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Solvency II and Current Economic Environment – Impact on Consumers

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Objective and approach

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Objective of the Working Party

- The *Solvency II and Economic Environment Consumer Impact Working Party* was formed in late 2016. Members are from a diverse background – consultancy, life insurance, asset management and pension schemes.
- The aim of the working party is to:
 - Investigate the impacts of Solvency II regulations and the current (low) interest rate environment on insurance contract design and pricing, and customer access to life insurance products
 - Investigate whether the current post-financial crisis low interest rate environment is causing changes in the way consumers evaluate products that meet their needs
- The working party used a combination of desktop analysis, group discussion and the results of a survey carried out to achieve its aims.



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SII impacts on risks, solvency and policy writing capacity

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Summary of respondents

- Our Questionnaire was emailed by the IFoA to 31 UK life insurers/groups
- Of these 31 firms, 27 provided responses to some or all of the questions.

	Large	Medium	Small
Premium Income	> £1bn	£500m - £1bn	< £500m
Assets	> £10bn	£5bn - £10bn	< £5bn
Responses	8	2	15

Standard Formula	Full or partial internal model
18	8



SII risk exposure of insurers – market risk

Market risk	1	2	3	4	5	6	7	8	9	10	11	12	Total
Interest Rate	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	12
Inflation	✓			✓			✓	✓		✓		✓	6
Spread	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	11
Currency	✓			✓	✓		✓	✓	✓	✓		✓	8
Property	✓	✓	✓	✓		✓	✓	✓	✓	✓	✓		10
Equity	✓		✓	✓	✓			✓	✓	✓	✓		8
Concentration	✓			✓	✓	✓			✓	✓			6

- Other risks include implied volatilities and counterparty default
- Interest rate, spread and property risk were noted as having materially higher capital under Solvency II than ICAS by 4 firms (circled red ticks).



SII risk exposure of insurers – insurance risk

Life and health risk	1	2	3	4	5	6	7	8	9	10	11	12	Total
Longevity risk	✓	✓				✓	✓		✓	✓		✓	7
Mortality risk	✓		✓	✓	✓			✓	✓	✓	✓		8
Proportions married risk	✓	✓								✓		✓	4
Disability / Morbidity risk	✓			✓				✓					4
Lapse risk	✓		✓	✓	✓			✓	✓	✓	✓		8
Expenses	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	11
Revision	✓									✓			2
Catastrophe	✓		✓	✓				✓	✓	✓			6

- Longevity and lapse risk were noted as being materially higher under Solvency II than ICAS for 2 firms
- Some mid-sized providers stated that counterparty default risk is materially higher under Solvency 2 than under ICA.



SII impact on companies' solvency positions

Q: We asked insurers to rank the value of **net assets** in order of size for Solvency I Pillar I, Solvency I Pillar II and Solvency II, before and after taking into account transitional adjustments

A:

- **Solvency I Pillar II** ranked highest by the most number of firms both before and after transitionals
- **Solvency I Pillar I** was ranked lowest by all firms before transitionals



SII impact on companies' policy writing capacity

Q: We asked insurers to comment on the impact of Solvency II on their policy writing capacities and whether it has brought new opportunities or caused products to be discontinued.

A:

- Solvency II is not a major game changer
- Greater flexibility in investment risk and diversification
- Linking of bonuses to risk exposures is good practice (more risk integration)
- Negative impacts include:
 - Liabilities for long-term life products with guarantees have increased
 - Additional reporting and capital requirement
 - Life and health risks are more onerous, particularly in terms of meeting the matching adjustment qualifying requirements
 - The risk-free rate caused strains on with-profit types removed by changing product terms
 - Risk margin caused increased capital requirement for annuities
- No surprises in terms of negative impacts?



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SII impacts on costs and consumer value

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SII impact on development and maintenance costs

Q. We asked whether the maintenance and running costs of SII valuation and capital models are expected to be higher, about the same or lower compared to those for SI.

A: Of the 31 respondents, 9 answered this question.

- 8 thought costs would go up, whilst 1 thought they would be about the same
- Larger companies have spent very large amounts on **development** SII valuation and reporting systems. We believe the largest companies spent in the region of hundreds of millions. One mid-sized life company gave an explicit estimate of £15m
- At the other end of the spectrum, several smaller companies stated that they spent between £300k and £500k only
- One large company and one mid-sized provider stated their **maintenance** costs are 25% higher under SII than SI, whilst an annuity provider stated their costs have doubled
- But there are companies that experienced a relatively small rise in maintenance costs, from £70k to £1m~£2m higher per annum.



SII impact on development and maintenance costs

Q. We asked whether the charge to policies (where made) for maintaining and running these SII systems would be increased to recoup some or all of the development costs.

A.

- Of the 31 respondents, 8 answered this question. 5 insurers answered "no" to recouping costs from policy charges, 2 answered "yes" and 1 answered "not sure"
- One company stated that their charges to asset share would increase by 3%~5% because of the risen costs
- Only a few companies continue to operate separate economic capital models from SII. For the other companies, running a single SII system seems to suffice.



Insurers' perceptions of SII impact on consumer value

- Some of the benefits of SII listed by insurers includes:
 - Greater degree of professionalism
 - A more realistic reporting regime
 - Encouraging more matching and responsive investment mix
 - More risk integration to the operational process
 - Diversification of investments
 - Boost investment to infrastructure and other long-term asset classes
- However, some mid-to-large providers and large composites, who spent considerable amounts on SII, tend not to perceive SII as “Value-for-money” one way or the other:
 - Adds value for consumers but not to shareholders
 - Raised risk awareness for management, but brings no significant consumer value
- Other companies that have not spent much think that:
 - Costs not substantial but neither are benefits.



Insurers' wish list for SII changes

- When asked what changes they would like to see made to SII, companies quoted several items:
 - Matching adjustment should be available to a wider category of products, including those that can be surrendered as long as the surrender value does not exceed the asset share
 - Look-through requirements on unit-linked business add no value and should be weakened
 - Reconsideration of counterparty risk capital required for reinsurance
 - Less capital requirement for lifetime mortgages
 - Replace risk margin with something smaller and more stable
 - Remove complexity for simple business; look through has no value
 - Better calculation of operational risk capital in SF and better calculation of morbidity risk capital
 - Simplify transitional measures, reset process, and Matching adjustment should be easier
- No surprises here!



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Product innovation

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Retirement and Savings products

Retirement

Annuity market in the UK now less than a third compared to its peak in 2012

- Annuities are replaced with income drawdown solutions
- Success of Flexible/Hybrid products yet to be seen, more can be done
- Mortality-indexed annuities, older age annuities alternatives can be explored
- Number of annuity players is reducing – bad for customers?



Long-term savings

Regulatory environment more supportive for product innovation in Europe

- Where life savings products are sold as investment vehicles with tax advantages used towards retirement
- Increased focus on less capital intensive products such as hybrids or unit-linked products with dynamic asset allocation (CPPI)
- Challenge: Lower or no guarantees may not be favoured by customers/advisors in certain markets.





And then they were 7...

‘Some consolidation was to be expected due to the lower demand and is not yet a sign of weakened competition, though there is a risk of competition weakening over time. We will continue to monitor this market.’

Source: FCA Retirement Outcomes Review – Interim Report, July 2017




Pension reform impacts

- Income drawdown products have become more popular due to both demand and supply effects
- The 'Zero-Income' Drawdown' product
- Insurers need to reposition their product offerings to make them more attractive in the new environment
- Companies are developing hybrid solutions to give flexibility to customers
- Asset managers will be competitors in the income drawdown space
- The extension of the accumulation phase in a flexible solution should mean that customers can invest in risky assets with better expected returns
- Advised market the way forward?




Lamborghini pensioners?

Figure 23: Most consumers saved or invested the withdrawn money; a minority spent it

14% 

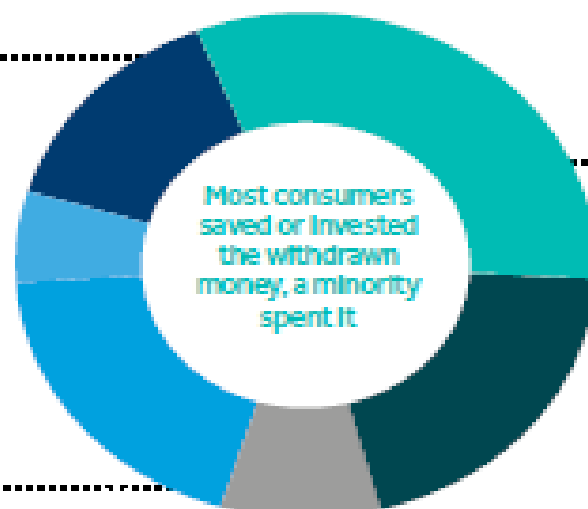
Used the largest share to pay off debts
Spent the largest share in paying off their mortgage or other debt

32% 

Saved the largest share
Put the majority of the money in an ISA, savings or current account to either drawdown or keep as a safety net

25% 

Spent all (8%) or the largest share (17%) of the pot (with no further access)
For example, spent their pot (or the largest share) on home repairs, a car etc



9%
Unknown

20% 

Invested the largest share in capital growth
Spent the largest share on buying property or made investments in bonds, stocks and shares or a business

Source: Consumer research commissioned by the FCA, Annex 4.

What happens after pensions?

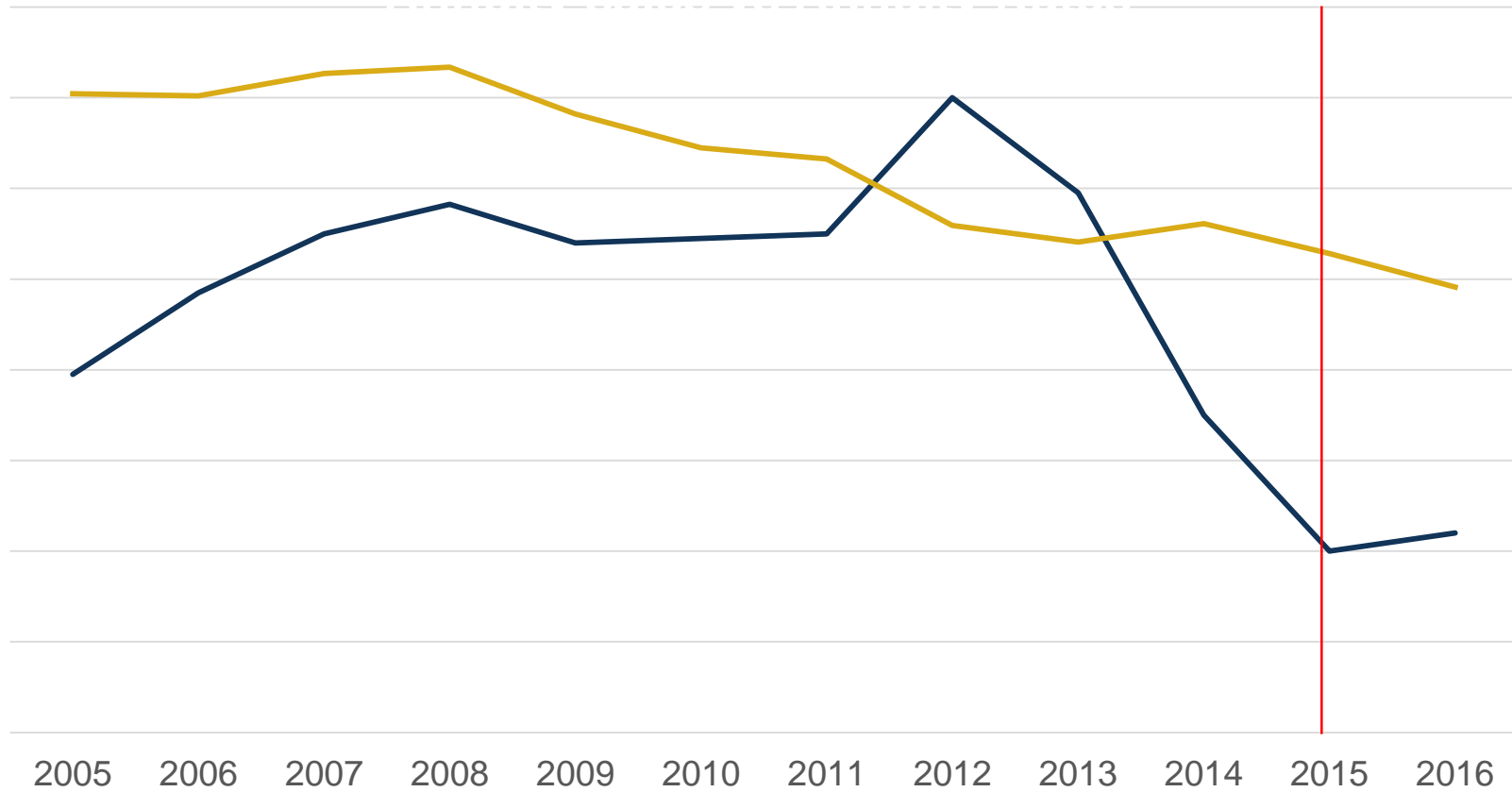
Individual Savings Accounts as of 31 August 2017



Source: HM Revenue & Customs

- In general, customers withdrawing their pension pot prefer to put their money into ISAs, savings and current accounts
- But which ISA for pensioners?

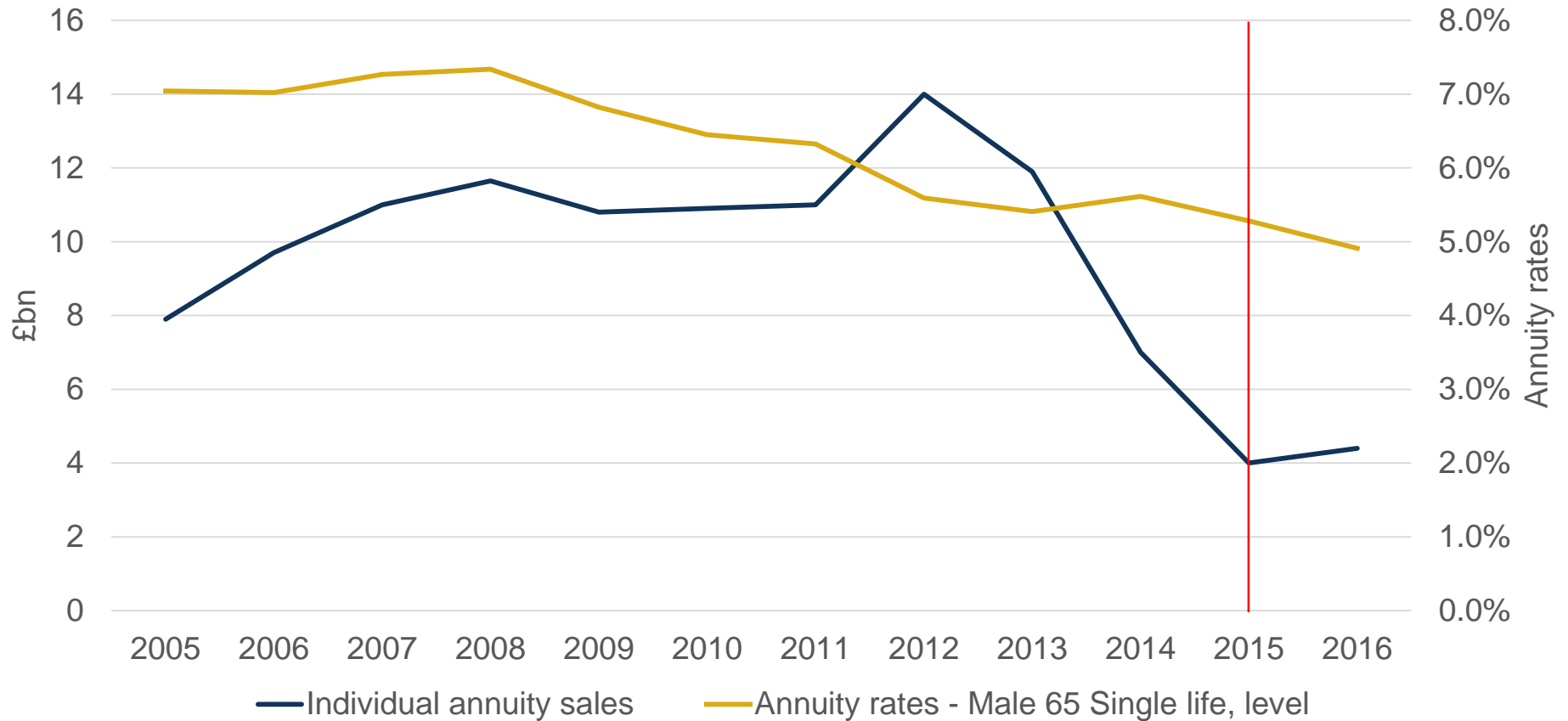
Can you guess the titles of the axis?





Can you guess the titles of the axis?

Annuity sales vs Annuity Rates



Source: ABI, William Burrows

Will annuities make a comeback?

- Increase in interest rates in a reflationary environment
- Slowdown in longevity improvements observed in recent years indicating a long-term trend, possibly in CMI2017 as well?
- DC market is expected grow to £1.7trn by 2030 from £340bn in 2015
- Launch of hybrid solutions giving customers flexibility
- Underwritten annuities – the way forward?
- An economic capital framework that supports the insurance industry for the benefit of the customer.

Protection products

We reinforced our leading global position in the Health business, growing again by 6% in this preferred and strategic segment.
Axa, press release 9M17

Generali chief seeks to cut costs and focus on protection products.
FT, July 11, 2016

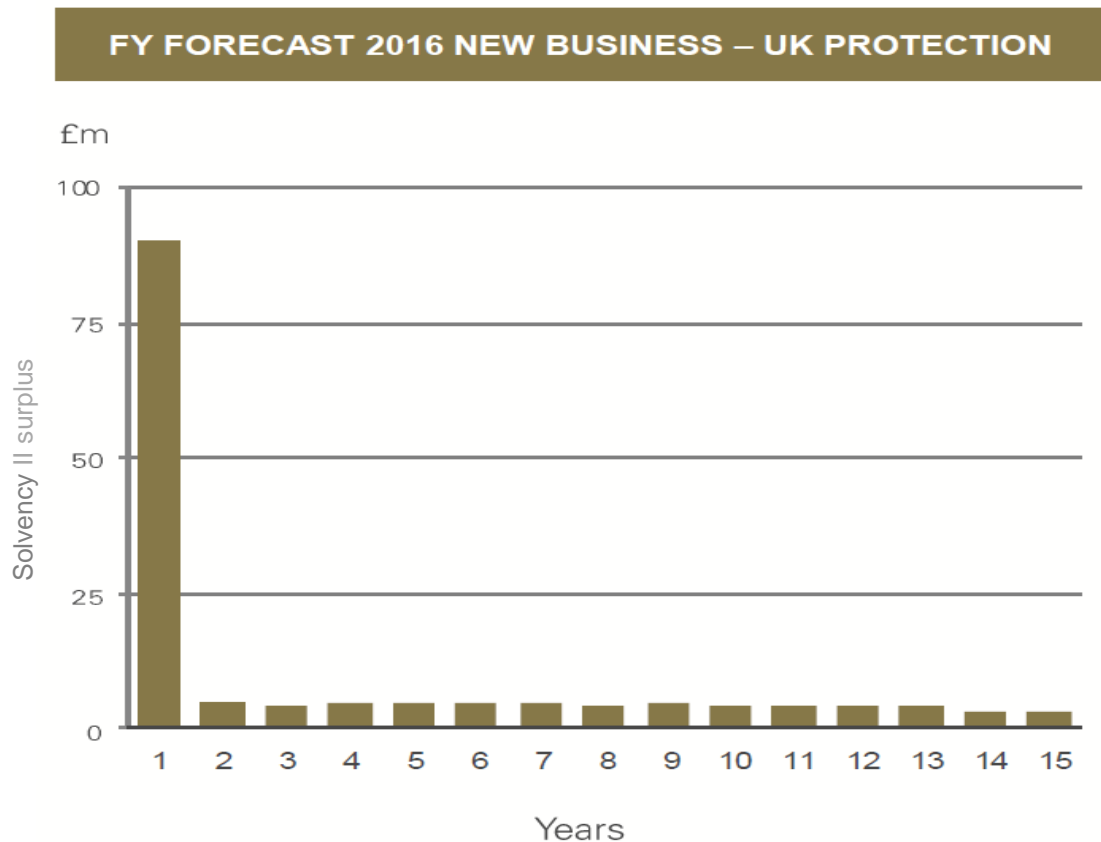
Transformed the profile of the company by focusing on fee and protection business
AEGON, BoA-ML Conference, September 27, 2017

Life has continued to execute on its protection and unit-linked strategy, which continues to drive solid growth with BOP up 16% over the first half.
Zurich, commentary Q2-17

...reflecting our continued focus on health and protection business.
Prudential plc, news release, 10 August 2016

"What I really believe in is an intelligent combination of asset accumulation and products that have intelligent biometric features"
Oliver Bäte, CEO Allianz, FT, 12 December 2016

Why do companies prefer protection products?



Source: Legal & General, Capital Markets Event, December 2016

- Protection products inherently have healthy underwriting margins
- Leading to short payback periods and attractive return on capital
- Diversification benefit between market risks and mortality/morbidity risks helped in the SII world
- Leveraging on reinsurers' excess capacity and expertise
- Success of the protection riders in Asian markets, leading to customer stickiness.



What about the customer?

- Still early days to see how the customer proposition will evolve in the SII world
- Contract boundaries may affect product designs, arguably providing guaranteed rates and comprehensive coverage
- Companies may feel comfortable pricing risks such as long-term care which can be bundled with decumulation solutions
- Similarly, reinsurance can provide capital efficiency in internal models whilst taking on new risks
- Develop long-term savings products with rider benefits based on diversification between market and underwriting risks
- Granular modelling of critical illness risks can be a catalyst to develop more attractive propositions.



Second line closer to the customer

- Input from the risk function into product development, customer propositions
- Conduct standards are the overarching principles
- Will see Key Risk Indicators (KRIs) as risk metrics
- Good way to demonstrate the value add of risk management
- Can be an essential part of Pillar II
- Overall, should lead to better customer experience.



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Post-Brexit and the continued low rate environment

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SII post-Brexit

- We asked companies which post-Brexit regulatory model they would like to operate under, if not the current version of SII:
 - Norway model: Full EEA membership, access to the single market, free movement applies. Solvency II will still apply but the UK cannot influence the rules
 - Swiss model: European FTA membership, governed by a series of bilateral agreements so an insurance specific sector agreement possible, free movement applies. A similar but different regime (SST) applies and the UK cannot influence the rules
 - Total exit from the EU: Different examples include joining the EU customs union (no tariffs or quotas to goods exported to EU countries), WTO rules or negotiate a special deal under free trade agreement
 - Or other models
- Which option would be in the interests of UK customers?



SII post-Brexit

- Companies that operate in the EU:
 - Generally believe full equivalence with SII should be maintained, but some consider that some simplification and UK-specific allowances (e.g. easing of the matching adjustment criteria) should be considered (provided that equivalence can be maintained)
 - Almost all the answering respondents (6 out of 7) believe Brexit brings more scope for tailoring the regulations to the UK, and potentially reducing the difficult components
 - Are mostly worried about losing the equivalence status and passporting rights. This seems to outweigh regulatory innovation intentions.



SII post-Brexit

- Companies that do not operate in the EU:
 - Do not particularly worry about SII equivalent status
 - Seem to have no intention to expand into the EU market by setting up subsidiaries in the future
 - Seek simplifications to the existing regime and less onerous capital requirements
- Interestingly, one life company believes *“the ability of the PRA to hold seemingly unchallengeable views should be curtailed”*, and the success of the UK insurance industry would *“critically depend on attitude/desire of the government to keep PRA in check”*
- This antipathy towards the PRA’s approaches is shared by another insurer, who stated that *“PRA are increasing reserving requirements for unit linked and with-profits products by removing some elements of SII they don’t like”*.



How consumers of long term savings products may continue to weather the low interest rate environment

- Traditional long-only, “Default” investment option in your pension plan might not suffice
- Select from a broader universe of investment managers and investable asset classes, especially innovative solutions with higher expected returns and a softer (but still valid) downside guarantee
 - Illiquidity premium earners that have close links to the real economy – private loans, rental property, infrastructure debt, etc.
 - Multi-asset strategies that apply discretionary asset allocation and dynamic leverage – E.g. Standard Life’s GARS, Aviva’s AIMS, LOIM’s All Roads, etc.
 - Robotic asset managers powered by the latest AI technology (?)
- Plan life assuming a later retirement age (>67?).



Implications for asset managers

- Unconventional monetary policy, ageing population and tightening regulations combined bring the expected returns lower across the spectrum of asset classes
- Asset managers need to rethink the definition of “risk-free” assets, the practice of liability-driven investing, and the role and optimal portfolio weight of government bonds
- More agile asset allocation decision-making and downside equity/currency risk management that creates value
- Adjust the management fee structure and differentiate themselves from other service providers
- Target diversification beyond asset class level and identify investment strategies that could deliver additional returns.



Final thoughts

- Companies have been focused on implementing Solvency II up to now, with less emphasis on consumer impact
- Theoretically, customers now have peace of mind:
 - The principles of prudential regulation in Solvency II format
 - Stronger policyholder protection than ever?
- But the evidence of benefits to consumer outcomes is much awaited
- Solvency II, low interest rates and pensions freedoms have created the perfect storm for annuities:
 - Number of annuity providers much reduced – less choice for consumers
 - Insurers have offered alternative propositions in the retirement sector, but no clear winning strategies yet.
 - Could annuities make a comeback in the future?
- Customer propositions expected to evolve to the external market:
 - Insurers currently favouring Protection products, with innovation in this area
 - More opportunities for products that offer exposure to market risks/real returns
 - Does the regulator restrict competitiveness/product innovation in the UK?



Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.