Institute of Actuaries Sessional Meeting – 26th March 2007

Briefing note – Solvency II

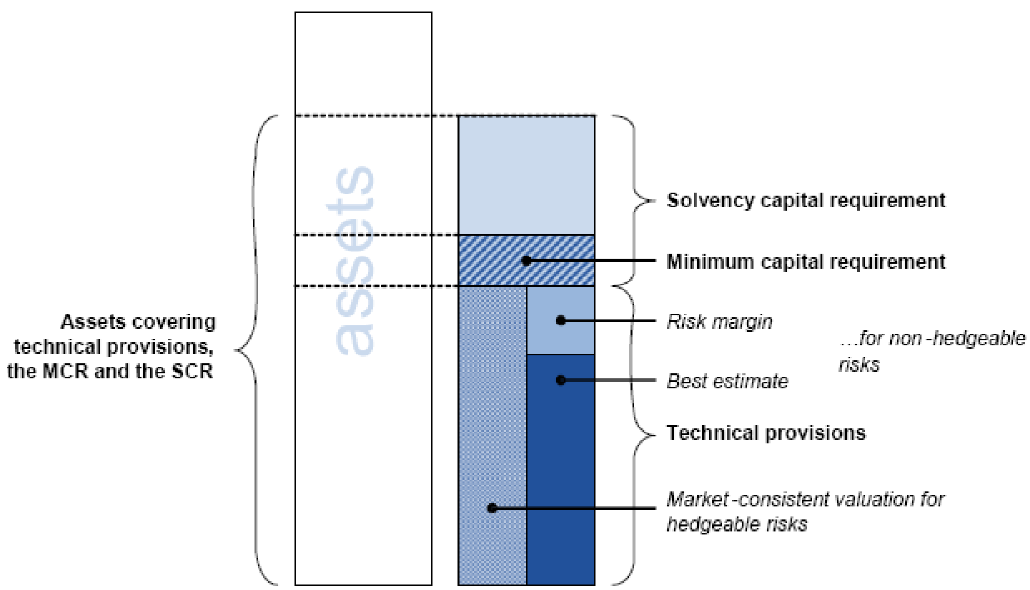
Aim of project:

Solvency II is the EU project which (quoting from the European Commission's "Framework for Consultation") aims to develop "a new solvency system to be applied to life assurance, non-life insurance and reinsurance undertakings, which Member States and supervised institutions are able to apply in a robust, consistent and harmonised way."

A three pillar system is envisaged, similar to Basel II:

- Pillar 1: quantification of capital requirements;
- Pillar 2: supervisory review process; and
- Pillar 3: market analysis of published data.

Pillar 1 encompasses two capital requirements (MCR and SCR) sitting on top of technical provisions made up of the best estimate of the liability plus a risk margin, as shown in the following diagram taken from CEIOPS Consultation Paper 20.



The SCR is to be calibrated to a probability (of being able to meet technical provisions) of 99.5% over a one year time period. Breaching it will lead to regulatory intervention of some sort. A ladder of intervention is envisaged depending on how far below the SCR the firm falls – ranging from a plan to restore capital to SCR level as soon as possible down to forced closure on breaching the MCR (and failing to produce a credible recovery plan). A "standard approach" to SCR calculation is being developed – a combination of factor-based and scenario-based risk capital components which then get combined through correlation matrices. There will also be the (very significant) option for firms to use their own "Internal Model", subject to supervisor approval (or insistence). "Partial internal models" are also envisaged in some circumstances.

Pillar 2 is likely to be similar to what currently happens in the UK – including the possibility of an IRCA (Internal Risk and Capital Assessment) requirement, more extensive than the current ICA.

Pillar 3 will comprise more accessible and meaningful public disclosure than at present in UK (covering business strategy, governance, risk and capital management approach as well as the basis underlying the Pillar 1 quantification), as well as confidential material required by the supervisor.

The Solvency II Directive will follow the Lamfalussy approach – i.e. Directive will be reasonably high-level and concentrate on the key principles and structure of the framework. (referred to as a "Level 1" or "Framework " directive). "Level 2" or "Implementing" Measures will be developed (mainly by European Commission and the Member States) which will put detail on the bones of the directive. "Level 3 guidance" will also be developed by CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) in order to support harmonised and consistent implementation.

Project Timetable:

After several years of consultation, the draft Directive will be presented to the European Parliament in July 2007, with implementation of the framework hoped to be by 2010 or 2011.

The 3rd in a series of EU-wide pilot calculations, QIS3, will run from April to June of this year. At least one more set of QIS is envisaged in 2008.

Development of implementing measures has already started and is likely to run well into 2008 (if not beyond!).

Desired Outcome:

While achieving consensus across EU Member States is not easy, most in the industry would share Paul Sharma's desire (quoting from a speech last October) for:

- a regulatory environment which incentivises and rewards insurance firms to use modern risk management practices that are appropriate to the size and nature of their business;

and also:

- a more risk-sensitive and risk-responsive capital requirement that not only takes account of the risks on the liability side, but also on the asset side, and gives due credit to the use of risk mitigation techniques

Key issues of current debate:

General

Form of MCR – with industry view that it should be based on (a percentage of) last year's SCR – the "compact approach" - but with a counter view from some in CEIOPS for a ("modular") factor based approach (which may not move in parallel with SCR).

Group issues – and the extent to which local subsidiaries need to hold the full SCR (with potential group diversification benefits expressed as additional regulatory capital) or whether they just need to cover MCR locally with a promise of SCR capital from Group should it be needed (with Group holding a diversified Group SCR at the centre).

Pillar 3 – and the extent to which disclosures should be public or just confidential to the supervisor (particularly regarding any breaches of the SCR and whether or not the SCR is subject to any supervisor-required capital add-ons.

Small companies – how to get more of them more involved in the implementation discussions.

Use of internal models to calculate SCR, or partial models replacing elements of the SCR formula – by "internal model", CEIOPS appear to mean an economic capital and risk-based decision-making framework rather than just a computational tool. Thus, obtaining regulatory approval for an internal model SCR could be significantly more extensive than the current UK ICA approval process.

Life insurance

UK WP business – the standard approach to the SCR may not prove as suitable as some would like (e.g. in terms of allowance for management actions). If a better alternative cannot be found, many UK offices may be forced down the "internal model" route (which may not be a bad outcome, but perhaps for the wrong reason).

Non-life insurance

Provisions will have to be estimated on a best estimate basis, discounted for the time value of money. This is not common practice in the UK.

The SCR formula in QIS3 does not allow future profits to be offset against capital requirements. This means that if an insurer wishes to do this they will need to model most of their business in a partial model

The SCR is aiming for a confidence level of 99.5% over one year. This does not include allowing for run-off of claims to ultimate, so is less strong than the current ICAS level.

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