EVOLUTION OF SOLVENCY 2 AND CAPITAL STANDARDS

TUESDAY 22 NOVEMBER 2016

Martin Pike, Sean McGuire, David Prowse, Dick Rae, Nick Dexter
CONFIDENTIALITY

Our clients’ industries are extremely competitive, and the maintenance of confidentiality with respect to our clients’ plans and data is critical. Oliver Wyman rigorously applies internal confidentiality practices to protect the confidentiality of all client information.

Similarly, our industry is very competitive. We view our approaches and insights as proprietary and therefore look to our clients to protect our interests in our proposals, presentations, methodologies and analytical techniques. Under no circumstances should this material be shared with any third party without the prior written consent of Oliver Wyman.

© Oliver Wyman
**Evolution of Solvency 2 and Capital Standards**

**Agenda – Tuesday 22 November**

<table>
<thead>
<tr>
<th>Time</th>
<th>Topic</th>
<th>Presenter</th>
</tr>
</thead>
<tbody>
<tr>
<td>1700 – 1730</td>
<td>Arrival/registration</td>
<td></td>
</tr>
<tr>
<td>1730 – 1735</td>
<td>Welcome</td>
<td>Martin Pike, Standard Life Group, Esure and Faraday</td>
</tr>
<tr>
<td>1735 – 1745</td>
<td>A consultant perspective</td>
<td>Sean McGuire, Oliver Wyman</td>
</tr>
<tr>
<td>1745 – 1755</td>
<td>A rating agency perspective</td>
<td>David Prowse, Fitch Ratings</td>
</tr>
<tr>
<td>1755 – 1805</td>
<td>An asset manager perspective</td>
<td>Dick Rae, BMO Global Asset Management</td>
</tr>
<tr>
<td>1805 – 1815</td>
<td>A regulator perspective</td>
<td>Nick Dexter, Bank of England</td>
</tr>
<tr>
<td>1815 – 1900</td>
<td>Q&amp;A</td>
<td>Audience</td>
</tr>
<tr>
<td>1900 – 2100</td>
<td>Drinks/Networking</td>
<td>All</td>
</tr>
<tr>
<td>2100</td>
<td>Close</td>
<td></td>
</tr>
</tbody>
</table>
Welcome
Martin Pike – Standard Life Group, Esure and Faraday
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 “wargaming” / 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)
A Rating Agency Perspective
David Prowse – Fitch Ratings
S2 An Improvement on S1

German life insurers
S2 Metrics Comparable For Similar Businesses

Example – motor insurers
S2 in Ratings – New Insights but Handle With Care...
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

Sovereign debt charges

S2 is still evolving
Transitionals Used Widely – May Distort Comparisons

SCR Coverage

- Transitional measures on technical provisions

Headline reported ratios at end-2015
Source: Companies

Fitch Ratings
Equivalence Pollutes S2 Metrics With Non-S2 Capital

**SCR Coverage**

- Equivalence significant for non-EEA operations

Headline reported ratios at end-2015
Source: Companies

FitchRatings
Disclosures – Not Bad, Could Do Better
An Asset Manager Perspective
Dick Rae – BMO Global Asset Management
# A Solvency II Scorecard

<table>
<thead>
<tr>
<th>Objective</th>
<th>Achieved</th>
<th>Not Achieved</th>
<th>Vote count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved consumer protection</td>
<td><img src="images/stars.png" alt="5 stars" /></td>
<td><img src="images/stars.png" alt="4 stars" /></td>
<td>43</td>
</tr>
<tr>
<td>Harmonisation across Europe</td>
<td><img src="images/stars.png" alt="5 stars" /></td>
<td><img src="images/stars.png" alt="4 stars" /></td>
<td>54</td>
</tr>
<tr>
<td>Effective risk management</td>
<td><img src="images/stars.png" alt="5 stars" /></td>
<td><img src="images/stars.png" alt="4 stars" /></td>
<td>55</td>
</tr>
<tr>
<td>Financial markets more stable</td>
<td><img src="images/stars.png" alt="4 stars" /></td>
<td><img src="images/stars.png" alt="5 stars" /></td>
<td>56</td>
</tr>
</tbody>
</table>

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

The cost of implementing SII is justified
- enhanced protection for consumers

SII is the reason for more capital being held
- not just impact of falling interest rates.

Pillar 3 disclosure benefits not proportional to the cost of implementation

<table>
<thead>
<tr>
<th></th>
<th>Strongly disagree</th>
<th>Neither</th>
<th>Strongly agree</th>
<th>Vote count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Counting the cost</td>
<td>52</td>
<td>65</td>
<td>55</td>
<td></td>
</tr>
</tbody>
</table>

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)

Divergence from true market consistency is necessary for the [life] insurance industry

Aspects of Solvency II that are not market consistent should be removed

The capital requirements should allow for
- introduction of management actions or
- markets to find new levels

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

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly disagree</th>
<th>Neither</th>
<th>Strongly agree</th>
<th>Vote count</th>
</tr>
</thead>
<tbody>
<tr>
<td>The UK regulator has gold-plated SII</td>
<td>57</td>
<td>51</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>Internal models are too complex</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Pillar 2 requirements add to financial stability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• governance/ORSA/Board responsibility/PPP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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...
This report is for the exclusive use of the Oliver Wyman client named herein. This report is not intended for general circulation or publication, nor is it to be reproduced, quoted or distributed for any purpose without the prior written permission of Oliver Wyman. There are no third party beneficiaries with respect to this report, and Oliver Wyman does not accept any liability to any third party.

Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been independently verified, unless otherwise expressly indicated. Public information and industry and statistical data are from sources we deem to be reliable; however, we make no representation as to the accuracy or completeness of such information. The findings contained in this report may contain predictions based on current data and historical trends. Any such predictions are subject to inherent risks and uncertainties. Oliver Wyman accepts no responsibility for actual results or future events.

The opinions expressed in this report are valid only for the purpose stated herein and as of the date of this report. No obligation is assumed to revise this report to reflect changes, events or conditions, which occur subsequent to the date hereof.

All decisions in connection with the implementation or use of advice or recommendations contained in this report are the sole responsibility of the client. This report does not represent investment advice nor does it provide an opinion regarding the fairness of any transaction to any and all parties.