the hard number LLC
consulting group

Non-Bank Financial Institutions and Financial Stability in a Regional Context

Guyana – January 15-16, 2014

Solvency II and the Implications for Insurance Companies

Samer Saab – Senior Partner - the hard number LLC

OUTLINE

- Definition
- Timeline
- Key Features - The 3 Pillar Approach
- Comparing US and EU systems
- Likely Impact and Challenges
- Criticism
- Should you care?
- Conclusion

Solvency II- What is it?

- A new, harmonized EU-wide regulatory regime to replace 14 existing national insurance directives.

<u>Objectives</u>:

- Greater <u>risk</u> awareness in governance and operations.
- Deeper integration of EU insurance market.
- Enhanced policyholder protection.
- Improved competitiveness of EU insurers.

Solvency II- What is it?

- **Specifically,** it adopts a more dynamic risk-based approach and implements a non-zero failure regime, i.e., there is a 0.5 percent probability of failure.
- As a result, Solvency II sets out to establish a new set of capital requirements, valuation techniques, and governance and reporting standards to replace the existing and outdated Solvency I requirements.

Solvency II- Timeline

- The new framework is being implemented, in part, as a result of the previous market turmoil, which highlighted system weaknesses:
  - November 2009 – **Framework Directive adopted.**
  - December 2011 – Adoption of **Implementing Measures.**
  - December 2011 – Delivery of **Level 3 Guidelines.**
  - By January 2016 (?) Transposition of the Directive into **national laws.**

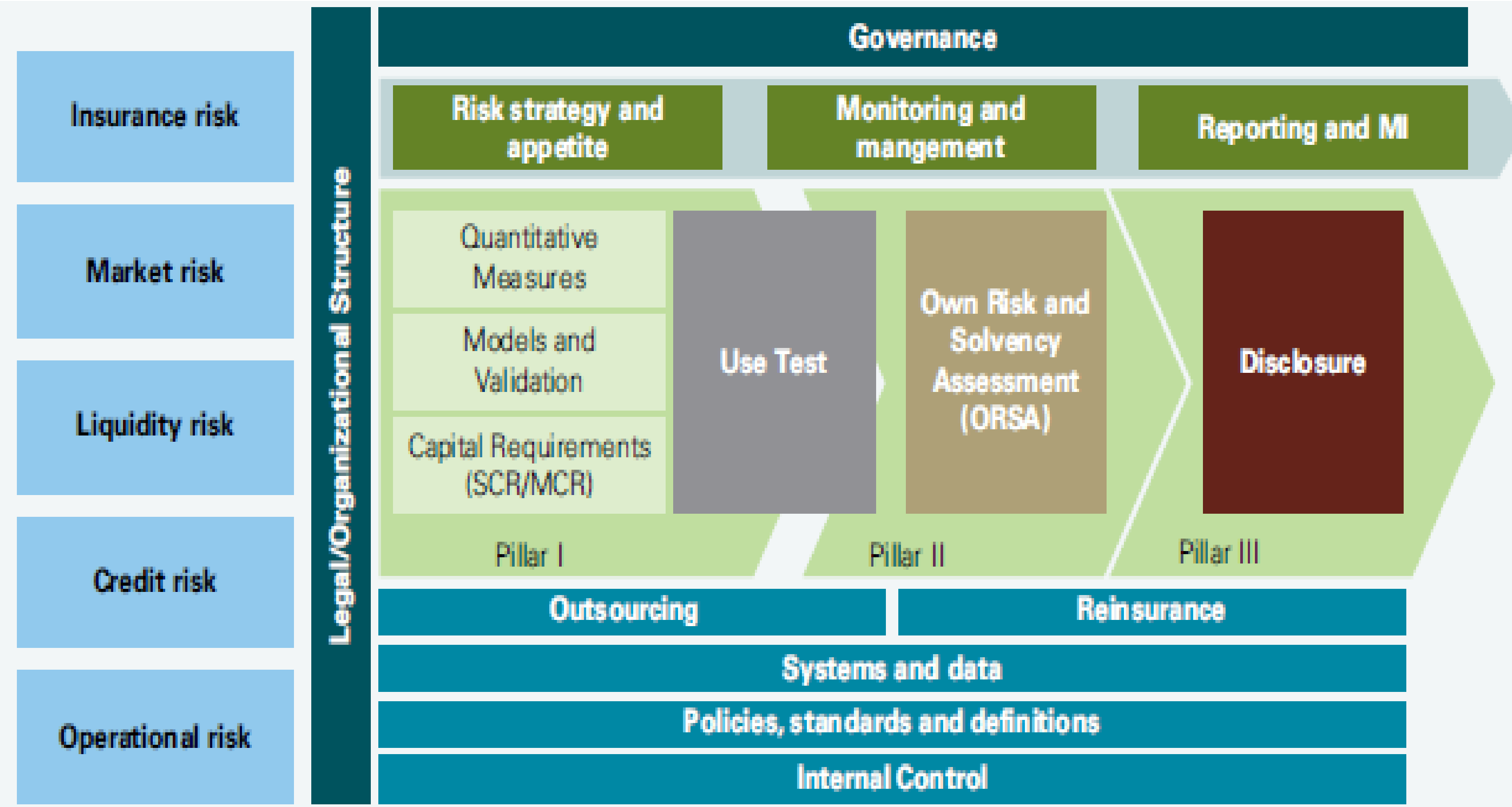
KEY FEATURES

- **Economic risk-based solvency requirements…**
  - …insurers required to hold capital against a range of risks, not just insurance risks.
- **Total balance sheet type regime…**
  - …all the risks and their interactions considered.
- Insurers required to **identify, measure and proactively manage risks…**
  - …introduction of Own Risk and Solvency Assessment **(ORSA).**
- **Supervisory Review Process.**
- **Greater public disclosure.**
- Strengthened role for **group supervisor.**

Key Features – The 3 Pillars

- The European Insurance and Occupational Pensions Authority (EIOPA) defines the three pillars as a way of grouping Solvency II requirements, which aim to promote capital adequacy, provide greater transparency in the decision-making process, and enhance the supervisory review process—all in the name of good risk management and policyholder protection.
- Achieved through the implementation of a holistic approach.

KEY FEATURES – THE 3 PILLARS



KEY FEATURES – THE 3 PILLARS

Harmonised EU-wide requirements

Pillar 1 Quantitative Requirements	Pillar 2 Governance & Supervision	Pillar 3 Disclosure & transparency
Measurement of assets, liabilities and capital. An insurer's SCR (Solvency Capital Requirement) is calculated by a standard formula or a supervisor-approved internal model.	Effective risk management system. Own Risk & Solvency Assessment (ORSA). Supervisory review & intervention.	Detailed public disclosure requirements. Improve market discipline by facilitating comparisons. Regulatory reporting requirements.

the hard number LLC
consulting group

Pillar 1 requires demonstration of adequate financial resources

- Six components of quantitative requirements:
  - Asset/Liability valuation
  - Technical provisions: best estimate liabilities plus a risk margin
  - SCR
  - MCR
  - Own Funds: arranged in tiers
  - Investments: no restrictions on asset classes, but under prudent person investment principles (PPIP).

PILLAR 1 REQUIRES DEMONSTRATION OF ADEQUATE FINANCIAL RESOURCES

- **Minimum Capital Requirement (MCR)**
  - Below the MCR, **policyholders are exposed to unacceptable risk.**
  - **Breaching the MCR leads to serious supervisory action.**
- **Solvency Capital Requirement (SCR)**
  - At a **confidence level of 99.5% over one year.**
  - May be calculated using **standard formula…**
  - …or an **internal model, with supervisory approval.**
  - Both calculation methods take at least **six specified risk modules** into account.

THE SCR CAN BE CALCULATED IN 2 WAYS …

The standard formula

- Detailed in Solvency II rules
- The default option
- Formulaic factor based calculation
- Not "firm" specific
- A means of calculating SCR only – no wider significance

vs

The internal model

- Standards set out in Solvency II rules
- Regulator pre-approval required
- Specific to individual firm and risk profile
- Can be partial or full
- Must be widely used and play an important part in firm's system of governance

Pillar 2 includes developing and embedding governance requirements

- An insurer must have an **effective risk management system…**
  - …owned and implemented by **senior management.**
  - Must consider **all risks to which insurer is exposed.**
  - **Risk and capital management must be integrated.**
- An insurer must undertake an **Own Risk and Solvency Assessment (ORSA).**
  - **Internal risk assessment process.**
  - Aims to ensure senior management have conducted a review of risks…
  - …and that the insurer holds **sufficient capital against those risks.**

PILLAR 3: HARNESSING MARKET DISCIPLINE TO SUPPORT REGULATORY OBJECTIVES

- Aims to ensure **consistent supervisory reporting and disclosure** across the EU.
- Detailed harmonized reporting requirements still to be finalized.
- Insurers should be prepared to **disclose more information publicly** than at present.
- The requirement will include producing:
  - Public, annual **Solvency and Financial Condition Report (SFCR);**
  - **Report to Supervisors (RTS) on a quarterly/annual basis.**

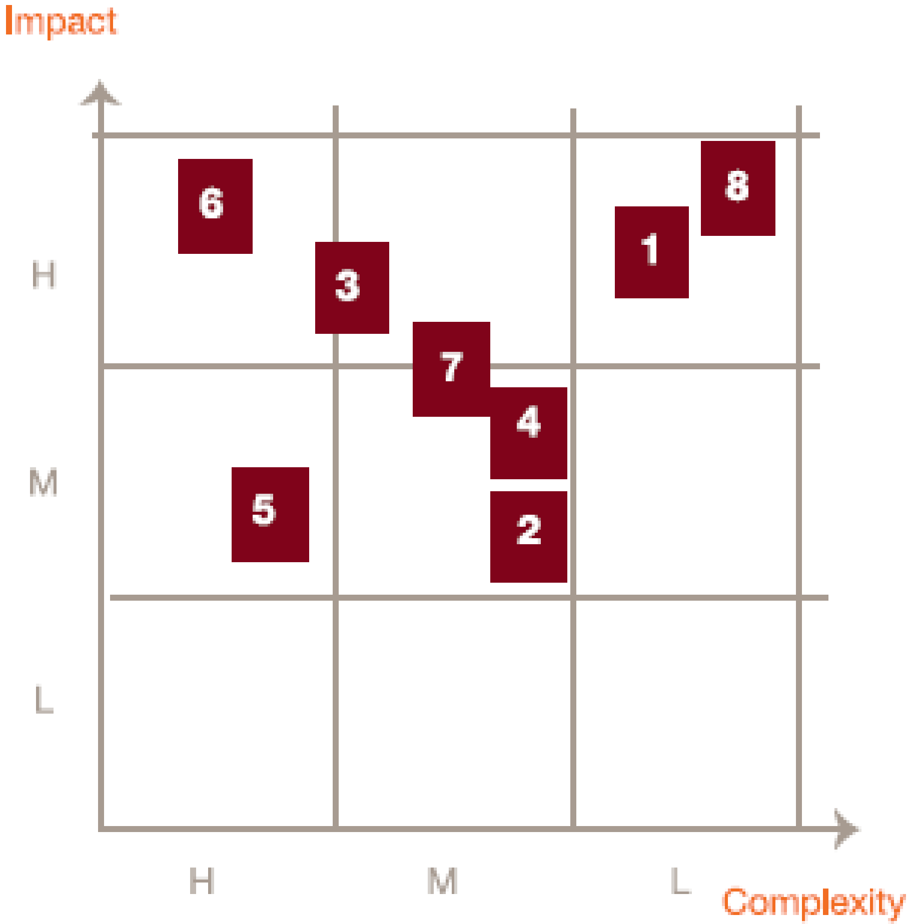
UK vs. US system

- While both Solvency II and the RBC standards in the United States share the common goals of protecting policyholders and strengthening insurers through sound regulation, they are very different.
- Like Solvency II, the NAIC's Solvency Modernization Initiative (SMI) program is seeking to make enhancements to the current RBC regime.

UK vs. US system

	Current RBC Model	Solvency II Internal Model
Methodology	Static factor model	Dynamic cash-flow model
Rule vs. principle based	Rules-based, except variable annuities	Principles-based
Total balance sheet approach	No	Yes
Definition based on market or book values	Book value	Market value, i.e., economic balance sheet created
Classification of available capital	No	Yes, economic value of assets and liabilities
Consideration of off-balance-sheet items	No	Yes
Time horizon	1 year	1 year, with planning cycle for ORSA
Risk measure	No risk measure	Value at risk/99.5 percent confidence level
Operational risk	Not explicitly (implicit via business risk)	Explicitly modeled
Catastrophe risk	Not specifically identified and considered in NAIC formula	An important shock component of the insurance risk component
Correlation among risk categories	Only considered correlation for credit risk and reserve risk; square root formula assumes other risk components are independent	Consider correlation within and across risk categories
Consideration of management risk	No, but future linkages between risk assessment and capital impact are being considered under the SMI initiative	Yes

IMPACT AND CHALLENGES



SURVEY RESULTS

1. Operational impact on benchmarking
2. Changes to Mandates and Service Level agreements
3. New investment strategies
4. Operational / IT changes
5. Market Value reporting
6. Reporting cycles
7. Risk Management
8. Cultural change

the hard number LLC
consulting group

Industry concerns and criticism

- Cost of implementing is high and resources are stretched
- Timescales are tight to achieve all that is required, and delays to Solvency II start date exacerbate frustration over regulatory uncertainty.
- Consistency of implementation across Europe, treatment of non-European entities (Equivalence)
- Lack of guidance in some key areas (e.g. ORSA)
- Onerous documentation requirements (quarterly reporting, no standardized format)

Should you care?

- Although it is a European directive, Solvency II will have both direct and indirect implications for the global insurance industry.
  - Direct implications relate to those companies who have direct compliance requirements such as subsidiaries of European parents or parents with European subsidiaries.
  - More importantly, companies are also likely to face indirect impact from changes in market competition, rating agencies' expectations, and regulatory regimes.
  - A trend of regulatory harmonization is already emerging, with other countries seeking to achieve equivalence to Solvency II through the adoption of risk-based regulatory frameworks.

Conclusion

- Solvency II will foster a holistic and forward-looking appreciation of (all) risk within the European insurance industry.
- Likely to initiate a global regulatory domino-effect.
- It's a long process with (already) implementation and adoption delays…
- …global debate shifts toward alternatives to convergence and towards SIFI designation. Special concern with the intersection of a new regulatory framework with enhanced requirements placed upon large, international insurers.