Institute and Faculty of Actuaries

A proportional approach to Solvency II

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Institute and Faculty of Actuaries

1. What does proportionality mean?
2. Where does it make a practical difference?
3. What has the PRA said?
4. What has industry told us?
5. What should firms be thinking about now?

Thought leadership Progress Community Sessional Meetings Education Working parties Volunteering Research Shaping the future Networking Professional support Enterprise and risk Learned society Opportunity International profile Journals

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Principle of Proportionality

Underpinned by European Union law - four stages:

- there must be a **legitimate** aim for a measure
- the measure must be **suitable** to achieve the aim (potentially with a requirement of evidence to show it will have that effect)
- the measure must be **necessary** to achieve the aim, that there cannot be any less onerous way of doing it
- the measure must be **reasonable**, considering the competing interests of different groups at hand

Solvency II Directive

"This Directive should **not be too burdensome for small and medium-sized** insurance undertakings."

"Member States shall ensure that the requirements laid down in this Directive are applied in a manner which is **proportionate to the nature, scale and complexity of the risks** inherent in the business of an insurance or reinsurance undertaking."

What are the legitimate aims of Solvency II?

Policyholder protection through:

- Effective **solvency capital requirements**
- Incentives to measure and **manage risk**
- Appropriate **governance** to manage risks that cannot be managed through capital requirements
- **Public disclosure** in a timely manner

But there are other legitimate aims….

Standard Formula

✓ Easier to implement, significantly cheaper to build and run

✓ On-going comparison to the ORSA

✓ Most mutuals are well capitalised

✗ Need to show it is appropriate to risk profile

✗ How do you deal with known deviations from the SF?

- Capital add-on
- Triggers
- Margins
- Partial Internal Model
- Pragmatic combination of SST, ORSA and triggers

Standard Formula messages from the PRA

- Should fit a significant proportion of UK firms
- Does not promote or encourage the use of an internal model where the SF is a good fit
- Simplistic comparison to ICA is not the full picture
- Firms responsibility to identify areas where business materially deviates from the SF SCR assumptions
- ORSA allows demonstration of appropriateness
- All firms will be reviewed for standard formula appropriateness before Solvency II implementation

Standard Formula appropriateness

- PRA focus for inappropriateness
  - Longevity – deferred, enhanced, impaired
  - Equity – active investment, concentrated portfolio
  - Credit – non-standard assets which differ from average corporate bond holding
  - Operational – outsourcing and legacy systems
  - Pension risk
- (Some) other assumptions
  - Volatility…

Governance

"A function is an administrative capacity to undertake particular governance tasks. The identification of a particular function does not prevent the undertaking from **freely deciding how to organise** that function in practice save where otherwise specified in this Directive. This should not lead to unduly burdensome requirements because **account should be taken of the nature, scale and complexity of the operations** of the undertaking."

"Furthermore, save as regards the internal audit function, in smaller and less complex undertakings it **should be possible for more than one function to be carried out by a single person or organisational unit**."

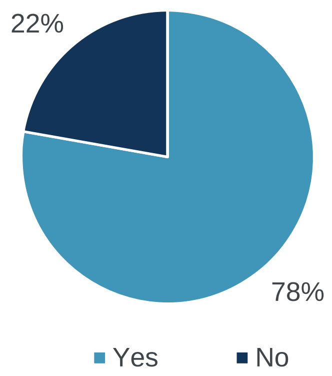
Disclosure and timescales

Proportionality and Materiality

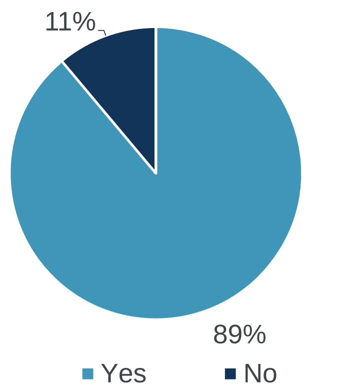
- High correlation between the two
- An item is material if it would change the decision being made – so context is important
- If a risk is not material then a proportionate approach would allow a simplified treatment of that risk
- A Materiality Policy will help
- Proportionality and materiality both require expert judgement so a sound Expert Judgement Policy is key
- Make sure Risk, Finance and other areas are also bought into proportionality, materiality and expert judgement

Does size matter?

Is your view of proportionality affected by your size?



Was your SCR calculation decision affected by your size?



Should size matter?

- “proportionate to the … scale … of the risks”
- Is it the scale of the risks rather than scale of the business that needs to be considered?
- Is it the nature and complexity of the risks for a smaller firm that means that proportionality might suggest a different approach?

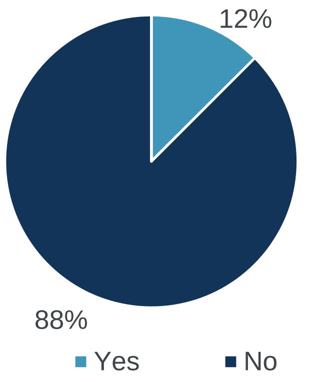
Biggest Challenges

- Re-engaging people now it’s really happening
- Volume of work and resource availability
- Pillar 3 requirements
- Data
- Demonstrating compliance
- Understanding/interpretation

There is a link to proportionality with all of these

Is the position different for mutuals?

Is your view of proportionality affected by your mutual status?



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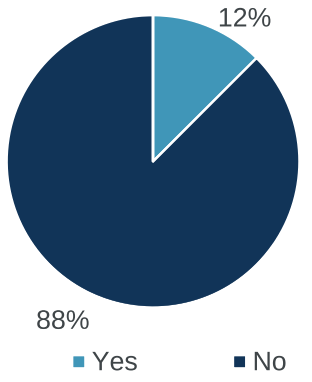


All firms worry about the same things

Solvency II aims to increase policyholder protection

✓ Good news for customers of mutuals and proprietaries

… through better measurement and management of risks

✓ Good news for customers of mutuals and proprietaries

… and timely public disclosures

? Who looks at these for mutual companies?

We all need to justify the costs of Solvency II whether to our policyholders or shareholders.

Should the position be different for mutuals?

- Perhaps – capital position needs to be "strong enough" but isn't a priority in itself
- Perhaps – have the luxury of being able to take a longer term view
- Perhaps – are able to consider the wider aspects of a decision
- Perhaps – mutuals generally are more highly capitalised than proprietaries
- Perhaps – have a greater affinity with their customers

Justifying the costs of implementation

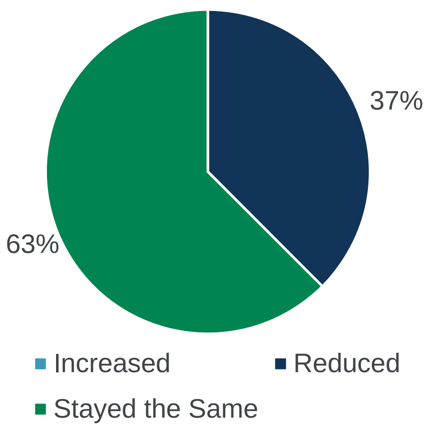
- Have you carried out a cost benefit analysis?
- Or is it just a cost of being in business?
- Who is bearing the costs in your business? Are you charging these costs to policyholders, shareholders or your estate?
- If the Daily Mail published the cost to the industry of Solvency II implementation then what would the public reaction be?

What are the benefits and costs?

- Greater capital protection
  - Is money being held back from current generations for the benefit of later generations?
- Better measurement and understanding of risks
  - Is this increased under Solvency II compared to the ICA regime?
- Has product development and product innovation slowed down because resource has been tied up with SII?
- If costs are being charged to policyholders or capital requirements have increased, does this reduce policyholders' payouts?
- Is customer service affected?

Appropriateness of the Standard Formula

Level of PRA challenge around your standard formula decision



Many have shared Board papers on this with the PRA/FSA but few have had any feedback …

But the consensus is that it's just a matter of time (and resource ☺)

Appropriateness of the Standard Formula

- The PRA have said that they will look at this for all Standard Formula firms in 2015
- General approach (including the PRA) has been to compare the ICA and the standard formula
  - Are the risks included the same?
  - Are the stresses applied the same?
  - Are the correlations between risks the same?
  - What features of the ICA model are not captured by the standard formula methodology?
- “Appropriate” or “Not Inappropriate”?

Police Mutual’s considerations

- Where are we not “standard”?
  - Equity volatility
  - Police mortality
- Look at the overall SCR result not just the individual items
- Look at the overall SII solvency position compared to the SI position
- Consider the TCF aspects

Appropriateness of the Standard Formula

- A number of firms have updated their ICA stresses and correlations to reflect those of the standard formula
- There are concerns that the PRA may “cherry pick” - focussing on areas where the standard formula understates and ignoring areas where it overstates

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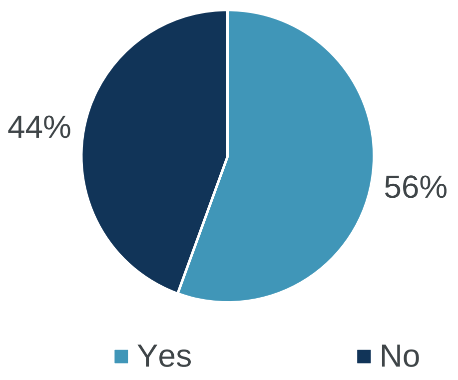
Governance

Have you changed your governance arrangements?



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Minimum Governance Standards

- Actuarial expertise required
- Demarkation of responsibility of production and challenge
- Directive does permit the same person to carry out more than one role
- Need to be sure about which hat people are wearing!

Governance arrangements: Risk / Actuarial / Internal Audit

- Most firms have included actuarial resource in their Risk teams – they don't feel that Risk can provide adequate challenge without it
- Most are using segregation of duties within Actuarial to ensure separation of model design & build / production of results / review of results
- For many outsourcing of Internal Audit is the preferred option

Risk / Actuarial / Internal Audit Challenges

- Ensuring the right person commissions outsourced Internal Audit work to avoid conflicts of interest
- Ensuring the scope of the Internal Audit work is right – be clear about whether they are auditing whether you have followed a process or the process itself
- Segregation of duties for Actuarial – being clear about who is commissioning the work, who is carrying out the work and who is reviewing it – for some small firms this is the same team or even the same individual
- Having actuarial resource in the Risk function adds value but comes at a high cost

Risk Committees

Size is a consideration when establishing committees:

- A smaller number of NEDs means less choice
- Increasing the number of NEDs means a proportionately bigger cost increase for a smaller firm
- Managing the overlap in personnel with other committees, particularly the Audit Committee
- Finding appropriately experienced NEDs

This means a number of smaller firms opt to have the Board as the Risk Committee

Board knowledge

- Board training is a challenge – and many NEDs serve more than one insurance company so there is duplication of effort
- All Board members need to:
  - Understand the key drivers of the numbers
  - Understand the sensitivity of the numbers
  - Understand the limitations of the model & assumptions being used
- But unless some Board members have a detailed understanding there is limited challenge

Things to Think About

- How to evidence the application of the Prudent Person Principle
- The relationship between a standard formula SCR and the “true” capital measure that you use for decision making
- Documenting the appropriateness of the standard formula
- Demarkation of responsibilities
- Be mindful of the internal model documentation standards
- Be clear on your materiality and expert judgement policies – and use them in earnest!

Questions Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

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