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

- 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

Solvency II: a Risk Based Approach

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

**Banking & Insurance convergence**
- BASEL II
- Adapting principles
- Adapt for insurance

**EU Convergence**
- Harmonisation
- De-risk
- Degree?

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

Solvency II – Three Pillar Approach

**Pillar 1: Technical Provisions**
- Minimum Capital Requirement (MCR)
- Solvency Capital Requirement (SCR)

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

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

- Market – Consistent valuations
- Internal or Standard Models
- New focus for supervisor
- Level of harmonisation
- Market pressure from capital markets
- More pressure from rating agencies
Adequacy of financial resources

- Technical provisions
- Risk margin
- Best estimate
- Minimum capital requirement
- Solvency capital requirement
- Market-consistent valuation for hedgeable risk components

Assets covering technical provisions, the MCR and the SCR

Solvency II – Financial Resources

**Technical Provisions Proposed principles**
- Best estimate plus explicit risk margin
- Non-hedgeable risks
- Allows confidence to specified level
- Market Consistent valuation of Liabilities
- Allows a transfer of liabilities if necessary

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
**Solvency II – Financial Resources**

- **Solvency Capital Requirement (SCR)**
  - Proposed principles
    - Part of supervisory review
    - Absorbs 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

**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

**Summary of Key Differences**

<table>
<thead>
<tr>
<th></th>
<th>Risk-Based Economic Framework</th>
<th>Current Framework</th>
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</thead>
<tbody>
<tr>
<td>Valuation of Assets</td>
<td>Market consistent</td>
<td>Market/book value subjects to solvency</td>
</tr>
<tr>
<td>Valuation of Liabilities</td>
<td>Market consistent</td>
<td>Prudential margins included in technical procedures</td>
</tr>
<tr>
<td>Available Capital</td>
<td>Adequate level (demonstrated by economic ability to absorb losses)</td>
<td>Partial recognition</td>
</tr>
<tr>
<td>Risk mitigation</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Solvency Control Levels</td>
<td>SCR important target, MCR hard</td>
<td>Only single control level – supplemented by various national</td>
</tr>
<tr>
<td>Group Issues</td>
<td>Fully recognised</td>
<td>Partially recognised</td>
</tr>
<tr>
<td>Calibration</td>
<td>Economic basis using market/historical data and actual</td>
<td>Subjective</td>
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</tbody>
</table>
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QIS – Quantitative Impact Studies

Critical to the development process

- QIS1: October 05
  - Focus on technical provisions
- QIS2: Spring 06
  - Technical provisions, MCR and SCR
- Preliminary Field Study: Spring 05
  - Limited participation
  - Strongly encouraged
- QIS3: Spring 07
  - Calibration
  - Group issues

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
### 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**
- 3 pure reinsurers (life & non-life)
- 7 mutuals (life & non-life)

Only 2 respondents could be classified as small.

*Source: FSA

### 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

### 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**
MCR: Highlighted issues (2)

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

  ![Diagram](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 the 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

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
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 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
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

Next steps and timetable

<table>
<thead>
<tr>
<th>End Oct 06</th>
<th>Jan 07</th>
<th>Feb 07</th>
<th>Apr 07</th>
<th>Jun 07</th>
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<td>QIS III/IV (Solvency II)</td>
<td>QIS II/IV (Solvency II)</td>
<td>Consultation CP13 and CP14 closed</td>
<td>Solvency II Framework Solvency II Directive</td>
<td>Impact Assessment Report</td>
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