EVOLUTION OF SOLVENCY 2 AND CAPITAL STANDARDS

TUESDAY 22 NOVEMBER 2016

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Dick Rae, Nick Dexter

CONFIDENTIALITY

Evolution of Solvency 2 and Capital Standards
Agenda – Tuesday 22 November

Time	Topic	Presenter
1700 – 1730	Arrival/registration	
1730 – 1735	Welcome	Martin Pike, Standard Life Group, Esure and Faraday
1735 – 1745	A consultant perspective	Sean McGuire, Oliver Wyman
1745 – 1755	A rating agency perspective	David Prowse, Fitch Ratings
1755 – 1805	An asset manager perspective	Dick Rae, BMO Global Asset Management
1805 – 1815	A regulator perspective	Nick Dexter, Bank of England
1815 – 1900	Q&A	Audience
1900 – 2100	Drinks/Networking	All
2100	Close	

1 Welcome

Martin Pike – Standard Life Group, Esure and Faraday

2 A Consultant Perspective

Sean McGuire – Oliver Wyman

Context

My Background

- Content focus
  - Solvency II (risk measurement and management)
  - Capital modelling, with a focus on credit risk and operational risk
  - Section 166 Skilled Persons Reviews

- Client focus
  - European insurers, most of which are UK based
  - Life and P&C insurers, but strong focus on Life

Key themes for today

A. Evolution of risk appetite including link to recovery and resolution plans

B. Use of Solvency II in decision making

C. Drill-down into impact of Solvency II on investment strategies

A. Evolution of risk appetite and link to recovery and resolution planning

Recent trends in insurer risk appetite frameworks

- Increase in number and granularity of risk appetite statements and limits
- More focus on what were historically “qualitative” risk appetite statements
- Better documentation including clearer definition of in vs. out of appetite
- Better linkage between strategy, risk appetite, operational level limits and business decisions
- Stronger and more explicit links between risk appetite and recovery and resolution plans
- Better Board level understanding of risk appetite in practice, including use of “war-gaming” / crisis simulation exercises
- Use of dynamic solvency / capital risk appetite measures to avoid pro-cyclicality
- Higher levels for “target” or “minimum” solvency ratios than before

B. Use of Solvency II in decision making

Example uses of Solvency II capital calculations

Risk appetite and limits (incl. solvency management)	Strategic planning and capital allocation	Investment strategy	ALM, hedging and reinsurance
Mergers and Acquisitions	Stress testing & scenario analysis	Product design and pricing	Performance management & compensation

Legend: Use of Solvency II capital in decision making

None/limited

Partial

Comprehensive

C. Drill-down into impact of Solvency II on investment strategies

Matching adjustment

Gilt-swap spread risk within internal models

Investment in illiquid assets

Periodical Payment Orders (PPOs)

3 A Rating Agency Perspective

David Prowse – Fitch Ratings

Solvency II

A Rating Agency Perspective

David Prowse
Fitch Ratings

22 November 2016

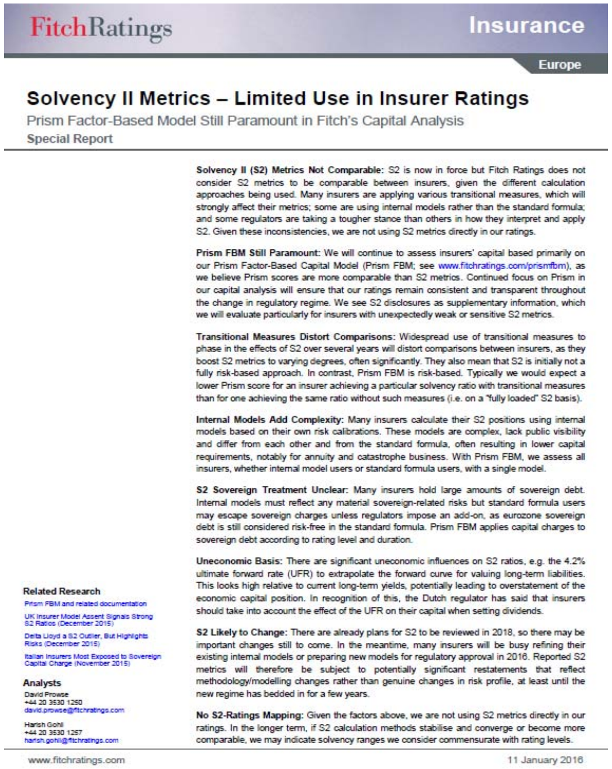
Fitch Ratings

S2 An Improvement on S1

S2 Metrics Comparable For Similar Businesses

Example – motor insurers

S2 in Ratings – New Insights but Handle With Care…



FitchRatings

Insurance

Europe

Solvency II Metrics – Limited Use in Insurer Ratings

Prism Factor-Based Model Still Paramount in Fitch's Capital Analysis

Special Report

Solvency II (S2) Metrics Not Comparable: S2 is now in force but Fitch Ratings does not consider S2 metrics to be comparable between insurers, given the different calculation approaches being used. Many insurers are applying various transitional measures, which will strongly affect their metrics; some are using internal models rather than the standard formula; and some regulators are taking a tougher stance than others in how they interpret and apply S2. Given these inconsistencies, we are not using S2 metrics directly in our ratings.

Prism FBM Still Paramount: We will continue to assess insurers' capital based primarily on our Prism Factor-Based Capital Model (Prism FBM; see www.fitchratings.com/prismfbm), as we believe Prism scores are more comparable than S2 metrics. Continued focus on Prism in our capital analysis will ensure that our ratings remain consistent and transparent throughout the change in regulatory regime. We see S2 disclosures as supplementary information, which we will evaluate particularly for insurers with unexpectedly weak or sensitive S2 metrics.

Transitional Measures Distort Comparisons: Widespread use of transitional measures to phase in the effects of S2 over several years will distort comparisons between insurers, as they boost S2 metrics to varying degrees, often significantly. They also mean that S2 is initially not a fully risk-based approach. In contrast, Prism FBM is risk-based. Typically we would expect a lower Prism score for an insurer achieving a particular solvency ratio with transitional measures than for one achieving the same ratio without such measures (i.e. on a "fully loaded" S2 basis).

Internal Models Add Complexity: Many insurers calculate their S2 positions using internal models based on their own risk calibrations. These models are complex, lack public visibility and differ from each other and from the standard formula, often resulting in lower capital requirements, notably for annuity and catastrophe business. With Prism FBM, we assess all insurers, whether internal model users or standard formula users, with a single model.

S2 Sovereign Treatment Unclear: Many insurers hold large amounts of sovereign debt. Internal models must reflect any material sovereign-related risks but standard formula users may escape sovereign charges unless regulators impose an add-on, as eurozone sovereign debt is still considered risk-free in the standard formula. Prism FBM applies capital charges to sovereign debt according to rating level and duration.

Uneconomic Basis: There are significant uneconomic influences on S2 ratios, e.g. the 4.2% ultimate forward rate (UFR) to extrapolate the forward curve for valuing long-term liabilities. This looks high relative to current long-term yields, potentially leading to overstatement of the economic capital position. In recognition of this, the Dutch regulator has said that insurers should take into account the effect of the UFR on their capital when setting dividends.

S2 Likely to Change: There are already plans for S2 to be reviewed in 2018, so there may be important changes still to come. In the meantime, many insurers will be busy refining their existing internal models or preparing new models for regulatory approval in 2016. Reported S2 metrics will therefore be subject to potentially significant restatements that reflect methodology/modelling changes rather than genuine changes in risk profile, at least until the new regime has bedded in for a few years.

No S2-Ratings Mapping: Given the factors above, we are not using S2 metrics directly in our ratings. In the longer term, if S2 calculation methods stabilise and converge or become more comparable, we may indicate solvency ranges we consider commensurate with rating levels.

Related Research

Prism FBM and related documentation

UK Insurer Model Assent Signals Strong S2 Ratios (December 2015)

Delta Lloyd a S2 Outlier, But Highlights Risks (December 2015)

Italian Insurers Most Exposed to Sovereign Capital Charge (November 2015)

Analysts

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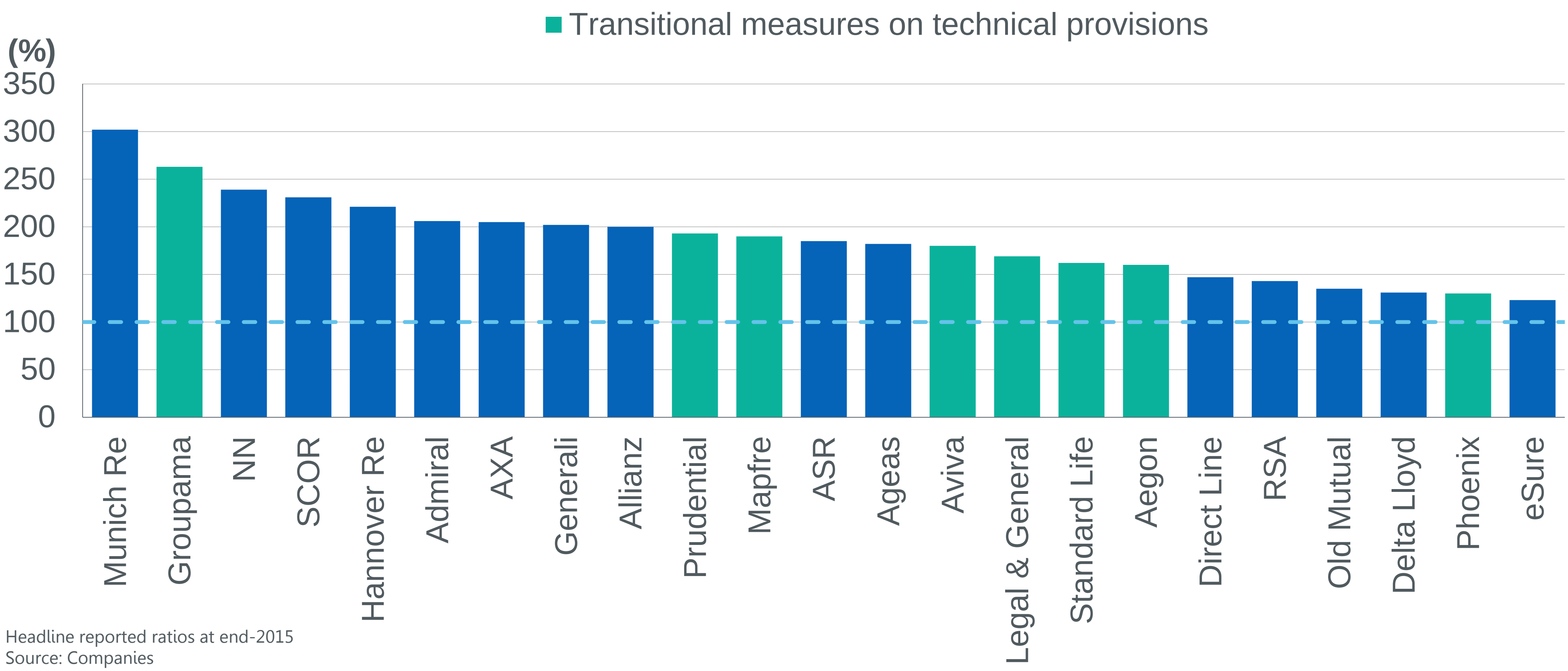
www.fitchratings.com 11 January 2016

Interpreting S2 Metrics – Things to Consider

- Time horizon
- Peer analysis
- Non-S2 metrics
- Transitional measures
- Comparability
- Different regulators
- Sovereign debt charges
- Internal models vs standard formula
- Ultimate forward rate (4.2%)
- Sensitivity, volatility
- S2 is still evolving

Transitionals Used Widely – May Distort Comparisons

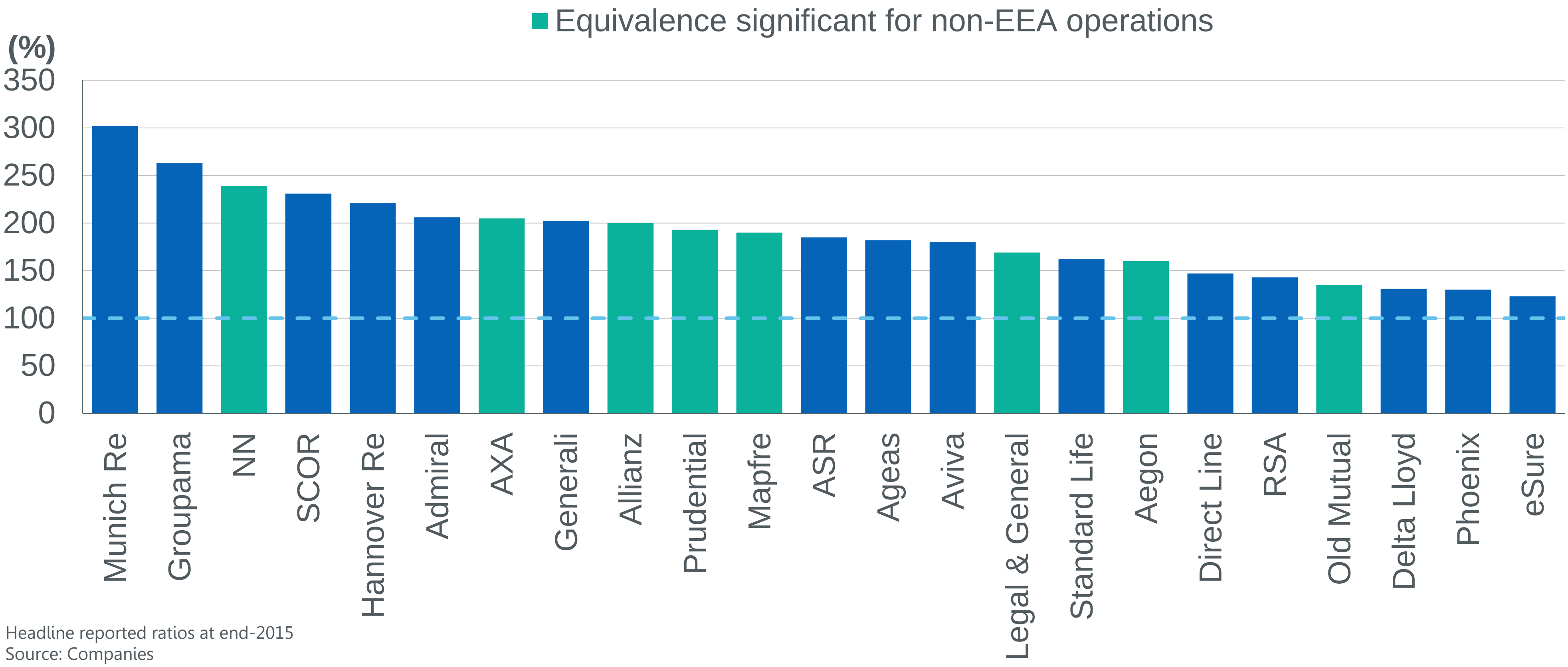
SCR Coverage



Headline reported ratios at end-2015
Source: Companies

Equivalence Pollutes S2 Metrics With Non-S2 Capital

SCR Coverage



Headline reported ratios at end-2015
Source: Companies

Disclosures – Not Bad, Could Do Better

4 An Asset Manager Perspective

Dick Rae – BMO Global Asset Management

Institute and Faculty of Actuaries

Dick Rae

BMO Global Asset Management

22 November 2016

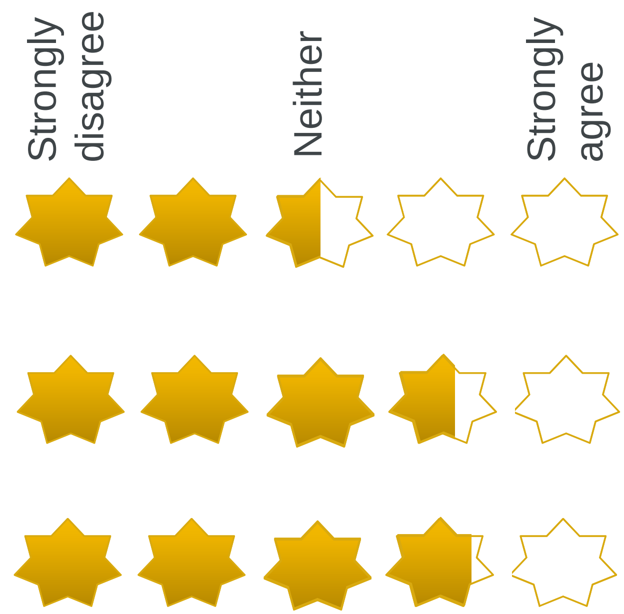
A Solvency II Scorecard

	Vote count
Improved consumer protection	43
Harmonisation across Europe	54
Effective risk management	55
Financial markets more stable	56

Source: Voting poll from workshop C4 “How well has Solvency II met its Objectives for the Life Insurance Industry?”, IFoA 2016 Life conference

Institute and Faculty of Actuaries

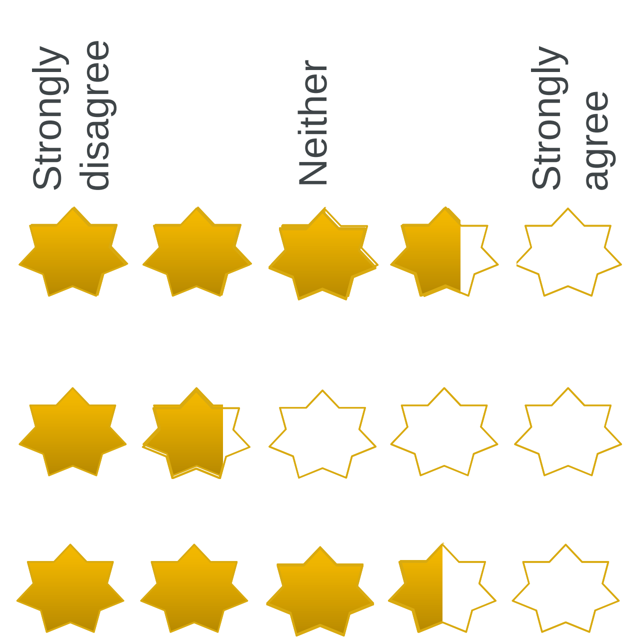
Counting the cost



	Vote count
The cost of implementing SII is justified • enhanced protection for consumers	52
SII is the reason for more capital being held • not just impact of falling interest rates.	65
Pillar 3 disclosure benefits not proportional to the cost of implementation	55

Source: Voting poll from workshop C4 “How well has Solvency II met its Objectives for the Life Insurance Industry?”, IFoA 2016 Life conference

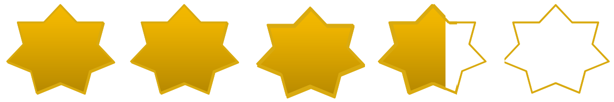
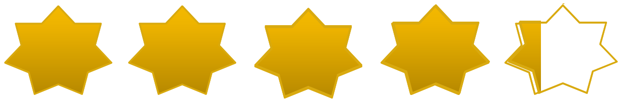
Technical standards
(life insurance oriented)



	Vote count
Divergence from true market consistency is necessary for the [life] insurance industry	58
Aspects of Solvency II that are not market consistent should be removed	59
The capital requirements should allow for • introduction of management actions or • markets to find new levels	43

Source: Voting poll from workshop C4 “How well has Solvency II met its Objectives for the Life Insurance Industry?”, IFoA 2016 Life conference

Other opinions

	Strongly disagree — Neither — Strongly agree	Vote count
The UK regulator has gold-plated SII		57
Internal models are too complex		51
The Pillar 2 requirements add to financial stability • governance/ORSA/Board responsibility/PPP		54

Source: Voting poll from workshop C4 “How well has Solvency II met its Objectives for the Life Insurance Industry?”, IFoA 2016 Life conference

5 A Regulator Perspective

Nick Dexter – Bank of England

Your questions…

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