The Actuarial Profession
making financial sense of the future

Current Issues in Life Assurance
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Solvency II – indications from QIS5

Agenda

- **Context, scope and timelines**
- Getting into gear
- The draft Technical Specification
- Questions

Background

- QIS5 is European Commission's fifth Quantitative Impact Study
- Pan-European exercise
- Last significant opportunity to test likely impact of Solvency II before Commission finalises L2 measures
- Vital importance for future direction of Solvency II

Benefits of QIS5

- Commission
  - To understand the impact of the L2 Implementing Measures Europe-wide and on different sectors and countries
  - To assess whether the current proposals are realistic and practical
- Firms
  - Vital opportunity to test likely quantitative impact of SII
  - Opportunity to test preparedness ahead of SII go-live
  - “Test run” of processes and methods

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The European context

- Level 1 finalised in April 2009
- Level 2
  - CEIOPS has recently completed its Level 2 advice to the Commission
  - Commission will now be drafting Level 2 measures, to be finalised during 2011
  - **QIS5 is a vital piece of the work on Level 2**
- Level 3 to be developed between now and 2012
  - **QIS5 will help point to areas where guidance is needed**

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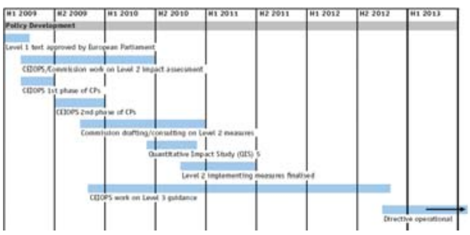
Timing is everything!



- Solvency II has moved on significantly since QIS4
- First post-crisis assessment of impact (“as-at” date is YE09)
- Direct influence on final stages of development of detailed rules

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QIS5 is not just about the standard formula

- Focus on quantitative aspects
  - Technical provisions
  - Valuation of assets and other liabilities
  - Own funds classifications
  - SCR – standard formula and internal model
  - MCR
- Some qualitative questions in addition
- **Solvency II balance sheet is key!**

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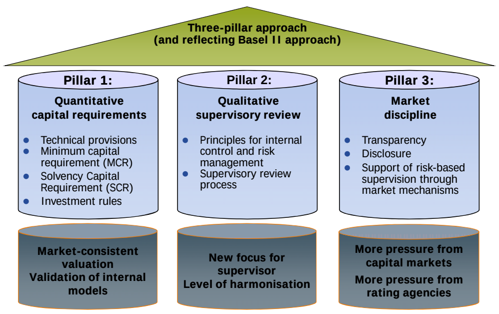
QIS5 is important for the wider SII context



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Participation

- All Directive-scope firms can participate
  - Groups and solos
- Commission's target is 60%.
  - Target 75% participation by groups
  - Keen to include small and medium as well as large firms
- For UK:
  - Not compulsory…
  - …but all firms are strongly encouraged to participate
  - This time it's serious: no longer "best efforts"

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The draft Technical Specification - overview

- Owned by the Commission
- Published 15 April, open for (limited) consultation for 5 weeks
- Many aspects based on CEIOPS' Level 2 advice and initial drafting of the technical specification…
- …but many areas where the Commission has provided revisions
- However:
  - Room for future reversal of positive developments
  - Need to continue pressing for market consistency of assets and liabilities with the right level of capital requirements
  - **Participation in QIS5 is still crucial**

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Next steps

Now
- Feed in to the Technical Specification consultation
- Start preparing balance sheet, data, processes

During the exercise
- FAQs provided by CEIOPS
- FSA will provide tailored support

After submitting results
- A chance to take stock of action points
- The final lap on the track to Solvency II

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Now is the time to get started

- **Preparation is key**
  - It's not too early to start preparing the balance sheet
  - No need to wait for the final specification or submission toolkit
  - Data as at YE09 is already available
- **Proper methodologies are vital** for credible results
  - Some systems and processes may need to be prepared in advance
- **This is a unique opportunity – firms, Commission and regulators should make the most of it!**

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Solvency II Principles

- Adequate capital resources in order to protect policyholders
- The capital held should be risk based
- Reflecting the specific mix of risks within that company
- Under a '1 in 200' year event
- A market consistent approach should be used to calculate this required capital

Variety of views on how to meet these principles

Evolving methodology

- CEIOPS consultation papers and responses
- Quantitative impact studies
- Papers from FSA, ABI, CRO Forum and others
- Working groups within the UK and across Europe
- Influence of recent financial crisis

Recent events

- CEIOPS consultation papers released in 3 waves over 2009/2010
- Widespread concern about calibration of stresses – extreme prudence
- Industry robustly objected to the proposals in feedback to consultation papers
- But CEIOPS final advice was largely unchanged

European Commission – Comment on QIS 5

"The argument has been made that the final advice from CEIOPS, if adopted unchanged, would result in a significant increase in capital requirements as compared to …. QIS 4. These concerns have been taken into account when modifying the technical specifications."

Recent changes

- A form of liquidity premium now included – and not just for annuity business.
- Although areas of debate remain
  - Method of extrapolation
  - Application of spot or forward rates
  - Transitional arrangements

Recent changes

- VIF is intended to be Tier 1
  - But mechanics of how this will be achieved still to be finalised
- Removal of asymmetric treatment of future premiums.
- Diversification in the risk margin.
- Swap rates as basis for risk-free rate rather than gilt yield.
  - But with a haircut
  - Which swap instrument should be used?
- Reduction in equity stress (39% vs 45%).

Credit spread risk calibrations

- General industry view is that these are well above a '1 in 200' year event.
- In QIS 5 draft:
  - LQP is allowed…..
  - but credit shock greatly increased
  - Does this really represent a '1 in 200' event?
- Punitive approach to credit risk on structured credit/credit derivatives.
- 100% correlation between spread modules (bonds, structured credit etc) is not justifiable.

No portfolio diversification in lapse risk module

- SCR impact floored to zero at per policy level.
- No diversification between policies within product for given shock.
- In reality shock would apply to (and be measured in terms of) whole product.
- Should benefit from netting of effects within product.

Contract boundaries

If a ‘boundary’ applies then no future premiums from existing business can be included after ‘boundary’ date.

Boundary applies if company has ‘…..*unlimited ability to amend the premium or the benefits at some point in the future*’

Key issues are:

1. Discretion with respect to future charges/benefits
2. Level at which these should be applied:
   1. In line with an objective, external measure (e.g. inflation)
   2. In line with company experience at a portfolio level
   3. Underwriting at an individual policy level

Impact on VIF

- Current wording (QIS 5 draft) is open to interpretation
- It may mean that future premiums on unit-linked policies should not be included
  - If we consider TCF requirements are too vague to constitute a restriction on future charges.
  - This would cause a significant reduction in VIF.
  - Or a change to UL terms and conditions, restricting changes to charges and introducing guarantee costs to cover expenses.

‘Unavoidable’ market risk in the risk margin

- Already implicitly allowed for in base risk-free curve.
- Intended to allow for interest rate risk beyond longest duration assets.
- But could be interpreted as applying to basis risk on hedges where perfect hedges not available in market.
- Text is straying towards this covering **unhedged** risk rather than **unhedgeable**.
- But this is already covered in market risk SCR.

Policyholder behaviour

- Empirical evidence contradicts 'rational' behaviour under stressed situations.
- QIS 5 draft says behaviour should reflect policyholder specific factors (e.g. employment, divorce etc).
- Obvious practical difficulties and additional data requirements.

Practical issues

- Segmentation – questionable added value, significant development costs.
- Zero LQP for policies with remaining term < 1 year
  - Management actions on WP on whole book
  - To run these together develop models to apply differential yield curves to these policies
- Policy by policy calculations.

Next steps

- Responses to draft QIS 5 spec – 20th May deadline
- QIS 5 (July-October)
- Draft Level 2 implementing measures
- Industry responses
  - Fast approaching deadline of 2012
  - Short timescales mean moving fast
  - Response papers need to be out within weeks rather than months
- Input to other industry groups (e.g. ABI, Groupe Consultatif)
- Detailed analysis of requirements and 'deep' planning needed. Will help identify:
  - More subtle implications
  - Practical problems

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 presenter.