the benefits too. Basel brought some important rewards, including:

- Potentially lower capital requirements
- Better risk management through more risk-based capital assessment
- Improved risk understanding
- Lots of clean, accessible, and granular data, the full business and marketing benefits of which banks are only now beginning to really get in their sights.

Successful insurance companies that tackle the challenges head on, can follow a similar route and can benefit comparatively over time.

¹ The level of capital below which ultimate supervisory action could be triggered.

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Solvency II news in brief

Expected developments

March 2007

CEIOPS issues advice on a number of aspects related to all the Pillars of the Solvency II regime.

CEIOPS issues a report including:

- The feedback over the questionnaire on the implementation of the current Insurance Directives which was distributed in November 2006.
- The industry's views and experiences collected online.

CEIOPS delivers advice on Pillar 1 issues.

April – June 2007

Third round of Quantitative Impact Study (QIS 3).

October 2007

CEIOPS issues a further consultation paper on capital requirements, including a draft advice on both design and parameters of the SCR and MCR standard formula.

Spring 2008

CEIOPS issues the final advice on capital requirements.

Other news

Framework Directive on track for 2007

The European Commission is sticking to its ambitious goal of publishing its Framework Directive proposal by mid-2007. Karel van Hulle, head of the Unit for Insurance and Occupational Pensions at Directorate-General Internal Market of the European Commission, has indicated that the new directive will not come into force in European countries before 2011 following translation into national law.

IAIS support margin of prudence

The IAIS support a margin of prudence being built into the technical provisions, which contrasts with the most recent IASB position which recommends that an exit value methodology should be followed.

European Commission to obtain view of Insurance Industry

At the end of last year, the European Commission requested the CEA to obtain the views of the insurance industry on potential administrative costs caused by the new supervisory rules. The Commission required an initial indication of the additional costs insurers expect to incur as a result of the implementation of Solvency II.

e-Mail for QIS 3

The FSA has set up a dedicated QIS 3 e-Mail address. QIS 3 queries should be sent to QIS3@fsa.gov.uk. The aim is to respond to questions seeking guidance within five working days. CEIOPS and the FSA also plan to provide a web-link to the most frequently asked questions.

Solvency II web site launched

The International Underwriting Association has set up its own web site dedicated to Solvency II at www.solvencyii.co.uk/home.html.

'The IAIS common structure for the assessment of insurer Solvency' released 14 February 2007

The International Association of Insurance Supervisors (IAIS) released 'The IAIS common structure for the assessment of insurer Solvency' on 14 February 2007. The paper aims to describe a coherent risk-based methodology for the setting of regulatory financial requirements and the respective roles and determination of technical provisions and required capital in a risk-based Solvency regime. There are 15 elements to the proposed structure, ranging from preconditions necessary for Solvency assessment to disclosure requirements. The publication is available on the IAIS web site www.iaisweb.org.

A global framework for insurance Solvency assessment

Acting in support of the IAIS, the International Actuary Association (IAA) formed an Insurance Solvency Assessment Working Party to prepare a paper on the structure for a risk-based Solvency assessment system for insurance. The paper focuses on principles for Solvency assessments such as, a three-pillar approach, a total balance sheet approach, the appropriate degree of protection and time horizon to be covered, the types of risk to be covered and appropriate risk measures to be used. The paper, 'A global framework for insurance Solvency assessment' is available at http://www.actuaries.org/LIBRARY/Papers/Global_Framework_Insurer_Solvency_Assessment-public.pdf.

Keeping you informed

Thought leadership

KPMG firms' thought leadership library explores the challenges for the financial services sector raised by change in the broader business environment – the economy, the regulatory framework and the forces of globalisation. Listed below are KPMG International and KPMG member firms' publications most relevant to the industry.

Insurance specific thought leadership

EU Solvency Report
Globalizing the Risk Business: surviving and competing in the global insurance industry
Implementing IFRS in the Insurance Industry
Insurance Insiders: www.kpmginsiders.com
M&A appetite and strategy in the global insurance industry
Principles & Presentation – Survey of insurers' 2005 financial statements
Risk and capital management : a new perspective for Insurers
Second survey of Capital Assessment Practice
The State of the U.S. Insurance Industry

Related thought leadership

BaselBriefing series
Financial Services Advisory Magazine: Headroom
Financial Services Industry Guide – Tax
Frontiers in finance – KPMG's regular financial services thought leadership magazine
Growth and Diversification in Islamic Finance
Increasing value from disposals – investing in divesting
Islamic Finance – Making the transition from niche to mainstream
Rethinking Cost Structures
Rethinking the business model
Sourcing: Future Sourcing – Evaluating the risks and benefits of sourcing
Strategic Evolution – A global survey on sourcing today
Tax in the boardroom
Tax risk management in the financial sector – A KPMG international survey
The Governance of Tax – turning tax policies into competitive advantage
Transfer pricing and international business
Working to rules

If you wish to request your own free copy, please e-Mail distributionpublications@kpmg.co.uk or download them from our publications library at: www.kpmg.com/financial_services

KPMG has an international network of regulatory and risk and capital management professionals. To discuss any of the matters raised in this edition of SolvencyII Briefing, or any other regulatory, risk management and data management matters please contact:

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