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Solvency II
Challenges and industry impact

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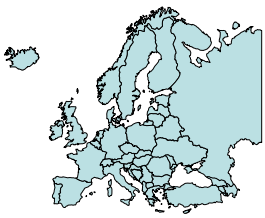
Solvency II

Agenda:

- What is Solvency II and where is it up to
- Quantitative Impact Study II (QISII)
- Assessment of Impact
- Future Challenges
- Timetable

Background: Solvency I vs. Solvency II

- **Solvency I (1970s)**
  - 'Prudent' valuation of liabilities reflects local accounting practices
  - Simplistic capital requirements
  - Asset risk managed by quantitative restrictions rather than capital
  - No provision for risk review
- **Solvency II (2010 or later?)**
  - Risk based approach
  - Three pillar approach
  - Overall risk management
  - Structure of EU insurance supervision
  - Covers entire insurance industry



Solvency II project – drivers

IAS & IFRS
- Consistency
  - At least attempting
  - Develop with reference

Banking & Insurance convergence
- BASEL II
  - Informing principles
  - Adapt for insurance

EU Convergence
- Harmonisation
  - Desirable
  - Degree?

Solvency II: a Risk Based Approach

- **Freedom for firms to innovate and respond to market demands, provided:**
  - they identify and manage the risks and
  - have adequate capital to support those risks
- **Maintaining strong consumer protection**
- **Minimising regulatory burden**

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Phase 2 structure

- **EIOPC** (European Insurance and Occupational Pensions Committee)
- **CEIOPS** (Committee of European Insurance and Occupational Pensions Supervisors)

Solvency II Framework Directive
(to be adopted by Council and Parliament)

EIOPC – implementing rules proposed by Commission
(advised by CEIOPS)

CEIOPS – advice on implementation, provides guidelines, recommendations – consultation with stakeholders (actuaries and industry)

Calls for Advice

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Solvency II – Three Pillar Approach

Three-pillar approach
recommended in KPMG study for EU
(and reflecting Basel II approach)

Pillar 1:
Quantitative capital requirements
- Technical Provisions
- Minimum Capital Requirement (MCR)
- Solvency Capital Requirement (SCR)
- Investment rules

Market – Consistent valuations
Internal or Standard Models

Pillar 2:
Qualitative supervisory review
- Supervisory review process
- Internal control and risk management

New focus for supervisor
Level of harmonisation

Pillar 3:
Market discipline
- Transparency
- Disclosure
- Market pressure for risk based approach

More pressure from capital markets
More pressure from rating agencies

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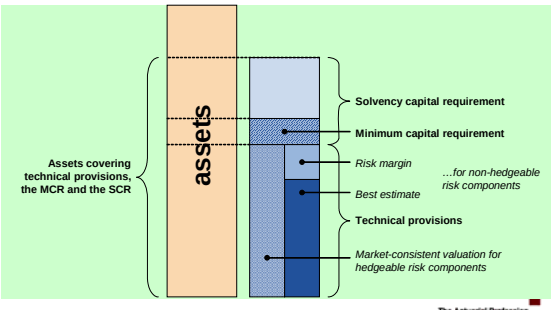
Adequacy of financial resources



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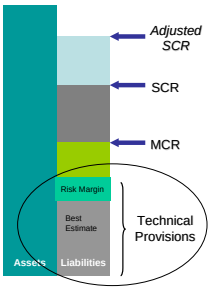
Solvency II – Financial Resources



Technical Provisions
Proposed principles

- Best estimate plus explicit risk margin
  - non-hedgleable risks
- Allows confidence to specified level
- Market Consistent valuation of Liabilities
- Allows a transfer of liabilities if necessary

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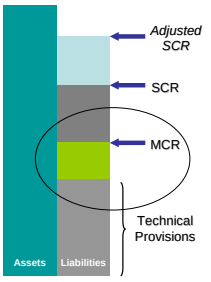
Solvency II – Financial Resources



Minimum Capital Requirement (MCR)
Proposed principles

- Has an absolute floor
- Level representing an unacceptable risk to policyholder
- Ultimate supervisor intervention – 'ultimate action'
- Simple and robust calculation
- Preference for factor based approach

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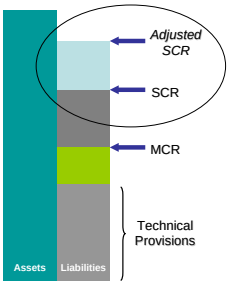
Solvency II – Financial Resources



Solvency Capital Requirement (SCR)
Proposed principles

- Part of supervisory review
- Absorb significant unforeseen losses
- Reasonable assurance to policyholders
- Provides change for remedial action
- Proposed 99.5% confidence over 1 year
- As a minimum to cover – insurance, market, credit and operational risks

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Other areas: Asset management rules

- Currently quantitative restrictions and eligibility rules
  - (only vis-à-vis technical provisions)
- Asset risk should be encompassed in SCR
- CEIOPS recommended Prudent Person Plus
  - Approach is sensible guidance for firms' investment strategy
  - Some asset concentration limits
- Possibility for additional capital requirement for poor diversification
  - via Pillar 2

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Summary of Key Differences

	Risk Based Economic Framework	Current Framework
Valuation of Assets	Market consistent	Market / book value subject to admissibility
Valuation of Liabilities	Market consistent	Prudential margins included in technical provisions
Available Capital	Adopts total balance sheet – based on economic ability to absorb shock	Partial recognition
Diversification	Yes	No
Risk mitigation	Yes	Partially
Solvency Control Levels	SCR important target, MCR hard limit	Only single control level – supplemented by various national rules
Group Issues	Fully recognised	Partially recognised
Calibration	Economic basis using market / historical data and actual experience – more objective	Subjective

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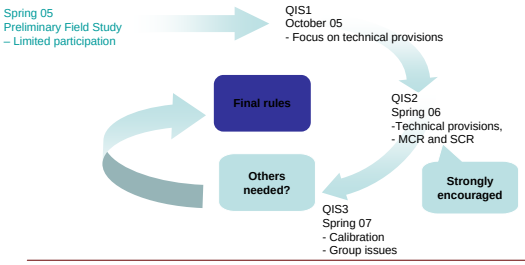
QIS – Quantitative Impact Studies

Critical to the development process



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QIS 2 Objectives

- Look at impact on individual entities of possible overall Solvency II framework, covering
  - Practicability of calculations, and resource implications
  - Effect on level of capital needed by firms
  - Suitability of approaches for establishing capital requirements
- Information to assist in further development and calibration of SCR and MCR

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UK QIS 2 participation*

- Sample size: 40 responses
  - 17 life
  - 21 non-life
  - 2 composites
- Market coverage by annual premium
  - 65% for life
  - 67% for non-life

- Life – With-profit, Linked & Protection
- Non-life – Personal lines & Commercial
- 3 pure reinsurers (life & non-life)
- 7 mutuals (life & non-life)

Only 2 respondents could be classified as small!

* Source: FSA

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Technical provisions: Highlighted issues

- Best Estimate
  - Calculation and robustness of methodology
- Cost of Capital approach v. 75th percentile
  - Practicability and suitability of approaches to measure risk margin
- Market-consistent valuation of liabilities
  - No clear definition
  - Solvency II v. IFRS

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MCR: Highlighted issues (1)

- Formulaic construction
- Arbitrary calibration
- Ratio of MCR to SCR
  - L: Inadequate reflection of profit-sharing business ('k factor')
  - NL: No adjustment for expected profitability (EP_{NL})
- Proposed response (1): Sticking with what we know – Modular approach

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MCR: Highlighted issues (2)

- Proposed response (2): Back to the drawing board – Compact approach*

* http://www.fsa.gov.uk/pubs/international/mcr_pres.pdf

SCR: Highlighted issues (1)

- Combined formulaic and scenario approach
  - Not all risks can be reduced to fixed factors
  - Setting appropriate scenarios
- Internal model v standard approach(es)
  - Full recognition by supervisors of internal models
  - 'Use test'

SCR: Highlighted issues (2)

- Role of Pillar 2
  - Individual Risk and Capital Assessment (IRCA)
  - Supervisory Review Process (SRP)
- Disclosure under Pillar 3
  - Adjusted SCR is <u>the</u> SCR

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Overall impact on firms*

- Calibration for QIS2 very provisional!
- General reduction in solvency ratios across EU but most would still be well above 100%
- Greatest impact on 'capital' (cf Solvency I) for
  - With-profit life business
  - Non-life commercial and reinsurance business
  - Monoline insurers
  - Linked life business

* Source: FSA

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Life insurance issues*

- Design of MCR
- Application of K factor
- Separate with-profit funds
- 'Capital' required for linked business
- Methodology & calibration for life u/w module
- Class VII operational risk factor

* Source: FSA

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Other relevant issues

- Practicability for smaller firms
- Resource issues
- Cost-of-Capital v. 75th percentile
- Internal models or Scenarios
- Group diversification issues

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Future Challenges

- **Internal Models**
  - Initial focus on enhancing models
  - High of scrutiny to ensure fit for purpose
  - Recent ABI Survey of Finance Directors:
    - 79% thought that full recognition by supervisors of firms' internal capital models was as the most important change expected from Solvency II
- **Lots of the detail still needs to be worked out**
  - Still many areas where the current QIS specifications don't work well
- **Particular challenges for small firms**
  - Special rules needed for small firms?
- **More efficient use of capital**
  - Move from modeling of the measurement of capital to management impact
  - Alignment of risk and capital planning with business operations

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Future Challenges

- **Opportunities**
  - Consistency across EU
    - Allows easier comparisons
    - improves customer security
  - Consistency of Supervision approach
  - Group supervision made easier
  - More risk sensitive approach
- **Solvency II can be seen as a business opportunity rather than compliance**
  - Benefits for early action in developing models and data infrastructures, management understanding.
  - Benefits in capital and underwriting decisions

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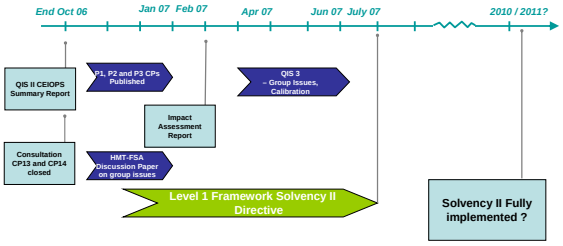
Next steps and timetable



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