Solvency II: An Update

The Road to Somewhere?

Association of Consulting Actuaries: 21 March 2013

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Agenda

- Quick Recap on Solvency II
- Key Areas of disagreement
- Solvency 1.5
- Expected Solvency II Timeline
- Whither Solvency II?

It seems like we’ve been at this a long time

As we speed along this endless road to the destination, I can't help but whine, 'Are we there yet?'

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Quick Recap on Solvency II

The need for a Solvency regime

- Essential to ensure that policyholders buying financial products are protected
- Policyholders pay premiums to insurers in exchange for a payout at a later date
  - Need to ensure that payout to policyholders will happen
- Insurers need to hold, not just enough in technical provisions to meet the expected payout, but also a capital buffer on top of this to cover the risk that experience isn't as expected
- Legislation specifies the amount of capital needed to be held:

  -> Solvency II for insurers

  -> Basel III for banks

Why a new Solvency regime ?

- Solvency I is out-of-date and not able to achieve Europe-wide objectives of consumer protection, deepening single market and competitive industry

- Solvency I disadvantages:
  - Rules can conflict with good risk management: focus on back-looking financial aspects rather than governance
  - Capital requirement is not transparent and not adequately directed to risks
  - A lack of harmonisation across Europe
  - Inconsistency with IFRS
  - No recognition of economic reality of groups (solo plus)

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Solvency II

- New regime expected to come into force in 20XX
- Will apply to all insurers registered in the EEA
- No gold plating by individual state regulators

- Solvency II is a risk-based regime covering much more than just capital adequacy alone

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Solvency II

- Solvency II framework structured around 3 core components:
  - Pillar 1 covers the quantitative requirements, i.e. *how much capital should the insurer hold?*
  - Pillar 2 covers the governance and risk management requirements, i.e. *how is the business run?*
  - Pillar 3 relates to the reporting and disclosure requirements
- Aims:
  - Market consistency ✓
  - Harmonise regulatory standards across Europe ✓
  - Provide an early warning system to supervisors ✓
  - Strengthen policyholder security ✓
  - Promote improved risk management ✓

Solvency II: 3 pillar approach

Measurement of Assets, Liabilities and Capital	Governance and Supervisory Review	Disclosure Requirements
▪ Technical provisions ▪ Capital requirements (SCR, MCR) ▪ Asset valuation ▪ Eligible capital ▪ Standard Approach & Internal model approach	▪ Internal controls ▪ Risk management ▪ Own Risk and Solvency Assessment (ORSA) ▪ Corporate governance ▪ Regulatory process: powers and scope	▪ Public reporting ▪ Private reporting to the supervisor

Solvency II covers not just capital requirements, also internal management and disclosure requirements.

➢ **Makes managers aware of the risks they run**

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Key Areas of Disagreement

Key Areas of Disagreement

1. Counter-cyclical premium

- Aims to allow the industry to cope during distressed market conditions
- Should be predictable so the industry can use it in forecasting the impact of known issues and must include sufficient discretion and control for EIOPA to react to unexpected situations

2. Matching adjustment

- Mechanism to recognise the significant benefits where investment strategies and product features mitigate the impact of spread movements
- Should not be artificially limited to very few products and must apply across Europe

3. Extrapolation methodology

- Should avoid creating volatility in the value of long-term liabilities
- Need to ensure extrapolation starts where bond markets are no longer deep, liquid and transparent (eg after 20 years for the Euro under current conditions) and reaches the Ultimate Forward Rate appropriately early (i.e. 10 years)

- Long-Term Guarantee Assessment (LTGA)

Based on Insurance Europe analysis

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Solvency 1.5

Solvency 1 ½

Many countries are exploring the introduction of certain elements of Solvency II in advance of the official implementation date - FSA has proposed a method for the early use of Solvency II work to meet ICAS requirements:

- This sets out a two phase approach by which firms, currently in Internal Model Approval Process (IMAP), may make use of their Solvency II internal models for ICAS purposes.
  - **Phase 1** - reconciliation between the firm's Solvency II model and its previous ICA model. This should include understanding any changes in the firm's business and in the model since the previous ICA review
  - **Phase 2** - allow firms to use their Solvency II balance sheet and model for ICAS purposes without further on-going reconciliation
- A firm currently in IMAP is not obligated to use its internal model for ICAS, nor is this approach a condition for IMAP review or approval
  - The FSA believes that the two phase approach will be most appropriate for IMAP firms subject to an ICAS review before the end of 2014
  - Firms will need to establish, through discussion with the FSA, whether they want to integrate their ICAS reviews with IMAP, revising their IMAP submission slots as required

Key Elements of ICAS+ (1)

- Current ICAS rules will continue to apply, i.e., ICAS+ does not require Solvency II tests and standards to be met
- The firm will need to confirm the scope of the material that should form part of the ICAS+ review
- ICAS review will seek to leverage IMAP work already conducted.
- The FSA intends to combine ICAS+ and IMAP processes and governance
- The main outcomes for ICAS+ review are listed as:
  - A review of the firm's ICA and setting ICG;
  - Feedback to the firm on the development of the Solvency II internal model; and
  - Updated work plan for the Solvency II model review.

Key Elements of ICAS+ (2)

- The FSA will review the in-development ORSA to facilitate the approach of the PRA, i.e., bringing together business model analysis, forward-looking capital planning, assessment of stress and scenario testing, evidence of use and capital risk management
- Some additional reporting will be required, e.g., data around stress testing, but full Solvency II reporting will not be required
- The current supervisory approach will continue for groups
- The FSA is working with EIOPA on the details of the interim measures and a consultation is planned for spring 2013

Expected Solvency II Timeline

Solvency II Expected Timeline (1)

Jan 2013 | Feb 2013 | Mar 2013 | Apr 2013 | May 2013 | Jun 2013 | Jul 2013 | Aug 2013 | Sept 2013 | Oct 2013 | Nov 2013 | Dec 2013

28 January 2013

Firms start LTGA

31 March 2013

Firms to submit results to their supervisor

14 April 2013

EIOPA to submit report to trilogue

12 July 2013

EC to publish final report

22 October 2013

Revised Omnibus II plenary vote

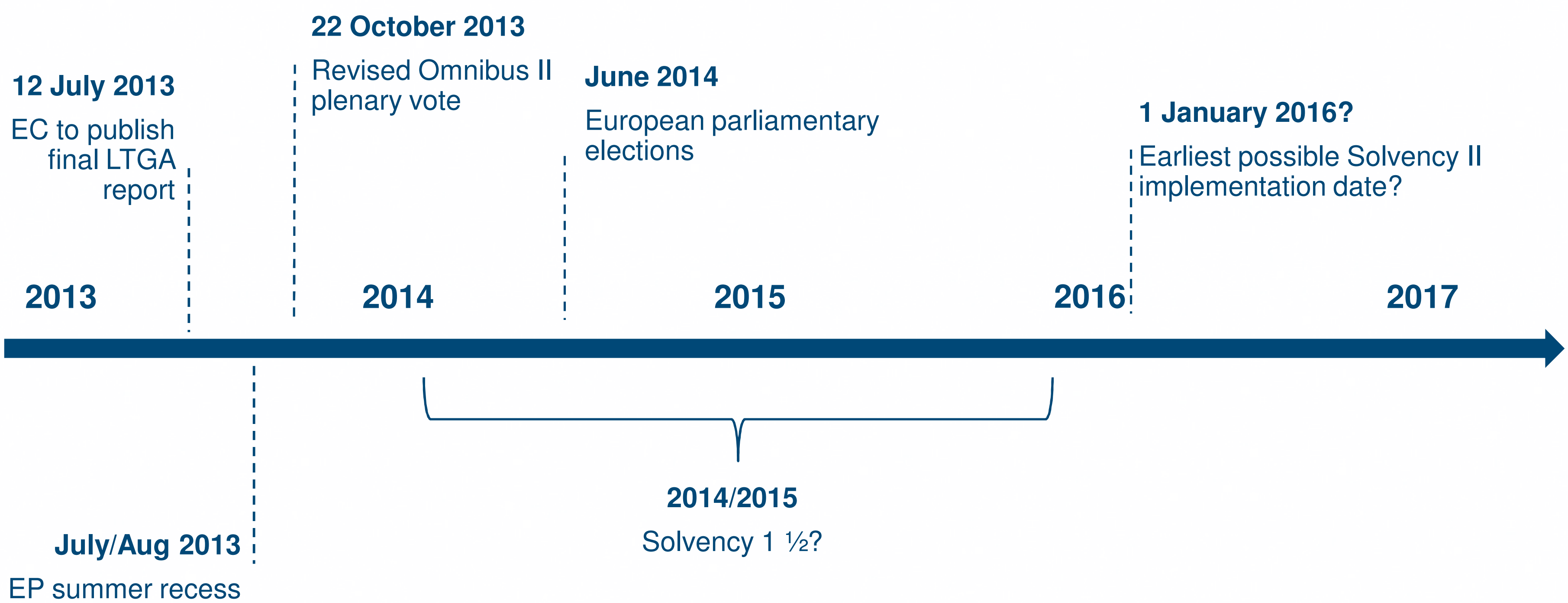
"Spring" 2013

EIOPA consultation on Solvency 1 ½ guidelines

Q3 2013

Trilogue discussions continue

Solvency II Expected Timeline (2)



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Whither Solvency II?

- Problems remain unresolved and no pan European risk based solvency regime comes in:
  - Potentially higher capital requirements than under Solvency II
  - Possible lower annuity rates if no matching adjustment
  - Intra-European regulatory arbitrage

- Agreement is reached, compromises are made:
  - Consistent capital requirements and a level playing field across Europe
  - If the matching adjustment allowed it will be beneficial to annuities
  - Firms can focus on developing products to meet needs rather than on regulation