

The Actuarial Profession
making financial sense of the future

A Closer Look at Solvency II
Eleanor Beamond-Pepler, FSA



An update on QIS5

© 2010 The Actuarial Profession - www.actuaries.org.uk

Agenda

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

2

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

3

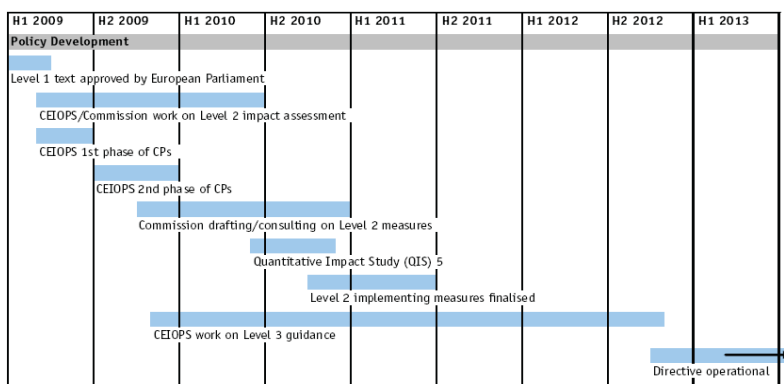
The European context

- 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**



4

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

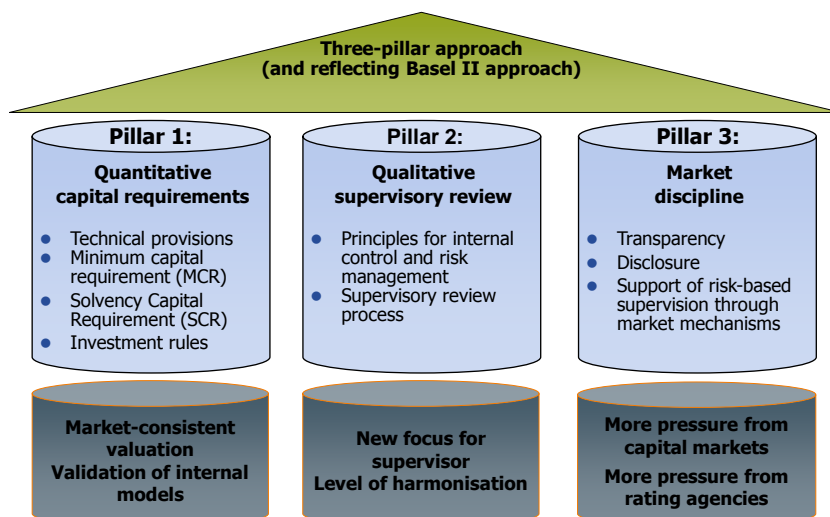
5

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!**

6

QIS5 is important for the wider SII context



7

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"

8

Agenda

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

9

The draft Technical Specification

- 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

- In more detail



10

Overview

- Commission has been sympathetic to industry views in many areas
- Many aspects of CEIOPS' Level 2 advice reversed out
- This doesn't mean UK should be complacent
 - Room for future reversal of positive developments
 - **Participation in QIS5 is still crucial**

11

Technical provisions - overview

- Builds on the market-consistency principles fundamental to the Level 1 text
- Many elements from CEIOPS Level 2 advice
 - Segmentation
 - Best estimate methodologies
- Contract boundaries
 - Examples provided
 - CEIOPS' asymmetric treatment of future premiums reversed out
- Some simplifications provided
- Validation of appropriate processes/methodologies required
 - Includes independent verification

- Correct calculation of technical provisions is fundamental to setting up the balance sheet

12

Non-life/health technical provisions

- Discounting required for all technical provisions
 - Separate calculations for each currency
 - Change from UPR to Premium Provision
 - Are your systems Solvency II ready?
- Segmentation by line of business
 - Example: motor TPL vs other
- TS notes that deterministic or analytical approach may be more appropriate
- TS includes considerations on expert judgement and documentation requirements
- Realistic future developments in legal, demographic, medical, technological, social or economic factors to be included in best estimate
- Reinsurance recoverables on asset side of regulatory balance sheet
- Health business according to whether similar to life (SLT) or non-life (NSLT)

13

Life technical provisions

- Segmentation by 16 segments
- Policy-by-policy as default approach but model points allowed
- Detailed specifications on simulation approach
- Evidence-based allowance for policyholder behaviour
- Management actions allowed in accordance with TS
 - Includes changes in bonus rates, asset allocation, management charges etc.
 - Realistic, verifiable, objective – burden of proof on firms
- Extensive list of considerations for discretionary benefits
- Details on asset model, expert judgement, documentation

14

Risk free rate

- Discounting at “swaps – 10bp”
 - Risk free rate term structures provided by CRO/CFO Forum, for major currencies
 - For other currencies, follow the steps in the TS
- Liquidity premium allowed for almost all contracts
 - 100% for specified retirement annuities
 - Transitional for existing contracts
 - Zero for contracts less than one year
 - 50% for all others (includes relevant non-life contracts)
- Extrapolation
 - Term structures for 135 years, converging to UFR

15

Risk margin

- 6% cost of capital, as in QIS4
- Allows for diversification between lines of business
- Unavoidable market risk defined as unavoidable mismatch between asset and liability cashflows
 - Envisaged as largely relating to interest down stress
- Risk margin calculation recognised as complex
 - Two appendices dealing with calculation of risk margin
 - “Hierarchy” of simplifications
- Specifications for TP as a whole similar to the CEIOPS advice

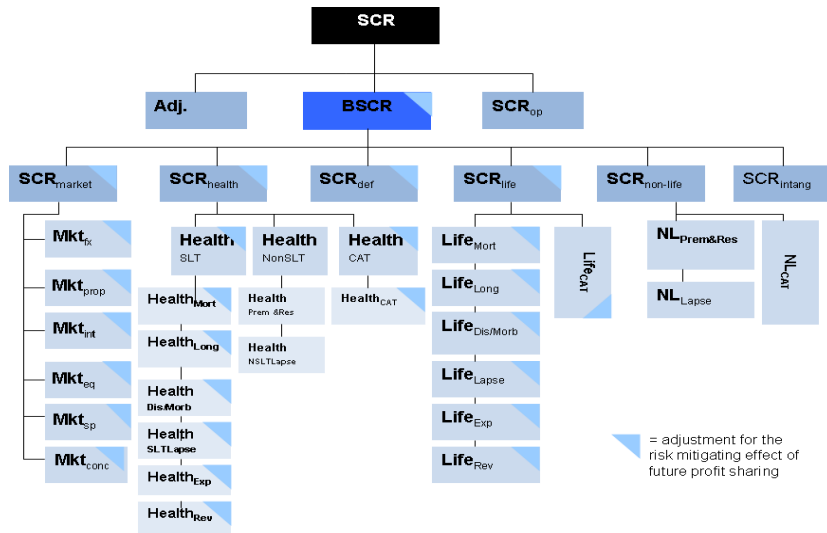
16

Capital requirements: SCR and MCR overview

- Overall structure and design of SCR standard formula aligned with CEIOPS' thinking
- Some areas of calibration in line with CEIOPS advice...
 - Life underwriting, counterparty default risk and most correlations unchanged
- ...However, many areas of downward adjustment compared with CEIOPS' calibration
 - Some of these adjustments appear arbitrary
- Introduction of 80% charge for intangibles
- SCR approach explicitly short-circuits circularity in risk margin
- MCR approach similar to QIS4 “corridor” approach but recalibrated

17

SCR standard formula structure



18

Non-life and health NSLT underwriting

Premium and reserve risk

- Approach remains factor-based
- Netting-down factor required
- Introduction of lapse risk stress represents new development since QIS4
- Calibration reduced from CEIOPS proposals
 - TS apparently takes average of CEIOPS and QIS4 factors

Cat risk

- Standardised scenarios available

Other points to note

- Undertaking-specific parameters available
 - Firms encouraged to take opportunity to test these
- Geographical diversification restored

19

Market risk

- Many calibrations retained from the CEIOPS Level 2 advice
 - No change to interest rates, property, FX, concentration risk calibrations
 - Spread risk per CEIOPS' most recent recalibration
- Major movement is in equity risk calibration
 - Reduced to 39%/49%
 - 3-year adjustment period means stress at YE09 is 30%/40%
 - Reduction in volatility stress
- Some changes in market risk correlations
 - Largely relates to FX and concentration risks
- Concentration risk charges now apply to non-OECD, non-EEA government bonds
- Look-through approach for investment funds

20

Other aspects of standard formula

Other SCR modules

- Operational risk calibration as average of CEIOPS advice and QIS4 calibration
- New SCR stress for intangibles: 80%
 - Corresponds to introduction of allowance for intangibles in balance sheet

Other items

- Charge for participations reduced
 - 22% for “strategic participations”
 - No shock for participations in financial and credit institutions
- Calculations of SCR for ring-fenced funds per CEIOPS advice

21

Own funds

Hybrid instruments and subordinated debt

- Restrictions on allowance for these instruments
- Allowance at group level only in proportion to weight of issuing undertaking in the group

Winding-up gap and expected future profits

- Approach in the TS addresses industry concerns
- No relegation to Tier 3

Ring-fenced funds

- Follows approach proposed by CEIOPS
- Reflects economic reality of ring-fenced arrangements
- For UK with-profits, note SHIFT considered available outside with-profits fund

22

Groups

- Participation in QIS5 from
 - Undertakings that are part of wider 3rd country group
 - EEA sub-groups
- Two consolidation methods requested under QIS5
 - Accounting consolidation method as default
 - Deduction-aggregation method as alternative
 - Possibility to combine these as optional extra method
 - Other methods discouraged
- Opportunity to include group internal model results
- Extensive specifications of considerations on availability of capital, calculation of group SCR etc.

23

Agenda

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

24

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

25

Now is the time to get started

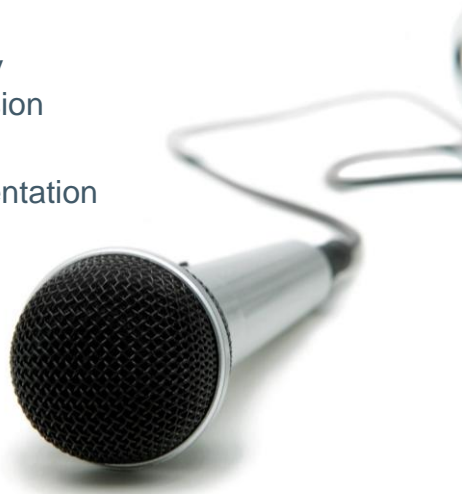
- **Preparation is key**
 - It's not too early to start preparing the balance sheet
 - No need to wait for the final specification or submission toolkit
 - Data as at YE09 is already available
- **Proper methodologies are vital** for credible results
 - Some systems and processes may need to be prepared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

26

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.



© 2010 The Actuarial Profession • www.actuaries.org.uk

27