The Actuarial Profession
making financial sense of the future

Highlights of the 2010 Life Conference
Niamh Hensey and Colm Guiry, Towers Watson

The Implications of QIS5 for UK companies

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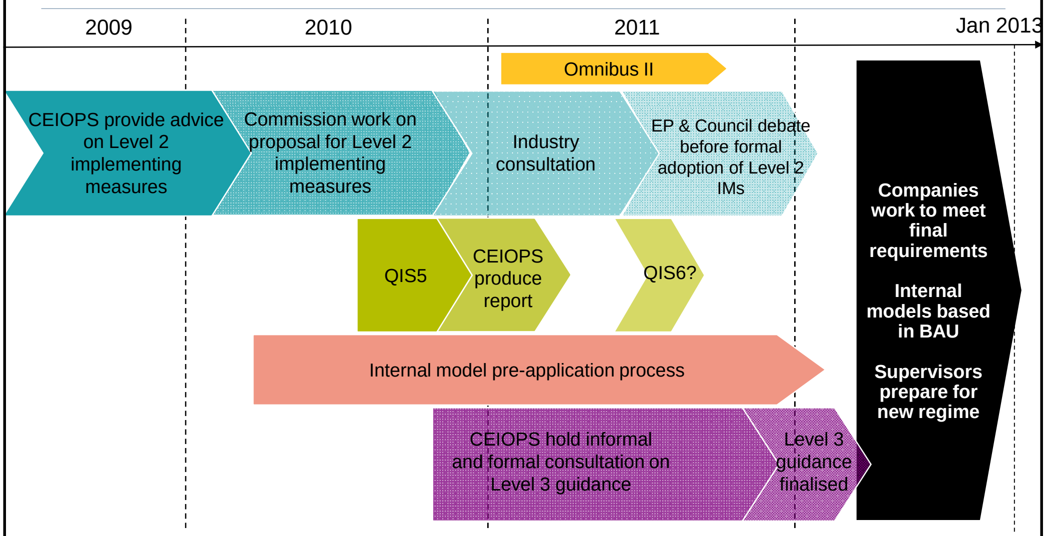
Quantitative Impact Studies (QIS)

QIS 1	QIS 2	QIS 3	QIS 4	QIS 5
Q4 2005	Q4 2006	Q2 2007	Q2 2008	August to October 2010
• Technical provisions • Asset values	• Technical provisions • Asset values • SCR and MCR	• Technical provisions • Asset values • SCR and MCR • Group issues • Own funds	• Technical provisions • Asset values • SCR and MCR • Group issues • Own funds • Internal models	• Mainly a test of revised calibrations compared to QIS 4 • Likely to be final QIS testing all aspects • QIS6 testing selected risks likely in 2011
312 companies	514 companies	1027 companies	1412 companies	60% insurers 75% groups

Solvency II timeline



Why is QIS 5 important?

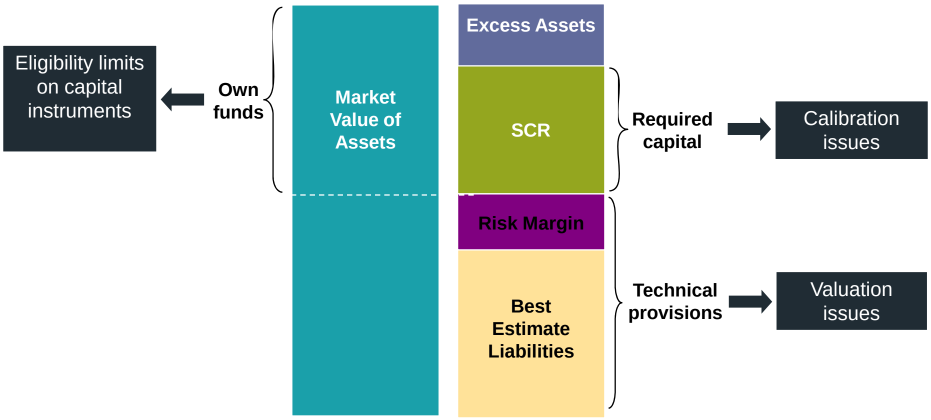
For EU Commission and supervisors

- Test the impact of proposed calculation of balance sheet and calibration of standard formula SCR
- Inform negotiations on finalising Level 2 implementing measures with EU parliament
- Contributes to preparedness of supervisors for Solvency II

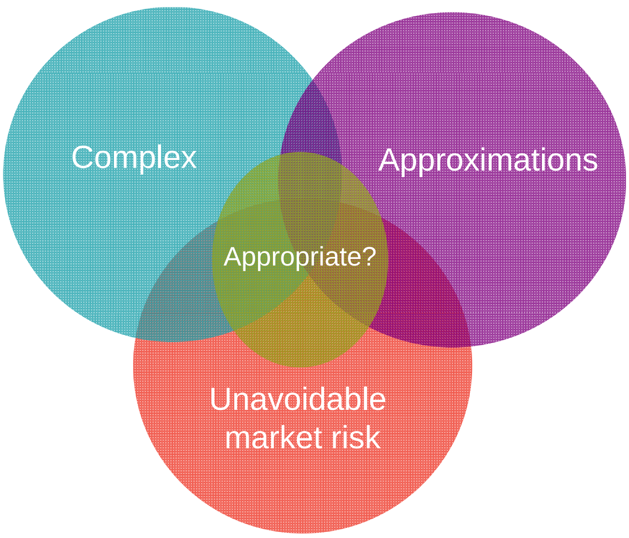
For companies

- Assess the likely impact of Solvency II on the capital requirements for the company
- Identify the important issues affecting the company for lobbying purposes and strategic planning
- As a gap analysis on preparedness for Solvency II
- Is mandatory for entry into FSA's internal model approval process

Key issues are still being debated that could have a major impact



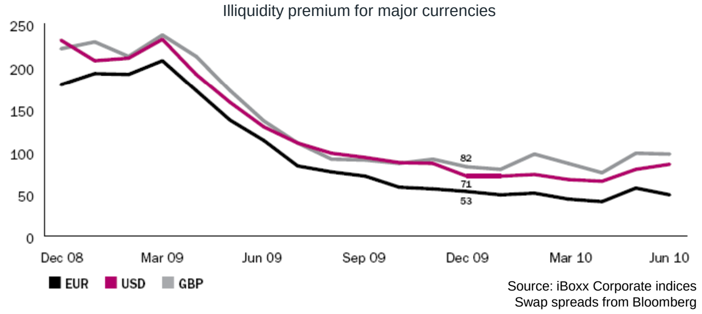
Risk Margin



Illiquidity premium: overview

- Risk-free rate is based on swap rates with 10bps adjustment for credit risk
- Illiquidity premium allowed:
  - 100% illiquidity premium for contracts which exhibit high levels of predictability
  - 75% illiquidity premium for contracts with profit participation
  - 50% illiquidity premium for all other business
- Illiquidity premium stress in market risk module

Illiquidity premium: calculation



- Calculated using a formula:
  - Illiquidity Premium = Max (0, 0.5*(Spread – 0.4))
- Will EIOPA have responsibility for determining whether there should be an illiquidity premium?

CEIOPS Illiquidity Premium Task Force report: https://www.ceiops.eu/fileadmin/tx_dam/files/publications/submissionstotheec/20100303-CEIOPS-Task-Force-Report-on-the-liquidity-premium.pdf

Illiquidity premium: impact on investment strategy

- Illiquidity premium calculation implies an investment strategy of approximately 50% gilts and 50% high quality corporate bonds
- If companies retain current approach, there will be a mismatch
  - Companies will need to distinguish between their back book and new business
  - Transitional measures will have an impact

Illiquidity premium: transitional measures

- There are transitional measures proposed for existing business eligible to use the 100% illiquidity premium
  - QIS5 requested a calculation based on transitional measures and on the revised discount rate but specification wasn't clear
- Current proposal is a fixed linear glidepath over 7 years.

Recognition of future premiums: contract boundaries

- QIS5 specification sets strict definition of contract boundaries
  - Differs greatly from current treatment under MCEV/EEV
- Has been some confusion and contradictory advice from CEIOPS
- Many companies have not tested the QIS5 definition
- The IASB have proposed a definition for contract boundaries in a recent paper
  - The European Commission are sympathetic to a move towards the IASB proposal

Recognition of future premiums: IASB definition of contract boundaries

"The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts.

The boundary of an insurance contract is the point at which an insurer either:

(a) is no longer required to provide coverage,

or

(b) has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (i.e. no discernible effect on the economics of the contract)."

Insurance Contracts exposure draft: http://www.ifrs.org/NR/rdonlyres/508B3E26-4355-46E6-ACCF-248E76AD3457/0/ED_Insurance_Contracts_Standard_WEB.pdf

Recognition of future premiums: Expected Profits in Future Premiums

- Previously, CEIOPS said in advice that the 'winding-up gap' and expected future profits (VIF) should be counted as Tier 3 own funds
- CEIOPS requested the calculation of EPIFP in QIS5 to determine the impact if this value was counted as Tier 3 own funds
  - Although for the purposes of QIS5 it is Tier 1 own funds
- Method prescribed is artificial: assumes all policies are made paid-up with immediate effect
  - Has been confusion about how to apply this in practice
  - Resulting in inconsistency between different undertakings
  - Different interpretations across Europe

Recognition of future premiums: implications

- If strict definition of contract boundaries
  - Could lead to more single premium contracts or changes to the terms of new contracts
- If EPIFP defined as Tier 3 own funds
  - Numbers calculated are large
  - Methodology likely to be different compared to approximate calculation in QIS5, potentially tested in QIS6?
  - Broad definition could lead to a proportion in Tier 1 and a proportion in Tier 3
  - Narrow definition may lead to cap on overall amount that can be Tier 1

Calibration of the SCR: market risk

Market risk

- Spread risk calibration
- Capital charges for non-EEA sovereign debt
- Equity stress symmetric adjustment of 9%

- Overall increase in calibration
- May have implications for investment strategy

Calibration of the SCR: life underwriting risk

Life underwriting risk

- Longevity risk
- Mass lapse capital charge
- No recognition of lapse diversification

- Simplified standard formula approach
- Impact on product design

Other issues

- Counterparty default risk
  - Difficult calculation
  - High charge for intra-group transactions
- Mitigating effect of technical provisions
  - Single equivalent scenario calculation difficult
- Operational risk for Unit-linked business
- Assets / current liabilities
- Group calculations
  - Fungibility
  - Currency risk
  - Single equivalent scenario for a Group

Omnibus II Directive

- Changing the Solvency II implementation date from 31 October 2012 to 1 January 2013 (Article 311 of the Directive).
- Proposed responsibilities for EIOPA (formerly CEIOPS).
- Providing the Commission the ability to apply transitional arrangements across all three Pillars of Solvency II.
- Increased powers of delegation from the Commission towards bodies such as EIOPA and some tidying up of areas around procedure.

Level 3 Guidance

- Following draft guidance issued
  - Ancillary own funds (AOF)
  - Calibration approximations
  - Classification of basic own funds
  - Classification of Items not on the list of own funds
  - Own Risk and Solvency Assessment (ORSA)
  - Profit and Loss attribution
  - Systems of Governance
  - Undertaking-specific parameters (USPs)
  - Use Test
  - Validation policy

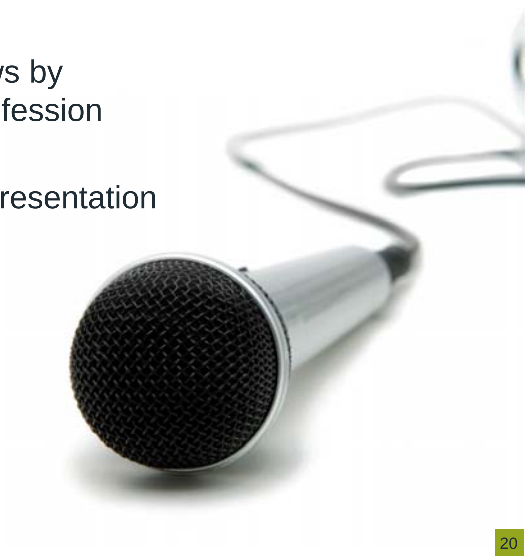
Next steps

- EIOPA expected to publish report on results by end March 2011
  - FSA expected to publish UK report at the same time
- Working parties set up to consider key issues
- EU Commission consultation on proposed Implementing Measures
- Companies should analyse results and assess impact
  - Re-calculate using YE2010 data
  - Communicate to management
  - Look at gaps in process to produce results
  - Consider strategies to reduce capital requirements
  - Reconsider whether a full/partial Internal Model is required
- Companies focus will move to Pillar 2 and Pillar 3 aspects of Solvency II
- ABI due to publish a guidance paper on Internal Model pre-application process next week

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenters.



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