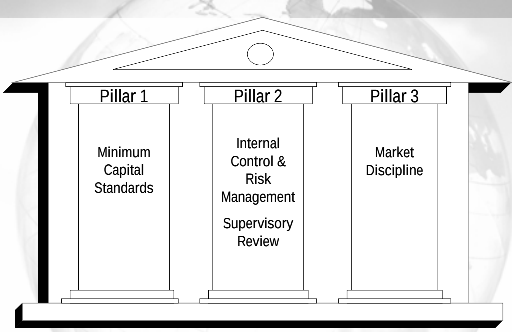
Business Implications of the New Capital Framework

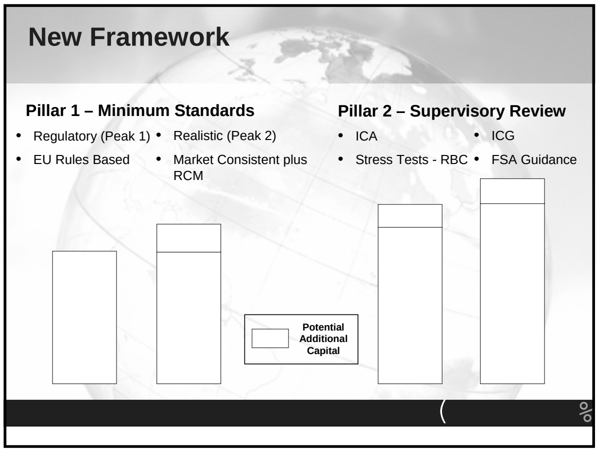
2005 Highlights of Life Convention
Tim Roff
14 February 2005

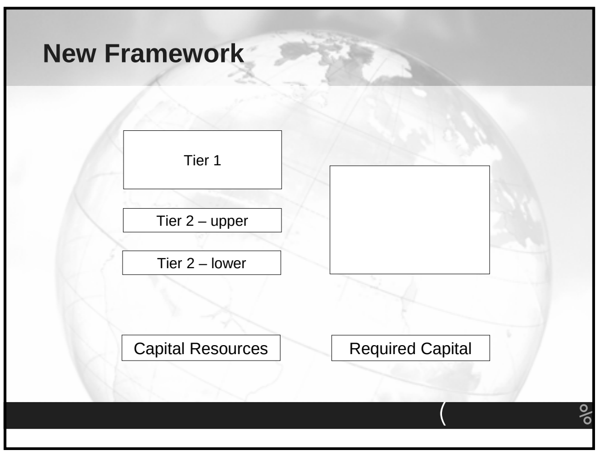
Content

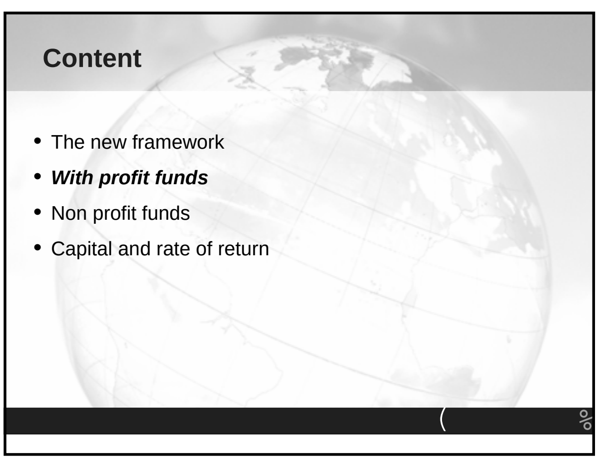
- ***The new framework***
- With profit funds
- Non profit funds
- Capital and rate of return

New Framework




New Framework
Pillar 1 – Minimum Standards
Regulatory (Peak 1)
Realistic (Peak 2)
EU Rules Based
Market Consistent plus RCM
Pillar 2 – Supervisory Review
ICA
ICG
Stress Tests - RBC
FSA Guidance
Potential Additional Capital


New Framework
Tier 1
Tier 2 – upper
Tier 2 – lower
Capital Resources
Required Capital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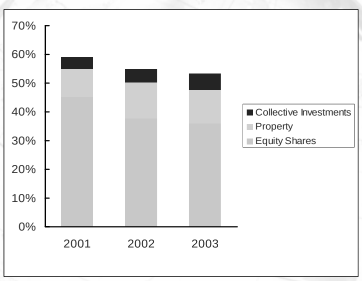
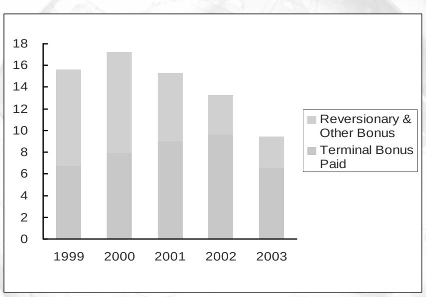
Derisking

- New capital requirements more onerous
- Rather than find more capital firms have derisked
- Derisking includes reducing equities and limiting the build up of guarantees
- The most extreme derisking is in the smaller/medium size funds

EBR



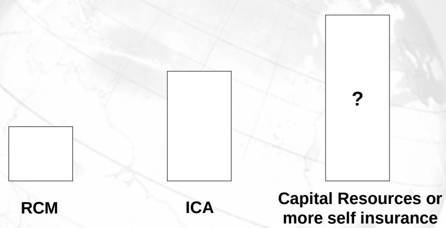
Bonuses



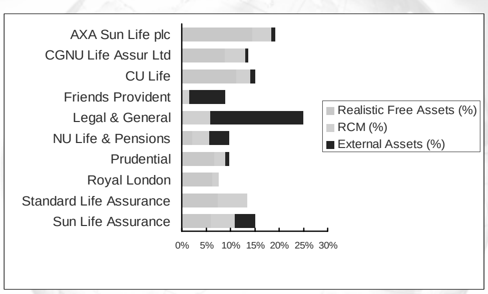
Other Actions Taken

- Separate pools for AS, Guarantees, RCM and balance
- Better matched fixed interest
- Derivatives
- Guarantee charges
- Self insurance by policyholders
- Shareholder support clarified by some
- Not all risks can be closed out
- Process will be needed to stay derisked and manage remaining risks

Capital Requirement



Realistic Results



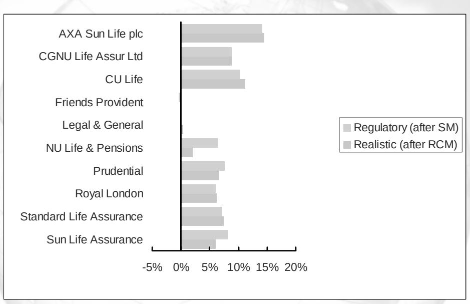
RCM Too Optimistic

- Insufficient allowance for longevity and operational risk
- Diversification too high
- Generous approach to taking credit for management action
- ‘Rule of thumb’ of 2 x RCM too low?
- Has the derisking gone far enough?

Treating Customers Fairly

- Honesty about shareholder support
- Future premiums into derisked funds
- Communication of valuable options and guarantees
- Are practices consistent with policy documents and representations to policyholders?
- Run off plans – pace of distribution, crystallising NP, dis-economics of scale
- Small funds not yet in the realistic net

Peak 1 vs Peak 2



Interaction Between Peaks and Pillars

- Most have not had time to investigate it
- Most do not have capabilities to do business plan projections
- This is a priority for 2005

Summary of With Profit Issues

- Has derisking gone far enough?
- Is too much credit being taken for management actions?
- What are you doing about treating customers fairly?
- Processes need to be developed to stay derisked/ manage residual risks
- Actuarial projection systems need upgrading (again)

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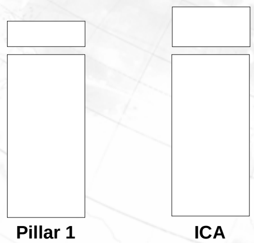
Annuities



Spreads

- Peak 1 and EV count part of spread
- In ICA some offices are also counting part of the increase in spread
- Is this an appropriate approach?
- Is annuity pricing sound?
- Is public reporting giving the right picture?

Protection

- ICA lower than Pillar 1
- EU/FSA minimum still a problem
- Good diversification properties
- Reinsurance less attractive
- Means taking real risk

Concentration

- Reinsurance normally treated like corporate bond in ICA
- But this does not address concentration risk
- Security arrangements may become more common
- Same issues for derivative counterparty

Diversification

- Typically reduces ICA by 40%
- Needs to be considered in business planning, M&A, corporate structure, etc
- Do you really believe this level of diversification benefit is available in the tails?
- Diversification benefit will change as the business runs off

Treating Customers Fairly

- Products linked to mortgage
- Complying with policy conditions – eg, special features added to base policy, reviews
- Informing policyholders of their options
- Projection bases
- Discretionary changes to charges
- Return of premiums

Other issues

- Pension fund
- UK GAAP
- Disclosure of ICA/ICG

Summary of Non Profit Issues

- Is credit risk being treated correctly?
- Is annuity pricing appropriate?
- Should you retain more mortality/morbidity risk?
- Should you be taking credit for so much diversification benefit?
- Should you derisk the pension fund?
- What are you doing about treating customers fairly?
- Do you have security arrangements on large counterparty exposures?
- Is your ICA robust enough for public disclosure?

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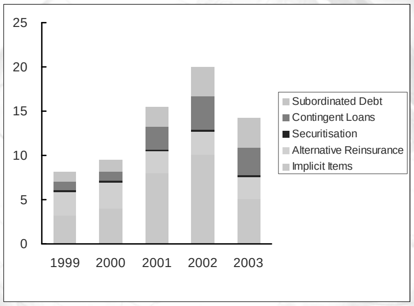
Low Grade Capital



Capital raising

- L&G and Pru rights issue
- RSA changed sub-debt terms
- Friends, Standard and Aviva innovative Tier 1
- NU Tier 1 Contingent loan
- Friends securitisation
- Swiss Re catastrophe bond
- EIB longevity bond

Acquisitions

- RSA by Resolution
- LAHC by Swiss Re
- Merchant Investors by Sanlam
- Zurich Life by Swiss Re
- Lombard by Friends Provident
- HHG by Sun Capital
- Swiss Life by Resolution
- Cornhill by Brittanic

Prices and Rates of Return

- 60% of EV on acquisitions?
- Higher discount and more locked in capital
- Prudential 14% (on new capital)
- Britannic 12% (on acquisition)
- Norwich Union 15% (on new business)
- Shake up of pension pricing and commissions

Profit Reporting

- IRR becoming more common for new business
- EV becoming discredited?
- EEV is a half way house
- Market consistent for internal reporting?
- Will we end up with no profit recognised on sale for public reporting?
- How are you going to produce the figures in 10 days?

Capital and Rate of Return Issues

- Is there now an exit route from UK markets
- What are your capital needs and capital raising options?
- What is your RoC target and how will you achieve it?
- Are you going to move to EEV or market consistent?
- How does this affect the attractiveness of products?
- Are you going to develop an EVM framework to provide an internal measure of RoC by product?

Contact

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