



The Actuarial Profession

making financial sense of the future

“Solvency II” developments in selected European countries

Brian Morrissey, KPMG

2004 Life Convention

7-9 November

EICC Edinburgh Scotland

Agenda

Solvency II project

Developments in selected European countries

Netherlands

Switzerland

Sweden

KPMG's Risk and Capital Management for Insurers
Survey, 2004

Solvency II - Outline

Phase I – the design of the system

Phase II – technical detailed rules filling the structure

Working parties in place

Draft proposal for a framework directive (end 2005?)

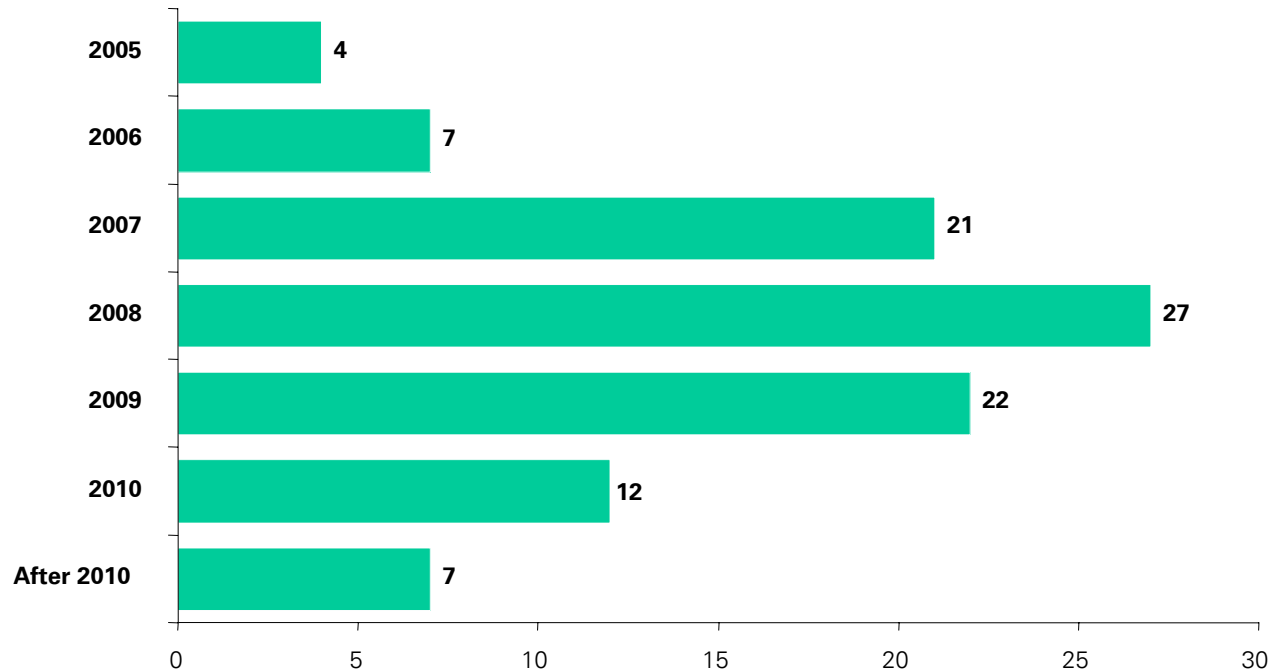
Implementation date - 2008?

Solvency II – Commission’s recommendations

Pillar I Financial resources	Pillar II Supervisory review	Pillar III Market discipline
<ul style="list-style-type: none">•Technical Provisions•Capital rules<ul style="list-style-type: none">- Two level requirement (MCR and SCR)- Recognition of internal risk models	<ul style="list-style-type: none">•Supervisory review process•Co-ordination of supervisory action in times of crisis•Prudential powers and measures•Transparency and accountability of the supervisory authorities•Peer reviews	<ul style="list-style-type: none">•Disclosures

Solvency II - Implementation

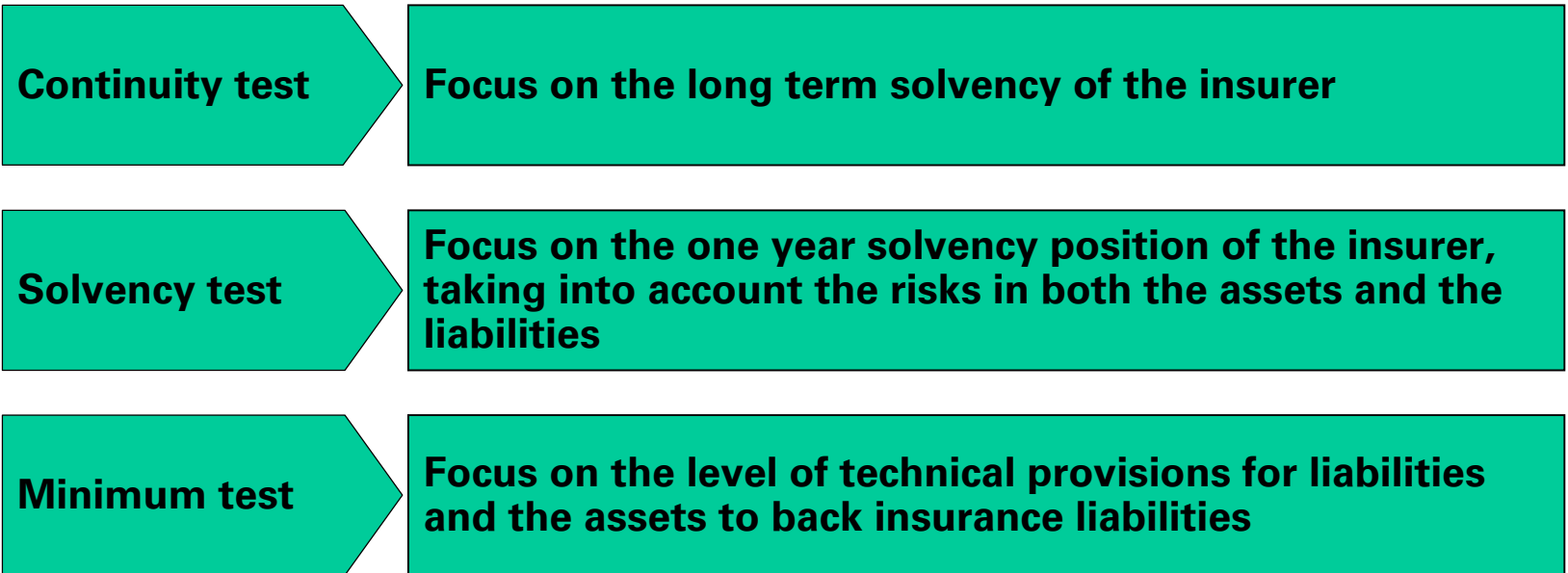
When do you expect that your country's regulator will reform the solvency regime for insurance companies? (%)



Source: KPMG International Capital Survey, Nov 2004

Netherlands - Overview

To ensure financial continuity, the insurer performs three tests:



Timetable:

Final set of rules to be formulated

Implementation 1/1/06 at latest

Netherlands – The Minimum Test

Purpose

To ensure an adequate level of technical provisions

Methodology

Based on fair value (with reference to IFRS developments)

Best estimate plus prudence margin

Related to a certain confidence level (circa 70%)

Netherlands – The Solvency Test

Assets are sufficient to cover liabilities to a defined confidence level over one year

Choice of models

- Standardised model is scenario based

- Internal models

 - Sufficient validation to prove the correctness of the results

Aim is for 99.5% confidence level over one year

Internal models - risk separated into 5 categories:

- Underwriting

- Market

- Credit

- Liquidity

- Concentration

Netherlands – The Continuity Test

Supervisory view of management/ Board understanding of risk factors

Purpose:

- Insight into balance between business objectives, related risks and capital adequacy

- Insight into own expectations

- To create insight into possible adverse scenarios in which the insurer becomes insolvent

- Insight into strategy and possibility to change strategy

- Back testing required - insight into degree of realism of intended policy and assumptions

Switzerland – Swiss Solvency Test (SST)

Timeline

Implementation uncertain

2004 limited field test - results now being assessed

2005 field-test with all companies invited to take part

Relatively principles based approach

Two complimentary views of insurers financial position -
statutory and market equivalent view

Minimum solvency level: based on statutory calculation (Solvency I)

Target capital based on economic risk (insurance, market and
credit risks)

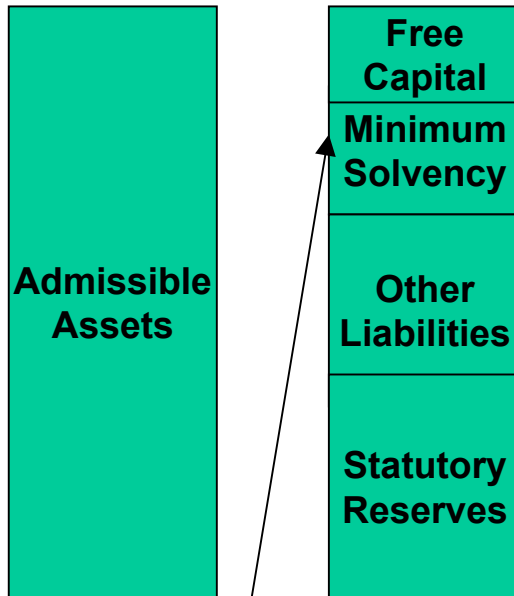
Disclosure requirements:

Provide results to regulator

Market disclosure more limited

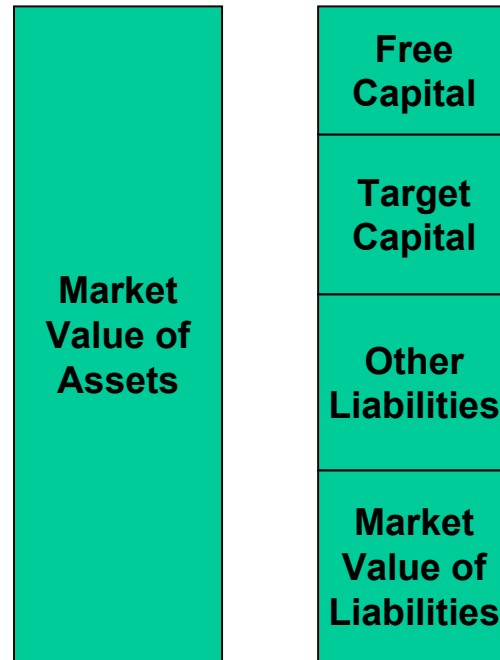
Switzerland – Swiss Solvency Test

Statutory Balance Sheet



Last step before insolvency. Not risk sensitive but model-independent and 'objective'

Market Value / Risk Balance Sheet



Early warning signal: risk specific but model dependent.

If target capital condition is not achieved, company is not insolvent but graded regulatory measures are implemented.

Switzerland – SST Target Capital

Measure to ensure adequate capital after one year

Target capital:

Risk factors

Financial, Insurance (and operational)

Analytical models for normal situation

Scenarios take into account situation when models break down

Compensate for $100\alpha\%$ of worst case expected shortfall

Confidence level $1-\alpha$ determined by calibration

Supervisor can allow greater α for some insurers

Results of analytical models and scenarios are aggregated to arrive at target capital

Regulatory intervention to ensure sufficient Target Capital

Sweden – Solvency Reform

Issued in December 2003

“Proposal for Modernised Solvency System for Insurance Undertakings”

Feedback provided

Alternative to full implementation?

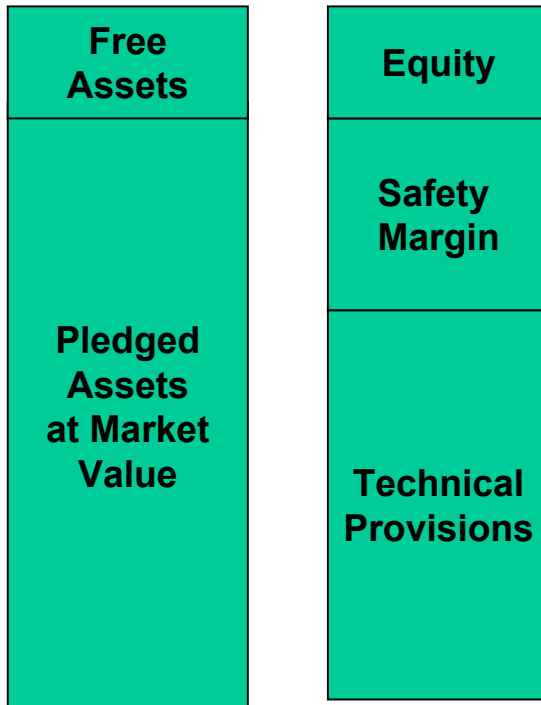
Move towards fair value based framework e.g. Denmark

Market based discount rates

Stress tests

Implementation for 2006?

Sweden – Proposed framework



Technical Provisions at Fair Value

Realistic assumptions

Discount factor or term structure

Treatment of options/ guarantees

Assets

Pledged Assets cover Technical Provisions plus Safety Margin

Free assets outside any supervision

Risk sensitive Safety Margin

Quadratic measure to sum risks

Assumed zero correlation

Sweden – Safety Margin

Risks considered:

- Insurance (diversifiable and systematic)

- Financial (market and credit risks)

 - Stress tests e.g. 20% equities, 30% property

 - 8% credit risks

- Matching (interest rate, exchange rate)

 - Impact of 20% change in interest rates

Operational risk not included

Challenges

- Risk mitigation key focus

- Match by duration

- Hedging strategies

- Foreign assets

Solvency developments - Summary

Pace of change differs

Common themes:

- Regulatory intervention

- Move to market values

- Internal models encouraged

But differences:

- IFRS developments

- Choice of confidence levels and time horizons

- Operational risk

- Model validation

- Terminology

Risk and Capital Management for Insurers survey

Objectives

Gain insight into capital assessment practice within the global insurance industry

Update survey work in KPMG's European Commission Solvency II Study (May 2002)

Relate findings in general terms to banking practice

Industry participants

Participants spread evenly across life, non-life, reinsurers, bancassurers

102 respondents; 19 countries

Methodology

One-to-one interviews and postal surveys

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