Introduction to Solvency II

Tim Edwards
Gavin Dunkerley

24th September 2008

Introduction

– The primary purpose of this presentation is to explain what Solvency II is and why it is important

– We also hope to challenge the way you think about your personal role within your firm, the role of actuaries within your firm, and the role of the actuarial profession within the GI industry

Terminology

Guide to the jargon

- CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors
- VaR – Value at Risk
- SCR – Solvency Capital Requirement
- MCR – Minimum Capital Requirement
- QIS – Quantitative impact study
- Lamfalussy – Belgian wise man

What is Solvency I?

- Current regime (Solvency I) 30 years old
- Lack of risk sensitivity and proportionality
  - No incentives for insurers to manage risks adequately; or to improve & invest in risk management
  - Does not facilitate accurate & timely supervisory intervention
  - Does not facilitate optimal allocation of capital
- Sub-optimal supervision of groups
- Divergence of Business and Regulatory capital
- Lack of convergence of supervisory practice across EU

Why do we need Solvency II?

- Desire to harmonise consumer protection across the EU:

  With consumers able to buy insurance from any company within the EU, it makes sense to provide a consistent minimum quantitative and qualitative regulatory standard

- With harmonised regulation, well-run insurers enjoy a competitive advantage
- Solvency II is principles-based, and risk-based, calibrated at the 1-200 VaR level

  Although, in principle, this is similar to current UK standards, there are many important differences

Fundamental Principles

- Principles based, risk based
- Market Consistent Valuation Principles
- Ladder of Supervisory Intervention
- Proportionality - related to the nature, scale and complexity of a firm's business
- Incentives for firms to model their own risks
- Captures most firms – scope threshold is likely to be EUR5m (premium) / EUR25m (technical provisions)

Making It Law…

- A 'Lamfalussy' Directive…
- Split into 3 Levels:
  - Level 1 - High Level Principles
  - Level 2 - Implementing Measures
  - Level 3 - Supervisory Convergence / Guidance
- The Level 1 Directive text was published by the European Commission in July 2007
- Political agreement is anticipated late 2008/ early 2009

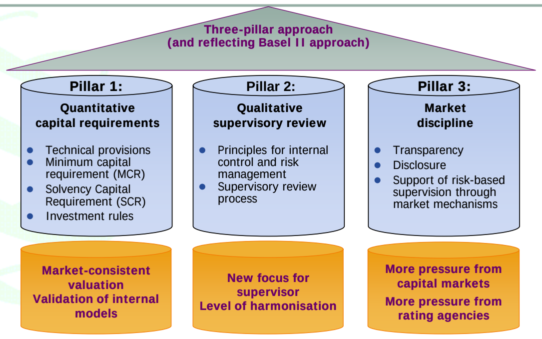
A risk management standard

- Solvency II is a risk management standard – the "system of governance" articles precede those on the calculation of regulatory capital requirements
- Article 43: "an effective risk management system comprising strategies, processes and reporting procedures….to monitor, manage and report risks … to which they are or could be exposed and their interdependencies"

Own Risk and Solvency Assessment (Art 44)

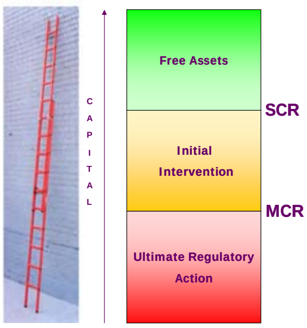
- Assess your firm's risk profile, risk tolerance and business strategy
- How does your firm's risk profile deviate from the assumptions underlying the SCR standard formula
- Identify short- and long-term risks, both internal (the business) and external (the environment)
- Direct link to strategic planning and implementation

Three Pillar Approach



Pillar 1

- Risk-based approach to solvency requirements
- Based around a 2-Level capital requirement
  - SCR is at a 1-200 VaR level over a 1-year time horizon
  - MCR is intended to be at around the 1-10 VaR level
- Ladder of supervisory intervention
  - Breach of SCR / MCR triggers supervisory intervention



Calculation of technical provisions (Art 76)

- "The best estimate shall be equal to the probability-weighted average of future cash-flows taking into account the time value of money"
- Method
- Discounting
- Don't forget "future expenses"

Actuarial function (Art 47)

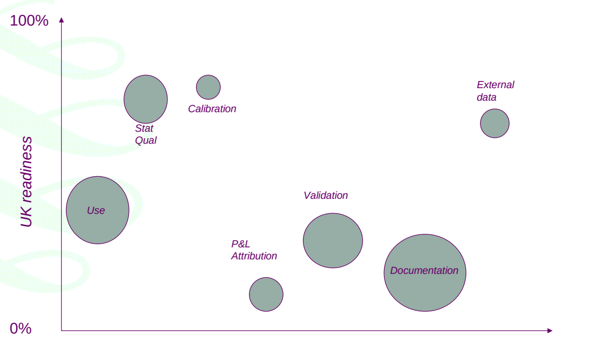
- Coordinate the calculation of technical provisions
- Ensure appropriateness of methodologies / models / assumptions
- Assess sufficiency and quality of data
- Express an opinion on overall underwriting policy and reinsurance arrangements
- Contribute to the effective implementation of the risk management system, *in particular* risk modelling

Calculating the SCR

- Standard formula or internal model?
- Standard formula cannot be ignored by any firm – being tested in QIS4
  - Even if you use an internal model, you will have to estimate the standard formula SCR
- The "approvals process" for internal models will be demanding
  - And will include a requirement to prove that the model is embedded in the business

UK Firms – preparation for Internal Models *:*

An alternative to using the standard approach / formula



Guidance to firms

The FSA will be issuing a Discussion Paper on Solvency 2 issues on 25th September 2008

- Main purpose is to address the core principles of the Directive in the context of firms' ongoing risk management and regulatory capital activities
- Hence to provide guidance on how firms can plan future risk management resourcing and structure
- Published tomorrow!

Contacts

- **For general Solvency 2 input and feedback:**
  tim.edwards@fsa.gov.uk

Presentation with James Orr on QIS 4 results AND introducing (launching) the DP tomorrow:
Workshop E5, at 1545

Recommended reading

- **FSA Discussion Paper – "Insurance Risk Management: The Path to Solvency II" (pub. 25th September 2008)**
- **Insurance Sector Briefing: Risk and capital management update, September 2008 http://www.fsa.gov.uk/pubs/other/isb_risk_update.pdf**
- **Insurance Sector Briefing: ICAS – lessons learned and looking ahead to Solvency II, October 2007 www.fsa.gov.uk/pubs/other/icas-isb.pdf**
- **Insurance Sector Briefing: Risk management in insurers, November 2006 www.fsa.gov.uk/pubs./other/isb_risk.pdf**
- **Solvency II Directive, especially the high-level summary, Articles 40-49 (risk management) and Articles 110-124 (internal models) http://ec.europa.eu/internal_market/insurance/docs/solvency/proposal_en.pdf**

A final piece of advice, from a famous billboard advertisement