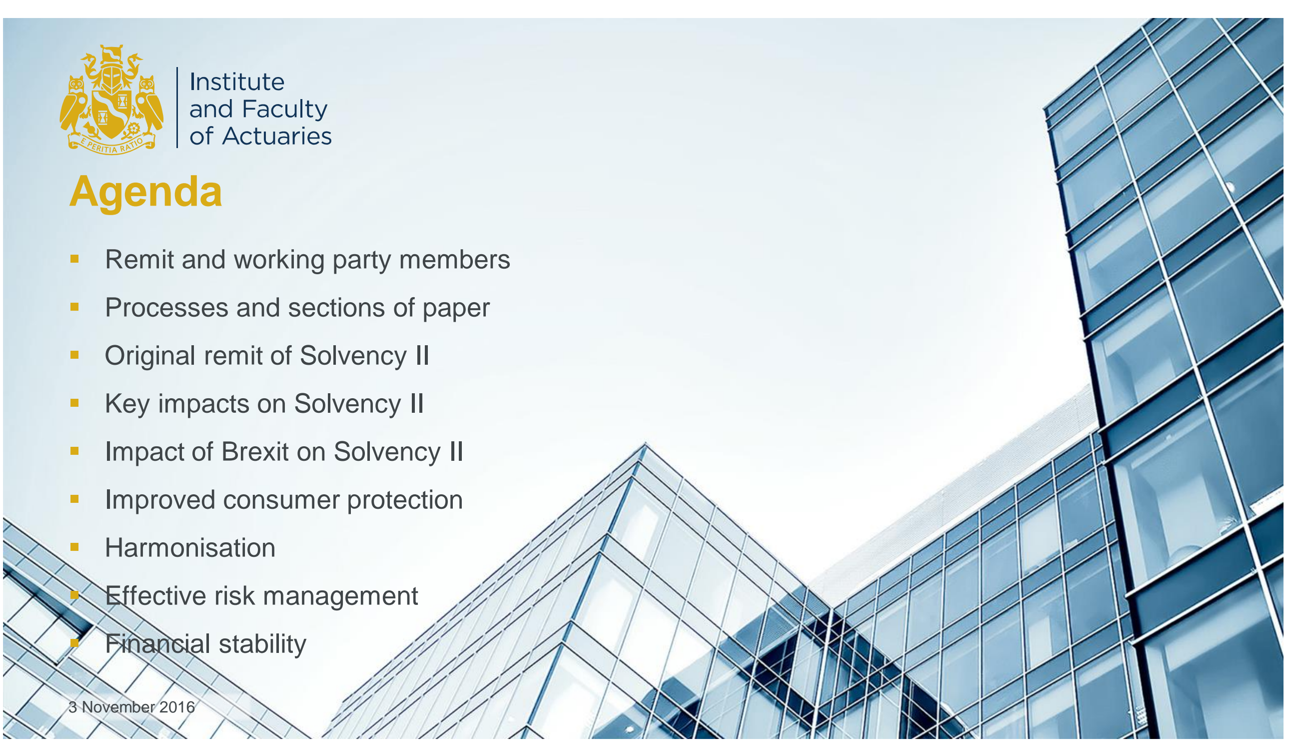
Institute
and Faculty
of Actuaries
How well has Solvency II met its Objectives for the Life Insurance Industry?
Dick Rae
Meshali Chotai
Chen Wang
3 November 2016
E PERITIA RATIO


Institute
and Faculty
of Actuaries
Agenda
Remit and working party members
Processes and sections of paper
Original remit of Solvency II
Key impacts on Solvency II
Impact of Brexit on Solvency II
Improved consumer protection
Harmonisation
Effective risk management
Financial stability
3 November 2016

Remit and working party members

- Our remit is to evaluate the objectives of Solvency II against the outcome of the final regulation with a focus on long term guarantees:
  - Which areas have the objectives been met?
  - Which areas has it fallen short?
- Working Party members:
  - Dick Rae (Chair)
  - Aisling Barrett
  - Chris Barnard
  - Dylan Brooks
  - Meshali Chotai
  - Andy Pelkiewicz
  - Chen Wang

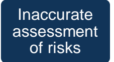
Processes and sections of paper

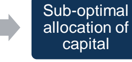
- Meetings were held in London and Edinburgh to gather the thoughts of the profession
- We have also sought the views of rating agencies
- Workshops and teleconferences were held to discuss the structure and content of the paper pre and post drafting
- Overview of Paper:
  - Background
  - Market
  - Capital
  - Impact on Behaviour
  - ORSA, Liquidity and Disclosures
  - Building on Solvency II

Original remit of Solvency II

Life before Solvency II

- Solvency I regime showed structural weaknesses across various aspects
- 'One-size-fits-all' intention but technically different in different countries e.g. market value vs book value
- Solvency I was not risk-sensitive
- Key risks not captured at all or not taken into account properly in capital requirements e.g. market, credit and operational risks





Improved consumer protection

Harmonisation

Effective risk management

Financial stability

Solvency II objectives

- Consumer protection:
  - Uniform and enhanced level of policyholder protection across the EU
  - Robust system to give greater policyholder confidence in the products of insurers
- Harmonisation:
  - More emphasis on promoting better regulation and comparability between firms
- Risk management:
  - Increased focus on the management of a firm's own risk management processes from governance through to operations
- Financial stability:
  - Addressing regulatory arbitrage that existed under Solvency I

Institute and Faculty of Actuaries

Key impacts on Solvency II

Institute and Faculty of Actuaries

Impact of Brexit on Solvency II

- UK may not be part of the SII review in 2017, and have no influence on future developments
- More flexibility to tailor regulatory regime to suit needs of UK, but divergence may affect equivalence
- Soft Brexit – must retain SII, but have no influence
- Hard Brexit – cannot amend SII to suit UK but passporting and equivalence in jeopardy:
  - There will be a cost of divorce
  - What happens if no agreements are reached 2 years after Article 50 is triggered?
- Passporting may not affect UK Life insurers significantly at present
  - More important for international insurers, reinsurers and asset managers
  - Will impact where international insurers choose to place their European headquarters
- For UK – economic impact more immediate
  - Interest rates: lower for longer
  - Investors do not like risk, will affect long term investment in the UK
- Rest of Europe can change SII to the disadvantage of UK, e.g. remove MA

Treasury Select Committee

- Current enquiry into EU Insurance Regulation covering the areas:
  - Competitive implication of SII
  - Development of SII
  - Implementation of SII
  - Safety and soundness
  - Proportionality
  - Financial reporting
  - Wider implications of SII

Improved consumer protection

Pros

- Solvency II is a significant improvement on Solvency I
- Market consistent foundation has removed prudent margins in reserves, encouraging proper asset and liability management
- Strengthening of reserves for products offering long term guarantees to recognise the true value of those guarantees up front
- Expectations of corporate governance to protect policyholders through Board responsibility
- ORSA is a winner emerging from the financial crisis.

Cons

- Internal models - a huge black box?
- Increased complexity in calculations and reporting
- Unachievable to audit the internal model SCR each time
- Significant cost of implementation and higher capital requirements ultimately passes to consumers
- Benefits of recognising true value of guarantees have been watered down by measures such as the VA and UFR

Institute and Faculty of Actuaries

Voting questions

Consumer protection
1. SII has added to the cost of traditional insurance products.
2. The cost of implementing SII is justified as it has led to an enhanced level of protection for consumers.
3. SII is also the reason for more capital being held, it is not just down to the economic impacts of falling interest rates.

Key: No opinion ☆☆☆☆☆ Strongly disagree

Neither agree/disagree ★★★☆☆ Strongly agree

Harmonisation (1)

Pros

Pillar I

- Market consistent basis for valuing assets and liabilities
- Compromises negotiated may indicate that regulators recognise true market consistency is overly harsh

Pillar II

- Improved risk culture in organisations and overall decision making, e.g. ORSA

Cons

- Gold-plating by national supervisors
- Reduced harmonisation due to the implementation of different adjustments:
  - Ultimate Forward Rate (UFR) – impact not disclosed
  - Matching Adjustment (MA) – impact disclosed
  - Volatility Adjustment (VA) – not with MA
  - Transitional Adjustments (TA) – back book only
- Internal models vs standard formula – different capital requirements
- Different internal model approval standards

Harmonisation (2)

Pros

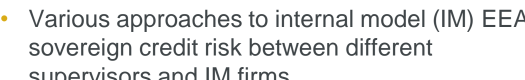
Pillar III

- Consistent reporting basis
- Standardised templates
- Improved documentation and transparency
- More stringent data requirements, e.g. look-through

Overall

- More harmonisation across Europe
- EIOPA – single regulator

Cons



- Various approaches to internal model (IM) EEA sovereign credit risk between different supervisors and IM firms
- Other areas of discretion such as capital add-ons
- Other issues, e.g. recalculation of risk margin and transitionals due to low interest rates
- Exemptions may be provided from quarterly and item by item reporting based on proportionality by member states

Voting questions

Harmonisation
4. Divergence from true market consistency is necessary for the viability of the insurance industry.
5. The UK regulator has gold-plated SII.

Key: No opinion ☆☆☆☆☆ Strongly disagree ★☆☆☆☆

Neither agree/disagree ★★★☆☆ Strongly agree ★★★★★

Effective risk management

Pros

- Those managing their risks effectively are compensated with lower capital requirements per unit of risk
- Eliminates scope for regularity arbitrage and reducing the probability of firm failure given poor risk management in the past
- Formalisation of Pillar 2 requirements
- Risk management has strengthened the regulatory regime

Cons

- PRA challenges on demonstrating the use test of the internal model to evidence full embedment in a firm's business decisions
- Intention is to have proportionate requirements for smaller undertakings – but is this really achieved in practice?
- Liquidity given greater emphasis since the financial crisis but directive non-specific
- Front ending illiquidity premium encourages greater risk taking
- Securitisation of assets backing MA evidences arbitration

Voting questions

Effective risk management
6. Internal models are too complex.
7. SII does not place enough emphasis on liquidity.
8. The capital requirements should be adapted to allow insurers to introduce management actions or allow for markets to find new levels.

Key: No opinion ☆☆☆☆☆ Strongly disagree ★☆☆☆☆

Neither agree/disagree ★★★☆☆ Strongly agree ★★★★★

Financial stability

Pros

- Accelerated removal of uneconomic guarantees
- Economic hedges rewarded through lower capital charges
- Board responsibility made clear
- Introduced governance
- ORSA introduced
- Pan European consistency
- Pan European regulatory regime
- Some known flaws being addressed

Cons

- Solvency ratios are lower and more volatile
- UFR introduces non-market consistent assumptions regarding long term reinvestment rates
- 1 year VaR – pro-cyclical
- 1 year VaR – de-risk in same time frame as banks
- Reliance/belief in highly complex models
- Some known flaws hard to address
- Less scope for regulatory forbearance

Voting questions

Financial Stability
9. The aspects of Solvency II that are not market consistent (e.g. MA, UFR) should be removed.
10. The Pillar 2 requirements – governance / ORSA / Board responsibility / PPP add to financial stability.
11. The benefits of Pillar 3 disclosure requirements are not proportional to the cost of their implementation.

Key: No opinion · Strongly disagree · Neither agree/disagree · Strongly agree

Final voting questions

Overall achievement
12. Improved consumer protection has been achieved.
13. Harmonisation across Europe has been achieved.
14. Effective risk management across Europe has been achieved.
15. Financial markets are more stable.

Key: No opinion · Strongly disagree · Neither agree/disagree · Strongly agree

Thank you

Questions?

Comments

The views expressed in this presentation are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this presentation and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this presentation.

The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this presentation be reproduced without the written permission of the authors.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.