

## Similar Intent, Similar Challenges? Applying The Learning From Basel II to Solvency II Planning

Insurers planning their Solvency II implementation programmes can benefit from reviewing the lessons from Basel II implementation. Despite some obvious points of divergence, Basel II, just like Solvency II, also strove to eliminate capital arbitrage, inadequate reporting, weak oversight of credit, liquidity and funding strategies, and inadequate supervision and disclosure of off-balance sheet exposures. Commentators judge the implementation of Basel II to have been less than successful in this regard. However, the shortcomings are good indicators of what **NOT TO DO** with Solvency II implementation.

### Harnessing The Voice Of Experience

In order to identify the key lessons learned from Basel II implementation, we asked some clients we supported to delivering Basel II, to comment on their personal experience.

#### Don't Try To Reinvent Everything. Work With What You Have Got

- “The most important aspect of the Programme is **keeping a suitable balance between business input and being tied to business approval**. Establish minimum standards for the collection of Risk data, with room to allow each particular business area to undertake risk management in the way they see fit. We lost a **LOT** of time and money in trying to develop detailed processes to suit each business. If I were to do it again, I would process map what exists currently (if any) and use that as a basis for deciding where to set the minimum standards for data collection and risk management processes”

#### Invest in Managing the Regulatory Relationship Well

- “Using the Regulators as a benchmark and **keeping the Regulators involved in the development of the framework** is a very useful practice. I think the reason that some banks got their AMA and kept good favour with the Regulators was because of the close contact they had throughout the whole development. The Regulators love “transparency”!

#### The Financial Impacts Might Not Be What You Expect

- “Many business plans for the implementation of Op Risk frameworks historically cited “reduced Operational Risk losses” as a tangible benefit that would be realised as a result of implementing the frameworks. But as people started to understand more about OR, they rightly started allocating more losses, but this **actually increased the loss count instead of reducing it**. That wasn't much good for the business plans, but it **was** good for the framework as there was more potential for root-cause analysis and mitigation of future losses. Moral of the story is: don't bank on reduced Op Risk losses!”

#### Plan for Data Quality and Systems Issues

- “Beware of “data collected to date”, particularly for modelling purposes. I found that if there has historically been little education around collecting the right data, **there is often a lot of rubbish data to sort through**. This data will need revisiting when a new framework is developed - and don't underestimate how long that takes.”
- “**With data repositories, choosing the right system is key**. Currently most of the financial institutions I know are either not happy with their system or are in the process of replacing it”.

#### Apply Robust Stress Testing Assumptions

- “One of the key lessons to learn about stress-testing is **having the right assumptions** to start with. A lot of the stress-testing that has proved to be inaccurate did not employ variables such as “what if the ratings agencies got it wrong””.

### Other Shortcomings

Our consultants have assisted a range of banks to implement Basel II, and many in addition to the above insights, we noted a number of issues which cropped up during the long march towards submission of the Basel II application, notably in:

1. *Credit Risk*

- Calibration of risk models to inadequate confidence levels
- Inconsistent pricing models
- Poor integration of provisioning policy with capital models
- Insufficient understanding of stress-testing processes, outputs and contingency requirements

2. *Operational Risk*

- Misaligned operational risk modelling and outcomes
- Insufficient risk identification, quantification and impact management
- Weaknesses in all three lines of defence – risk management, risk governance and risk audit.

Poor data availability and the poor quality of data that could be accessed – was a recurring theme. Many companies found it difficult to identify and organise data, to transfer data between systems, and to ensure data accuracy, completeness, and correct application. This was often a significant obstacle to work on Pillar 1.

**Don't Forget The Opportunities Solvency II Presents**

On the plus side, the Basel II process was a significant success in promoting some positive behaviours.

- It allowed banking divisions to understand the performance of their business lines better, aided by strengthened processes and integrated systems mapping, formalised governance structures and MI to support business decision making
- This understanding, coupled with a renewed emphasis on risk-focused operating models, organisation design, and mapped the landscape for optimisation initiatives.
- The renewed focus on risk promoted more efficient allocation of risk capital
- The very need to engage with all stakeholders in the compliance process led to a more open and collaborative conversation with Regulators in particular.