Association of British Insurers

The impact of Solvency II on Annuities

ACA, London

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Association of British Insurers

Solvency II: Improving insurance regulation and supervision Europe-wide

- Move away from crude ‘Pillar 1’ factors to an ‘economic approach’ to the valuation of assets and liabilities, including options and guarantees
- Recognising and integrating internal models in the regulatory regime
- Introducing risk-based approach to supervision with a much greater focus on internal risk management
- Eliminating arbitrary restrictions, for example on the assets insurers may hold
- Goes significantly beyond Basle II and UK’s ICA

Solvency II: State of Play

- Directive approved April 2009
- CEIOPS advice on ‘Level 2’ commences immediately: Wave 1 and Wave 2 published July 2009. Key issues include:
  - Liquidity premium
  - ‘winding-up’ gap – or ‘non-recognition of VIF’ (run-off technical provisions)
  - Risk margin (no diversification)
  - Own funds (no hybrids)
  - Geographical diversification excluded from standard formula
  - Largest counterparty 0.5% op risk charge
  - Counterparty default risk

Solvency II: State of Play - 2

- Wave 3 published November 2009. Key issues include:
  - Pillar 2 dampener – design and application
  - Partial internal models – integration with SF
  - Treatment of participations
  - Treatment of ring fenced funds
  - Calibration of market risk (esp. Equity and Spread)
  - Non-life underwriting risk
  - Third country equivalence
- Next Steps – Development of Level 2 proposals by EC
- Implementation 31 October 2012

Solvency II and Annuities: A clash of cultures?

- Solvency II is based on an economic ‘market consistent’ balance sheet
- UK immediate annuities continue to use traditional actuarial methods linking liability valuation to the assets held by the insurer
- This provides a significant discretion to each insurer, within certain norms and parameters
- However, the philosophy of Solvency II does not preclude a liquidity premium, but it is the entity specific methods and inconsistent outcomes which are anathema to Solvency II
- To secure a liquidity premium under Solvency II will require the industry to agree on a method that is consistent, reliable and objective.

Solvency II: Valuation Methodology

"Best Estimate: probability weighted average of future cashflows……

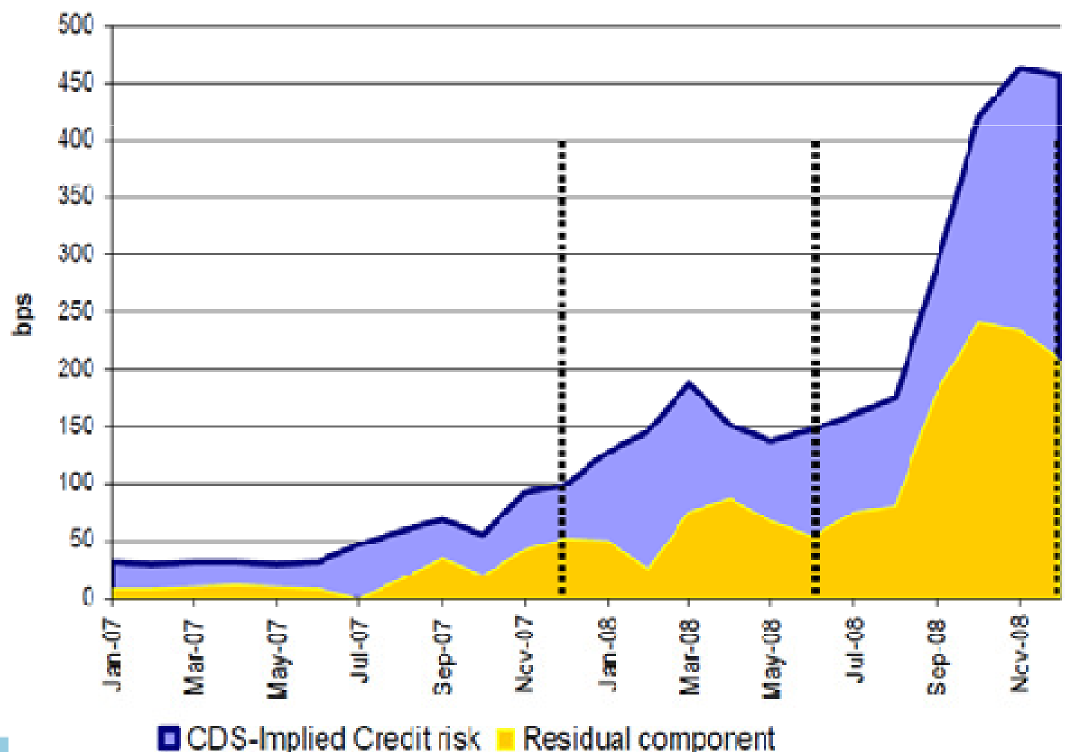
- …….taking account of the time value of money….
- …using the *relevant* risk-free interest rate term structure"

<u>This does not preclude liquidity, but provides a new framework in which it must be considered</u>

Solvency II and Annuities: Why such a controversial subject?

- Developments in financial markets since summer-2007, in particular since the Lehman's collapse of September 2008.

Indicative European corporate bond spreads



Liquidity Premium: What do others say?

Extracts from IASB Discussion paper on Insurance contract discounting

"Liquidity is a relevant characteristic of an insurance liability"

"A rate that excludes … all credit default risk is often referred to as a 'risk free rate'. However, that rate could still include a component for liquidity that is reflected in … the liquidity premium"

"An insurer [should] reflect the time value of money by discounting the expected cash flows via a discount rate that reflects the characteristics of the liability [that] excludes credit default risk in the observed market rate [and] matches the liability on currency, duration and liquidity"

Liquidity Premium: What do others say?

Morgan Stanley research note 9 July 2009:

“There is a very sound – and we believe persuasive – economic argument for allowing UK annuity writers to include illiquidity premia”

“We think there is a very strong chance that a compromise solution will be found for UK annuity writers [in Solvency II].”

Morgan Stanley research note by Jon Hocking, “Legal & General: Solvency 2 fears overdone”

Liquidity Premium: can it be made compatible with Solvency II?

- A fundamental principle of Solvency II, valuation of liabilities (article 74 (1)):

  "liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction."

- The Commission has already registered liquidity as a key policy issue for Solvency II

- CEIOPS's hard line against liquidity has now shifted in the final advice, for the first time accepting that the 'back book' should continue to benefit from the liquidity premium but further work will be needed if liquidity is to be recognised for new business (Final advice on CP40)

Liquidity Premium: Proposed Solution

- Must involve a move away from entity-specific methodologies
- A methodology compatible with the Solvency II Framework must be:
  - Consistent
  - Reliable
  - Objective
- European industry is working hard on this.
- CRO Forum have developed agreed “principles”
- CRO & CFO Forum are taking work on calibration with Barrie & Hibbert
- EC have ‘requested’ that CEIOPS undertake further work, to include the full range of stakeholders in the industry and profession
- EC will develop Level 2 and prepare draft QIS5 spec March 2010

CRO Forum proposals for the Liquidity Premium: Seven Principles

Principle #1

The swap curve plus Liquidity Premium should serve as risk free reference rate.

Principle #2

The Liquidity Premium should be applied to the valuation of the liabilities, not to the valuation of the assets. As a consequence, the Liquidity Premium should be independent of the investment strategy adopted by the company.

Principle #3

Insurers should be able to purchase assets available to the company such that:

1) the Liquidity Premium being taken into account on the relevant liabilities may be captured in the financial markets, through assets that do not contain, or have been suitably adjusted for, risks other than liquidity; and
2) the liability cash flows are replicated.

CRO Forum proposals for the Liquidity Premium: Seven Principles

Principle #4

Liquidity Premium should apply to all liabilities. However, the magnitude of the Liquidity Premium should depend on the nature of the liabilities, i.e. the Liquidity Premium may vary by Line of Business, depending on (i) the currency and (ii) the predictability of their cash-flows (e.g. the ability to withdraw/ surrender).

Principle #5

The calculation for the Liquidity Premium should be consistent & transparent across the industry and Liquidity Premiums should be disclosed regularly.

Principle #6

The Liquidity Premium should be assessed and quantified based on objective market data from the financial markets.

Principle #7

The Liquidity Premium should be measured at all times but may be set to zero if less than a minimum amount (TBD).

CRO Forum proposals for the Liquidity Premium: Five buckets

Very Predictable

Products which have no variability in cash flows or very predictable cash flows. The impact of claims, lapses/survivorship and investment returns on the certainty of cash flows should be very limited.

Highly Predictable

Products which have minor variability in cash flows. The impact of claims, lapses/survivorship And investment returns on the certainty of cash flows should be limited or highly predictable.

Moderately Predictable

Products in which impact of claims, lapses/survivorship and investment returns on the certainty of cash flows should be moderately predictable.

Some Predictability

Products in which impact of mortality / lapses/ survivorship and investment returns on the certainty of cash flows should be, at least, slightly predictable.

Not Predictable

Products in which impact of mortality / lapses/ survivorship and investment returns on the certainty of cash flows should be highly unpredictable.

Solvency II and liquidity premium: Next Steps

- New task force proposed by CEIOPS – essential that this includes a wider range of input from stakeholders in industry and the actuarial profession

- ABI has met with Commission officials and presented papers demonstrating the significance of the liquidity premium and highlighting the damage that would result in failing to take liquidity into account. We will continue to press this case in close co-operation with other European bodies

- CRO Forum work provides a promising framework – but the "crunchy" issue of a consistent calibration lies ahead, but protracted debates will undermine the chances of securing any recognition of the liquidity premium

- Need to engage the Groupe Consultatif: the "honest broker"

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Questions ?

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