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# Update on Solvency II

Thomas C. Wilson

## Solvency II draft Framework directive

### Issued in July:

- Favourable reception by CRO Forum.
- A brief summary of the key aspects of the draft directive are:
  - Market consistent valuation of assets and liabilities
  - A Solvency Capital Requirement (SCR) based on 99.5% Value-at-Risk (VaR) confidence level over a one year horizon. It will take into account diversification effects and risk mitigation techniques.
  - Allowance of internal models (when approved)
  - A Minimum Capital Requirement (MCR) represents a threshold below which policyholders are exposed to an unacceptable degree of risk.

## Major priorities that require further work (1/2)

### Reflection of structural mismatch between assets and liabilities

- The CRO Forum is concerned that this could allow the inappropriate treatment of equity risk (or other asset risk) in the standard SCR by tagging equities with a liability-based holding period. This may make some firms reluctant to change their positions or put regulators in a difficult position following a crash.
- We believe this can be adequately addressed by other means such as the ladder of intervention or Pillar II measures, i.e. by clearly stating that the intervention should depend on the overall risk situation of the company. We have communicated this view to CEIOPS and the EU Commission.

### Structure and calibration of the MCR

- The CRO Forum is concerned that a modular approach may be proposed, given the testing of such approaches in QIS2 and QIS3. Such an approach would raise the following concerns:
  - There is no guarantee that the MCR will be well below the SCR.
  - The ladder of interventions will only work when there is a relation between MCR and SCR.
  - Also the modular approach does not guarantee that the calibration will not artificially restrict group diversification benefits
- We endorse the CEA's suggestion that the solo MCR is calculated as a percentage of the last SCR approved by the supervisor, whether calculated using an internal model or the standardized approach.



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## Major priorities that require further work (2/2)

### Diversification

- Although the draft directive recognizes diversification benefits, the CRO Forum is concerned that the extent of group diversification benefits available in fact may be limited, as the calculation of the group SCR is "on the basis of consolidated data"
- This could result in diversification benefits being related to legal entities and not to risks and their inter-dependencies.
- In particular, ruling out geographical diversification benefits would be an arbitrary restriction of group diversification benefits.

### QIS 3 – CRO Forum benchmarking study

- Total capital requirements are similar under QIS3 and internal models for market risks
- Different levels of conservatism for each type/class of risk
- Life Solo: QIS3 produces higher capital requirements than internal models
- Non-life solo: QIS3 capital requirements are systematically higher than internal models
  - There are significant variations by company
  - The underwriting risk component is calibrated conservatively
  - The catastrophe risk component is not appropriate
- The Qualitative Impact Studies (QIS) are important for the EU and CEIOPS to calibrate the standard model and for agreement with the diversification benefits. Therefore the CRO Forum is in the process of developing recommendations for QIS 4.



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## Potential strategic implications

### Level of industry capitalization - stable

- Solvency II requirements are expected to be higher than under the current regime, reflecting increased risk coverage and greater differentiation by risk
- However, most companies base pricing and risk management already on higher requirements to better reflect economic risk and to meet rating agencies requirements

### Business lines/product mix - stable

- Solvency II is likely to reinforce economic risk-based pricing
  - Riskier products, e.g., those with financial options and guarantees, NATCAT, etc., will possibly attract more capital
  - On the other hand there will also be products that need lesser capital, like term products and some non-life products

### Level of industry consolidation – stable trend

- Solvency II should accurately reflect both diversification and risk mitigation, so that smaller companies also benefit

### Transparency and Disclosure - improved

- Disclosure requirements will increase, but should line up with IFRS requirements



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## Potential management implications

### Reporting for Solvency II

- Significant workload for developing internal models and control environment
- The work related to the standard formula depends on the design and complexity of such standard model.

### Managing in-force book of business

- Improved capital and balance sheet management and increased transfer/hedging through derivatives, insurance securitization, reinsurance and dividend policy, etc.
- Potential change in crediting behaviour and product re-rating

### Product pricing and design

- Structuring, underwriting and pricing of financial components using capital markets techniques
- Improved design and pricing of customer behaviour (e.g. surrender) and own behaviour (e.g. crediting policies)
- Restructuring financial guarantees, aligning customer willingness to pay versus cost of production

### Corporate skills

- Financial Engineering skills as complement to traditional actuarial skills
- Greater investment in financial controls and trading systems



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