IUMI 2008

VANCOUVER

Facts & Figures Committee

Solvency II update

Phil Ellis

September 15, 2008

"Solvency II is not just about capital.

It is a change of behaviour."

CEIOPS Chairman, Thomas Steffen

launching the framework directive in July 2007

Solvency II update

Structure of today's talk

- Reminder of the background
- Progress in last year
- Three pillars
- Capital calculation
- Implications for balance sheets
- Governance and risk management requirements
- Disclosures
- Final thoughts

- Anne to follow with implications for Marine Underwriters

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Background: The big questions

Where?	The European Union
	… but as a model for the world to follow
What?	Change view of risk management & solvency (Bal. Sheets)
	… but consistent with IFRS, so P&L too
Why?	Improve behaviour to manage and reduce risk
	… aiming for a coherent risk framework
How?	A change to internal procedures & modelling
	… but with the fallback of a standard model
When?	2012
	… but impacts already beginning to be felt
Who?	Accountants, actuaries, analysts
	… and everybody, including marine underwriters

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The major themes

- Principles based, not rules based
- Risk sensitive economic approach
  - Market-consistent values for both assets and liabilities
  - No arbitrary implicit margins or restrictions
  - Recognition of diversification effects
- Alignment with latest risk management techniques
- Proportionality
- Capital add-ons only applied as the exception and not the rule
- Promotion of internal models
- Group supervision

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What’s happened in the past year?

- Solvency II timetable confirmed
- QIS 4 completed … and QIS 5 conceived for 2009
- In-fill of various details within framework (… still incomplete)
- Consideration of “Own model” approval process (eg UK FSA first publication due this month)
- Other worldwide regulators moving in similar direction
- IFRS progress, broadly in parallel

- Subprime crisis / credit crunch hit banking sector

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Structure: Three pillars (simple version)

PILLAR 1	PILLAR 2	PILLAR 3
Measurement of Assets, Liabilities and Capital	Supervisory Review Process	Disclosure Requirements

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Three Pillars (reprise)

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Pillar 1	Pillar 2	Pillar 3
Quantitative requirements	**Supervisor review**	**Disclosure requirements:**
Technical Provisions Investment Framework SCR MCR	Internal controls, risk management, documentation, governance. Supervisory intervention The 'ORSA'	Frequent Forward-looking Relevant
Financial resource requirements for solvency purposes	**Additional capital evaluation based on internal assessment of risks and controls, subject to supervisory review**	**Requirement to disclose information relating to risk and capital levels, designed to exert discipline of market influence**

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The pillars in practice

Much of the market's initial concern was with **Pillar 1**

- Plans were more detailed, with "trial runs" QIS 1, 2, 3, 4, …
- Potentially large, visible effects ("distortions"?)
- Marine business all in one big class (split prop and non-prop)

More recent focus has included **Pillar 2**

- Regulator aim is widespread embrace of ERM culture
- ORSA is set to be much larger than UK ICA analyses
- Potentially very significant changes to procedures
- Except in the very largest and/or smartest companies(?)

And some are now starting to really worry about **Pillar 3**

- Disclosures will me *much* more comprehensive than currently

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Pillar 1 - Basis of Solvency II Calculations

Assets

- Market Values (or as close as possible)

Liabilities

- Best Estimate Economic Values (≈ transfer cost)
- Discounted for Future Investment Return
- Loaded with a prescribed Risk Margin (cost of capital)

Solvency Capital Requirement (≈ Minimum Capital)

- 1 in 200 chance of insolvency over one year horizon
- Reflects actual risk profile for company (realistic values)
- Either from complex set of cross-EU standard factors
- Or from agreed internal model

All more realistic than what we're used to!

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Solvency and Minimum Capital Requirements (SCR & MCR)

SCR by standard formulae for all European insurers *or* internal model

Current draft of standard model is not liked by many

- “too simple” and/or “too complex” (!)
- “Inappropriate for my business”
- “Geographical diversification more political than real”

Internal model approval process still unclear

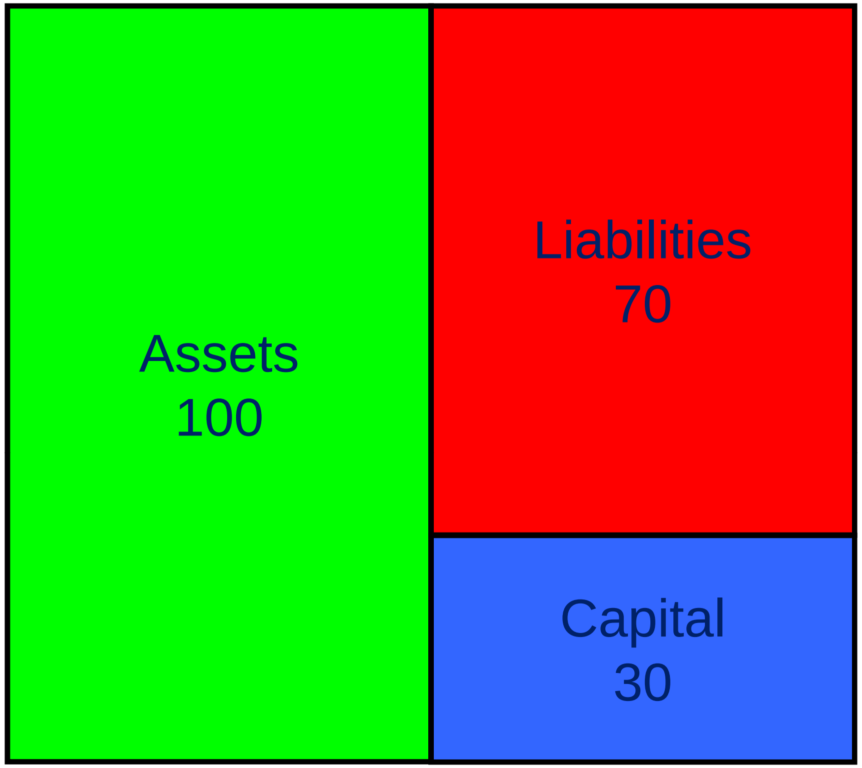
- But *will* clearly be onerous
- And multi-faceted … not “just a good capital model”
- And a huge task for the regulators

MCR is a lower “safety net” trigger for more active intervention

- Precise details still uncertain, but concept is clear

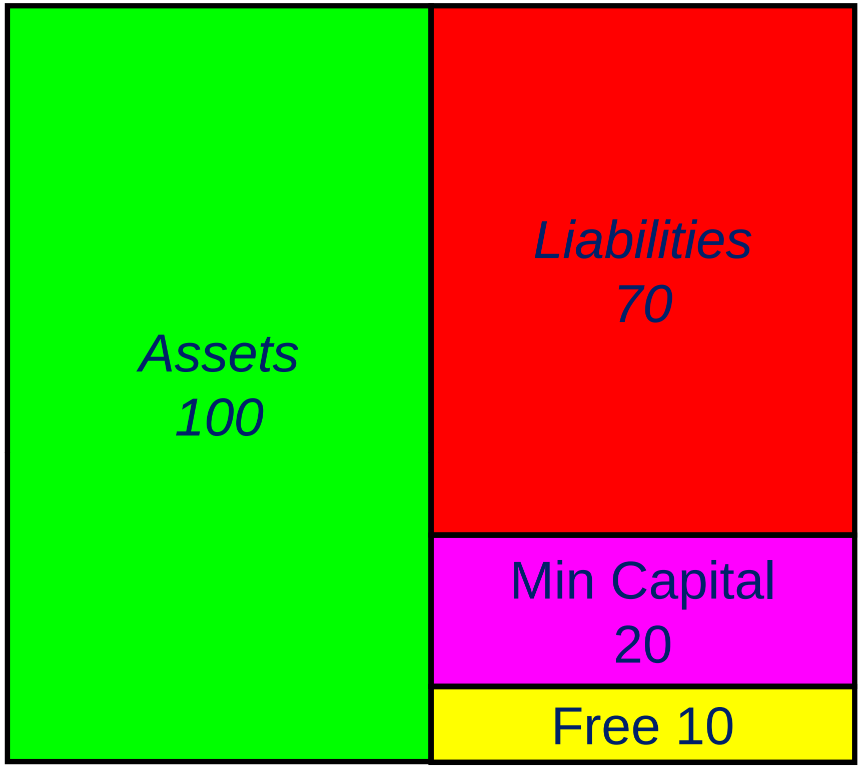
(Reminder) Pillar 1 Impact on the Balance Sheet

- Very Simple Balance Sheet



- Capital is Assets less Liabilities
- Regulator specifies minimum capital required

- A simplified balance sheet



If Min Capital is 20

Solvency ratio is
30 / 20 = 150%

Solvency II changes
each of:
- Assets
- Liabilities
- Min Capital (SCR)

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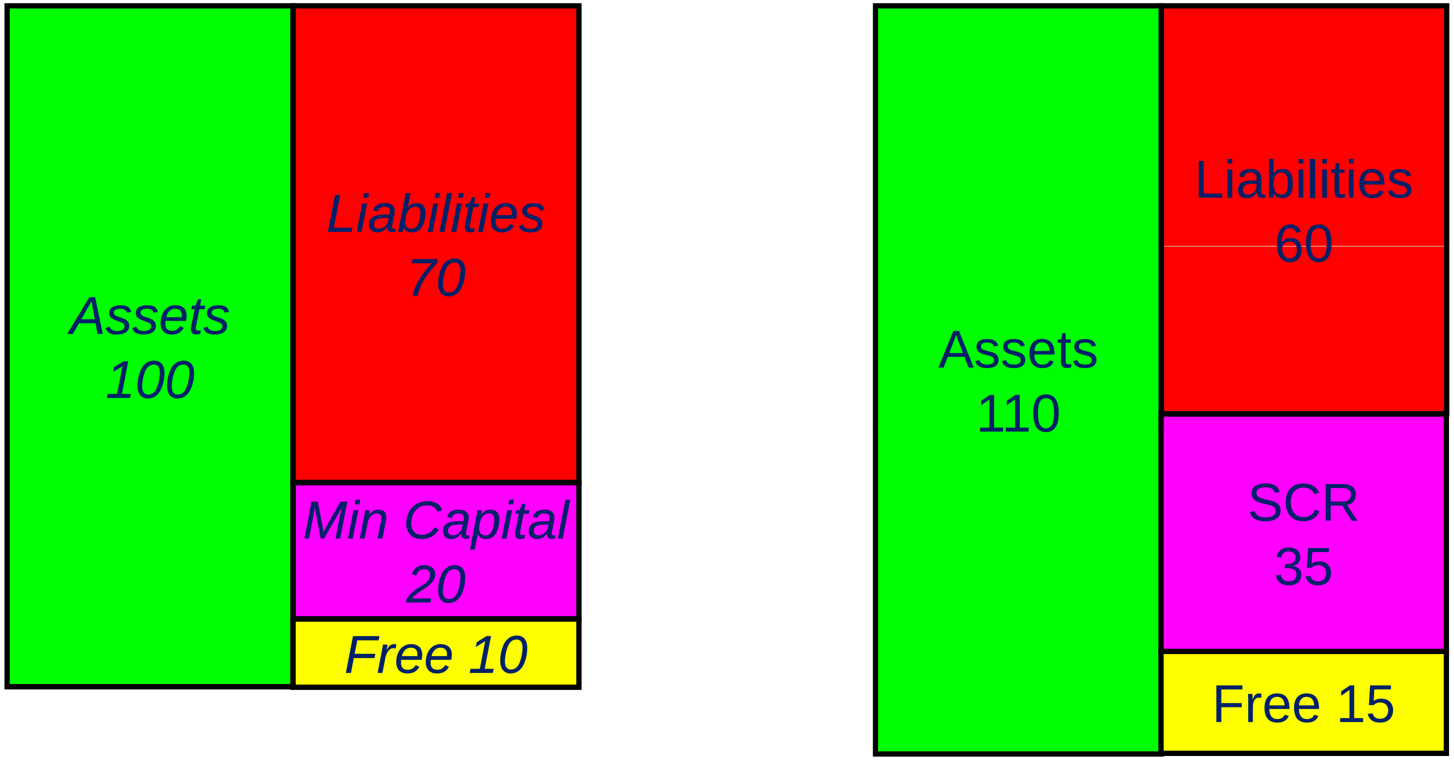
Balance Sheet Impacts - 1

Current Position (150%)

Solv II – “Plausible” (143%)



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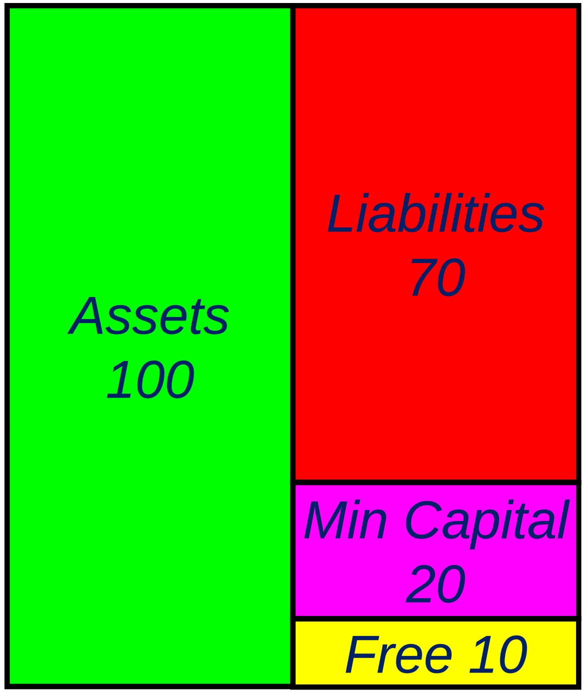
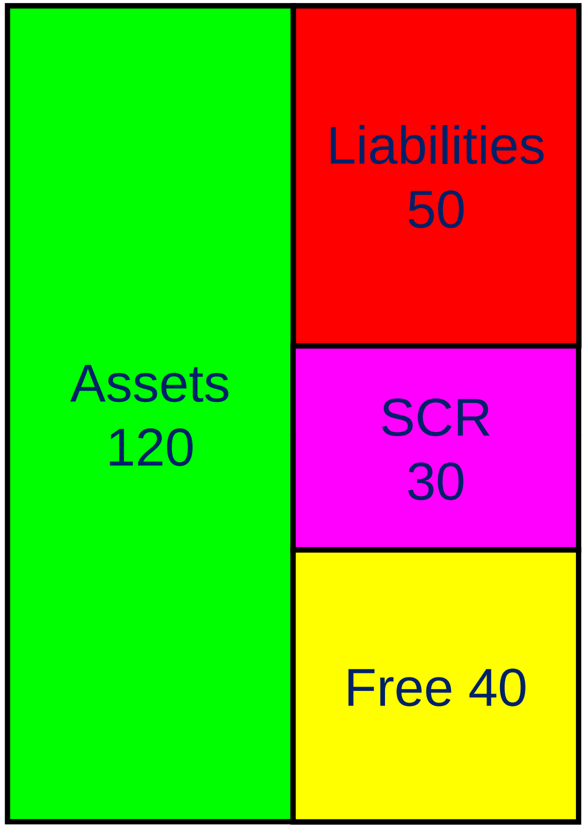
Balance Sheet Impacts - 2

Current Position (150%)



Solv II – "Good" (233%)



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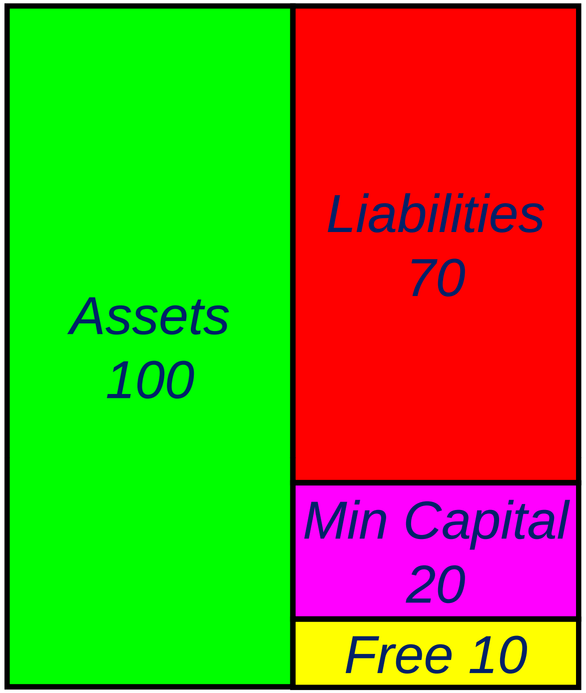
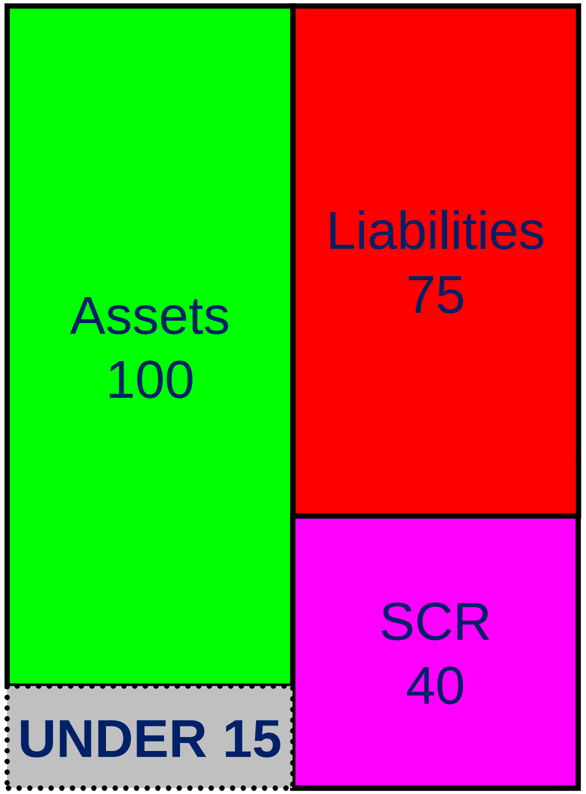
Balance Sheet Impacts - 3

Current Position (150%)



Solv II – “Bad” (62%)



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Who are the winners?

Relative Solvency Position improves where:

- Asset Valuations currently well below market values
- Liability Valuations currently well above best estimates
- Reduction for discounting exceeds risk margin addition
- SCR increase is relatively small
  - nature and scale of risks small
  - and/or risk controls excellent

- Some impacts are "guessable" from outside a company
- Others may be very hard to spot in advance
- Large companies may well gain (recognition of diversity)
- Group regulation should also get much easier

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Sensitivity of SCR to changes

SCR reflects all risks, valued at extreme probabilities(!)

- Time horizon is one year
- A key driver is prospective rating levels
- If rates have cycle +/- 20% around the mean
- Then SCR may vary by 2.5x over cycle (say)

- Self-correcting mechanism
- Reduce volumes of risky and/or unprofitable lines at bottom
  (A key element of SCR is new business risk)
- But lines do not move perfectly in phase with each other
- Pressure within companies on poorest rated areas

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Pillar 2 – Conditions governing business

- Firms need to have in place an effective system of governance which provides for sound and prudent management of the business
  - Specific requirements for risk management, internal controls, the actuarial function and control over outsourcing arrangements
- Clear articulation of risk strategy and appetite is required with associated limits on exposures and activities
- Firms must have in place an effective risk management system:
  - Including the strategies, processes and reporting procedures to monitor, manage and report the risk exposures of the company
  - Integrated into organisation structure and with contingency plans
- Demands on data quality and flexibility are onerous

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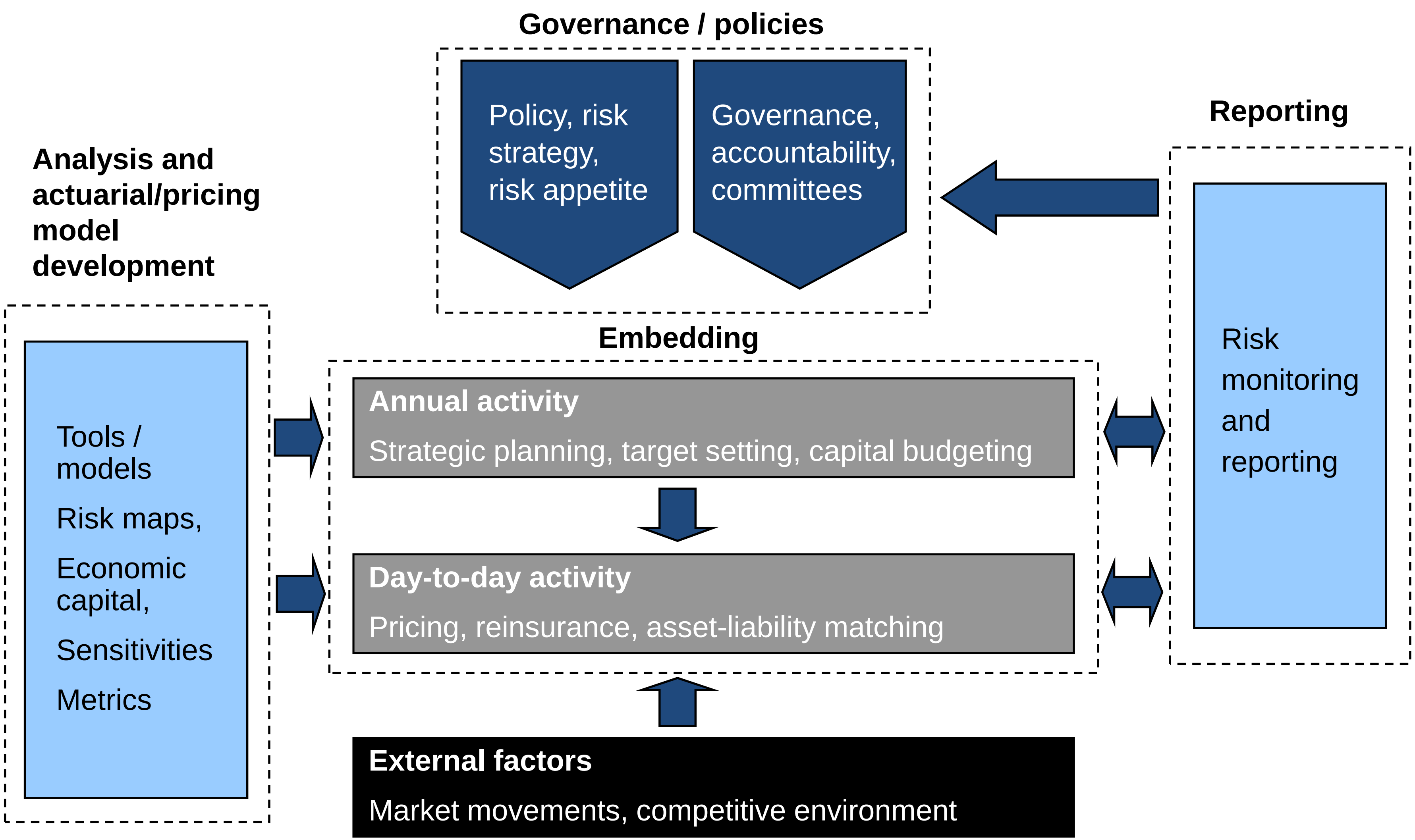
Illustrative Internal Model Framework



Source: Tillinghast

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What impact from “The Subprime Crisis”?

- Basel II banking regulation is the template for Solvency II
- Similar 3 pillars, same philosophy

- The subprime crisis is recognised as a widespread model failure
- Bank losses and write-downs total over $500billion (?!)
- High profile company failures

- But this is not thought to invalidate Enterprise Risk Management(!)
- … Insurers will just have to do it better

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Pillar 3 Disclosures

Annual, publicly available reports on solvency and financial condition

Include information on:

- Risk profile
- Governance systems
- Nature & performance of business
- Approach to valuation
- Approach to capital management

… Details and market practice to emerge over time

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Final thoughts

Regulatory Plans & Procedures still not final

Big demands on insurers and regulators

- Will change the way we "play"

"Proportional" enough for smaller companies?

Possible EU political compromises?

Other world regulators going same way

Good to be ready for this as early as you can!

Contact details

Comments and Questions are welcome

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