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Solvency II – Developments, Issues and Possible Implications (E06)

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Standard Life
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What the brochure said

- What the European Commission are seeking to achieve and how they are going about it
- The key role that CEIOPS is playing in the process
- What the key issues are and what is happening with them
- How Solvency II might sit relative to the current UK regime
- Possible implications for insurance companies (both now and post implementation)

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The order I will cover the material in

- CEIOPS
- The Lamfalussy Process
- Solvency II
  - The background
  - The aim
  - The development process
  - The timetable (and why 2006 is a critical year)
  - The QIS 2 experience
  - The issues currently being discussed
  - Who is doing what?
- Conclusions

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CEIOPS

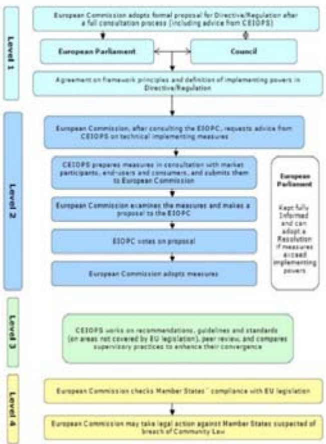
- Committee of European Insurance and Occupational Pensions Supervisors
- Established November 2003
- Composed of high level representatives from the insurance and occupational pensions supervisory authorities of the European Union Member States
- Performs the functions of the Level 3 Committee for the insurance and occupational pensions sectors under the Lamfalussy Process (as CEBS and CESR do for, respectively, banking and capital markets sectors).

The Lamfalussy Process

- Proposed in 15 February 2001 report from "Committee of Wise Men", chaired by Baron Alexandre Lamfalussy
- 4 level approach to legislative process for securities to solve shortcomings identified in report (i.e. speed up processes and make more flexible through use of Committees)
- Proposed the creation of:
  - European Securities Committee (ESC); and
  - Committee of European Securities Regulators (CESR)
- Process also now extended to Banking (EBC and CEBS) and Insurance & Occupational Pensions (EIOPC and CEIOPS)

Lamfalussy Process

- **CEIOPS version**
- Level 1 (Parliament)
  Framework Directive
- Level 2 (Commission)
  Implementing measures
- Level 3 (CEIOPS)
  Guidance, standards, peer review, convergence
- Level 4 (Commission)
  Compliance check of MSs



CEIOPS – “Role Profile”

- **Advises the Commission**, either at the Commission’s request or on the Committee’s own initiative, in particular on the preparation of draft implementing measures in the fields of insurance, reinsurance and occupational pensions; (Level 2 activities)
- Contributes to the **consistent implementation** of EU Directives and to the convergence of Member States’ supervisory practices throughout the Community; (Level 3 activities)
- Constitutes a forum for **supervisory co-operation**, including the exchange of information on supervised institutions;
- Deals with **convergence in the supervision** of insurance companies and occupational pension funds

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Solvency II: The background

- 1970s – first EU non-life and life directives on solvency margins
- 1997 – Muller Report: “Solvency of insurance undertakings”
  - review of solvency rules
  - Solvency I project initiated
- 2001 – Solvency II initiated – Sharma Report
- 2002 – Solvency I completed
- 2004 – Solvency I in force

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Solvency II: The background (contd)

- “Better Regulation” agenda leads to 4 goals:
  - Codification of currently 14 Insurance Directives into one Directive;
  - a Directive that is as principle based as possible, but still aiming at a high level of harmonisation through its implementing measures;
  - a Directive developed in transparency with stakeholders and based on a solid impact assessment; and
  - a Directive compatible with international developments.
- “At the same time, we see Solvency II as a contribution to the emergence of a world-wide standard. A large number of countries around the globe are looking with great interest at the EU developments. And our work is very much in line with the solvency standards being developed by the International Association of Insurance Supervisors. I take this opportunity to underline how much I value the gradual convergence of insurance regulations at international level. This is a long-term process but one that will bring tremendous benefits to insurers, policyholders around the world and the economy at large.”
- “Solvency II should enhance this confidence [in the capacity of the industry to honour its commitments] by improving risk management and by setting capital requirements that are directly based on the level of risk taken. Within this new system, supervisors will have to co-operate more closely and independently. The possibilities for further integration of the insurance industry largely depend on this supervisory convergence. Solvency II is already having a positive effect on the way companies are being run. More emphasis is being put on modern risk management, and I am happy to see that.”

Speech by Commissioner Charlie McCreevy, LIMRA Conference, Warsaw, 15 September 2006

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Solvency II: The aim

"The European Commission, having consulted the Insurance and Occupational Pensions Committee (EIOPC), requests CEIOPS and other stakeholders to advise on the development of a new solvency system to be applied to life assurance, non-life insurance and reinsurance undertakings, which Member States and supervised institutions are able to apply in a robust, consistent and harmonised way."

"The solvency system aims at the protection of policyholders and beneficiaries."

"It should also improve the competitiveness of EU insurers and provide for a better allocation of capital resources, without causing significant market disruptions and impeding innovation in the insurance industry."

"Amended Framework for Consultation on Solvency II"
European Commission (April 2006)

Solvency II: The aim

- prospective and risk-oriented approach
- three-pillar structure
- two Pillar 1 capital requirements
  - Solvency Capital Requirement (SCR)
  - Minimum Capital Requirement (MCR)
- gives an incentive to the supervised institutions to measure and properly manage their risks
- recognition of internal models (either partial or full) provided these:
  - Improve the institution's risk management
  - Better reflect its true risk profile than under the standard formula and
  - Can be appropriately validated
- main focus … is … at the level of the individual legal entity. However, issues related to insurance groups and financial conglomerates also have to be addressed
- should be compatible with accounting rules elaborated by IASB
- provide for uniform application and sufficient consumer protection whilst supporting fair competition
- avoids regulatory arbitrage between and within financial sectors

Solvency II: The development process

- Lamfalussy process
- European Commission writes Framework Directive, based on advice from CEIOPS (with much of the implementation detail left to lower level specification)
- CEIOPS consults with industry on its answers to the Calls for Advice (3 "waves" so far, as well as other CPs)
- CEIOPS organises EU-wide pilot Quantitative Impact Studies (QIS 3 expected to run from April to June 07)
- Political negotiating by Member State Finance ministries

Solvency II: The timetable

- Solvency II initiated in 2001
- Call for Advice Waves 1 and 2 completed in 2005
- Wave 3 final answers published by CEIOPS in early 2006
- QIS1 completed end 2005; QIS2 ran from 1/5 to 31/7/06; QIS3 planned for quarter two 2007
- EC developing draft text for Directive
- EC to produce Impact Assessment later this year
- Framework Directive due to European Parliament in July 07

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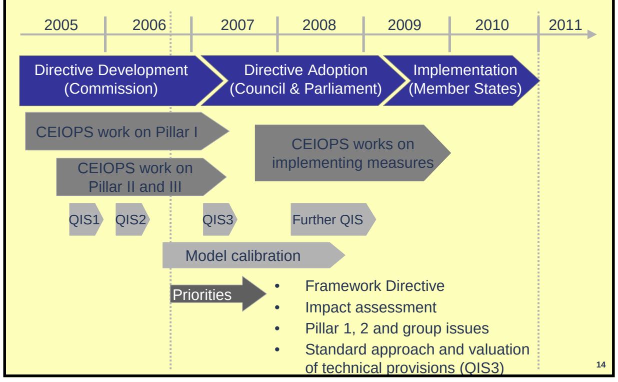
Where are we?



Developments in 2006

Consultation Papers

CP 13
- Internal Risk and Capital Assessment requirements (IRCA)
- Supervisors' evaluation procedures
- Harmonised supervisors' powers and tools including Pillar II capital add-ons

CP 14
- Sub-group supervision
- Diversification effects
- Cooperation with third countries
- Issues related to the MCR and SCR in group context

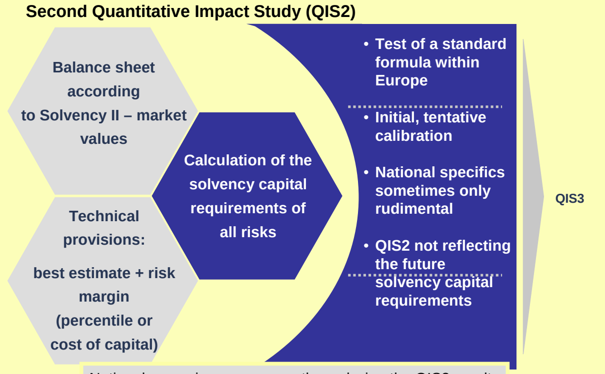
Comments from the Groupe worked out by the project teams and adopted by the GCIC

Consultation period ended in September 2006

Next consultation papers focus on the calculation of the MCR, SCR and technical provision (Start October 2006)

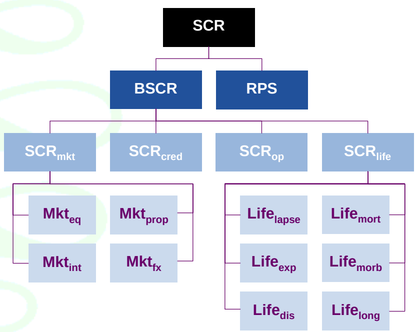
Developments in 2006

Second Quantitative Impact Study (QIS2)



National supervisors are currently analysing the QIS2 results

Profit sharing under QIS2



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**

Participation

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

Industry representation

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

Size – Only 2 respondents could be classified as small!

Overall impact observed in QIS2

- **Calibration for QIS2 very provisional!**
- **A general reduction seen in QIS2 in solvency ratios across EU for non-life firms, and for life firms in some countries, but most would still be well above 100%**
- **Greatest potential impact on 'capital' (cf Solv I) for**
  - With-profit life business
  - Non-life commercial and reinsurance business
  - Monoline insurers
  - Linked life business

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

Ratio of Internal Model figures to SCR Placeholder

	Minimum	Median	Maximum
Total	16%	63%	216%
Market risk	13%	85%	305%
Credit risk	21%	142%	1023%
Life u/w *placeholder*	246%	335%	1113%
Life u/w *scenario*	70%	139%	208%
Non-life u/w risk	16%	54%	130%
Operational risk	16%	121%	514%

Other relevant issues

- Practicability for smaller firms
- Cost-of-Capital cf 75th Percentile
- Resource issues
- Internal models
- Group diversification issues

Summary of perceived Key Issues for UK firms from QIS2

- Design of MCR
- Application of K factor
- Methodology/Calibration for non-life u/w risk
- Use of Internal models or Scenarios
- Group Diversification effects

Solvency II: The issues

- The size of margin in technical provisions and how it is calculated:
  - Market value margin for financial risks
  - 75th percentile or "Cost of Capital" for non-financial?
- Principles-based or prescription?
  - "Prudent person plus"
- Follow banking approach – e.g. to Eligible Capital?
- Group issues:
  - diversification benefits
  - lead supervisors, especially for internal model validation

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Solvency II: The issues (contd)

- Ensuring consistency of technical provisions:
  - "Same risk, same charge"
- Ensuring consistency of regulatory discretion
- Alignment with IASB
  - "prudential filters"
- Pillar 3 disclosure options
- Calibration of standard formula SCR and form of MCR
  - treatment of with profits business (k factor)
- Should actuaries have reserved roles under Solvency 2?

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Solvency II: Who is doing what?

- European Commission: ec.europa.eu/internal_market/insurance/solvency2/index_en.htm
- CEIOPS: www.ceiops.org/content/view/17/21/
- FSA is a key player in CEIOPS and is encouraging UK industry to be active in Solvency II debate:
  - Insurance Standing Group (www.fsa.gov.uk/pubs/international/isg_minutes13.pdf)
- HMT does the Member State lobbying for UK, drawing on input from UK industry
  - Industry roundtable (www.fsa.gov.uk/pubs/international/solvency2_discussion.pdf)
  - HMT Working Group
  - High-level meeting
- ABI lobbying directly and as part of CEA
  - ABI Working Party

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Solvency II: Who is doing what? (contd)

- CRO Forum lobbying directly on behalf of large firms and has published a number of influential position papers (www.croforum.org/publications.ecp?inlog=)
- CFO Forum now publishing material too (on IASB Phase 2) (www.cfoforum.nl/phase.html)
- European mutual sector lobbying actively and getting noticed:
  - Joint AISAM/ACME Solvency Working Party
- UK Actuarial Profession has two working parties:
  - Non-Life (chair: Kathryn Morgan)
  - Life (chair: Me)
- Groupe Consultatif has a substantial project structure too and is making effective input direct to CEIOPS and the Commission (www.gcactuaries.org/solvency.html)
- Swiss Solvency Test is a useful initiative, as is the UK ICAS regime

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Solvency II: Conclusions

- Solvency II aims to produce a Europe-wide solvency measurement system, for implementation in 2010, with the following features:
  - Prospective and risk-oriented approach
  - Three-pillar structure (statutory calcs, IRCA and supervisor review, market disclosures)
  - Technical Provisions will be Best Estimate plus some margin for prudence
  - Pillar 1 will have two capital requirements:
    - Solvency Capital Requirement (99.5% over 1 year)
    - Minimum Capital Requirement (forced closure if breached)
  - Should give an incentive to firms to measure and properly manage their risks
  - Potential recognition of internal models
- What this might mean for UK firms:
  - Technical provisions become "son of RBS"
  - Variation on ICA becomes Pillar 1 capital requirement
  - Large parts of existing valuation systems functionality become obsolete
  - Pillar 2 and Pillar 3 changes too
  - Taking part in QIS 3 (and 4 and …?) will be important learning opportunities
- The fun has already started - 2006 and 2007 will be critical years for the ultimate regime

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