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The Geneva Association - General Secretariat - 53, route de Malagnou - CH-1208 Geneva
Tel.: +41-22-707 66 00 - Fax: +41-22-736 75 36 - secretariat@genevaassociation.org - www.genevaassociation.org

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Layout & Distribution: Valéria Kozakova

Solvency II: Current Developments and Unresolved Issues

Rob Jones

Agenda

- Market impact
 - Group support
 - Equity capital requirements
 - SCR and MCR calibration
 - (IFRS Phase 2)
 - Changing competitive landscape
- Impact on ratings
 - How does Solvency II compare with our rating approach?
 - How will Solvency II change our rating approach?
 - Economic capital model analysis

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Solvency II: Our Views On Market Impact

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Group Support (1)

- **Initial proposal to allow subsidiaries to cover only MCR rather than SCR, with difference made up by parental guarantees**
 - Would allow groups to downstream diversification benefits to subsidiaries
 - Fundamental to Directive
 - Smaller member states opposed
 - Council of Ministers versus EC and EP
- **CEA supportive although most insurers (quietly) opposed**
- **Implications of absence**
 - Undermines group solvency proposals
 - Loss of market efficiency / competitiveness
 - Local / multiple internal model validations

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Group Support (2)

- **Market response**
 - Group structure rationalisations accelerated
 - Incentives for other domiciles to modernise reduced
- **Possible solutions**
 - Transitional arrangement?
 - Member state option?
- **However, not worth sacrificing Solvency II**
 - Solvency I is not fit for purpose

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Capital Requirements For Holding Equities

- **QIS 2 tested 40% for global equity SCR**
- **QIS 4 tested 32% and a dampener (reduced SCR by 10%)**
- **Per QIS 4 report: Majority of insurers and supervisors believe minimum should be 40% and believe dampener lacks credibility**
- **Internal models average equity stress = 39% per QIS 4**
- **Opposition effectively questions time horizon**
- **Possible solution**
 - Pillar 2 shadow SCR (CRO Forum proposal)?
- **Over to the Czech presidency!**

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SCR Calibration

- **Internal model SCR / Standard SCR (median ratios)**

- Equity risk 108%
- Property risk 107%
- Mortality risk 130%
- Operational risk 133%

- **Incentive to provide internal model?**

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Impact On Capital Adequacy

- **Based on QIS 4: 11% of Europe's insurers fail to cover SCR (QIS 3: 16%) but:**

- Only 28% participated in QIS 3 (QIS 3: 20%)
- What about the buffer?
- Capital adequacy at cyclical peak (QIS 4 based on 2007 balance sheets, QIS 3: 2006)

- **Offsets**

- Insurers' incentives
- Downstreamed diversification benefits (based on group support)

- **25% of Europe's insurers may need to:**

- Raise capital
- Buy more reinsurance or other mitigants
- Reduce risk
- Write less business
- Merge or be acquired
- Close to new business

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MCR Calibration

- **QIS 4 tested linear approach with corridor of 20% - 50% of SCR**
- **Imperfect solution**
 - Only 55% inside the corridor (life 44%, non-life 67%)
 - 27% of insurers at the floor
 - 17% of insurers capped
- **Workable solution per QIS 4 report *but***
- **Many supervisors prefer compact approach (35% of SCR)**
- **Directive wordings narrow corridor to 25% - 45%**
 - May be narrowed further?

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Implementing Measures Work In Progress

- **Validation of Solvency II balance sheet**
 - Solvency II / IFRS differences
 - Financial turmoil issues
- **Pro-cyclicality**
- **Correlations, structured products, equity volatility**
- **Quality of capital**
 - Hybrid capital

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Competitive Landscape Changes

- **Pillar 1 diversification benefits will give the bigger, more diversified groups capital relief and a pricing advantage**
 - *Smaller insurers may find it increasingly difficult to compete while providing similar returns to their owners (depends on group support!)*
- **Risk management capability and sophistication required to respond to Solvency II is demanding**
 - *Systems overhauls may be needed, actuarial skills are in short supply*
 - *Insurer readiness (Simplifications and Proxies used extensively in QIS 4)*
 - *Supervisor readiness (63% of insurers to use internal models per QIS 4)*

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Solvency II: Impact On Ratings

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How Does Solvency II Compare With S&P's Rating Approach?

- **Different objectives**
- **Supervisors operate the traffic lights**
 - Licensing
- **Rating agencies provide 'shades of green'**
 - Rating scale
- **Some convergence of processes under Solvency II**
- **Good preparation for Solvency II?**

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Elements Of S&P Analysis Mapped To Solvency II

| | |
|---|-----------------|
| 1. Management & corp. strategy | Pillar 3 |
| 2. Enterprise risk management | Pillar 2 |
| 3. Industry risk | Pillar 3 |
| 4. Competitive position | Pillar 3 |
| 5. Operating performance | Pillar 3 |
| 6. Capitalisation | Pillar 1 |
| <ul style="list-style-type: none"> • Capital adequacy • Reserves • Reinsurance ceded | |
| 7. Investments and Liquidity | Pillar 1 |
| 8. Financial flexibility | Pillar 3 |

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How Will Solvency II Change S&P Rating Approach?

- **Overall approach unlikely to change**
 - Smooth transition by 2013
 - ERM analysis already well established
 - ECM analysis will be well established by 2013
- **However:**
 - Criteria required for group support
 - Supervisory view of capital adequacy will become more important (especially less well diversified insurers)
 - Industry risks (competitive landscape) will change



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ECM Example Of Proposed Calculation

| AA rating level | Standard & Poor's charges | AA rating level | Company's charges |
|-----------------|---------------------------|------------------|-------------------|
| Credit Risk | 200 | Credit Risk | 100 |
| Market Risk | 500 | Market Risk | 300 |
| Non-life risk | 200 | Non-life Risk | 250 |
| Life risk | 150 | Life Risk | 300 |
| Diversification | (50) | Operational Risk | 150 |
| TOTAL | 1000 | Diversification | (300) |
| | | TOTAL | 800 |



Credibility factor is 20%

New Standard & Poor's diversified Target Capital =
 $1000 * 80\% + 800 * 20\% = 960$



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Areas To Be Reviewed

- The model set-up and controls
- Model validation processes
- Model documentation
- Valuation of assets and liabilities
- Modelling approaches for each risk type
- Diversification approach
- Fungibility of excess capital
- Risk mitigation activities
- Stress and scenario tests completed
- Absolute model results for specific risks in specific markets
- Assumption setting process
- Resulting assumptions
- Definition of risk quantum
- Company specific exposures and offsets
- Drivers of differences from S&P capital model
- External reviews carried out by consultants and regulators

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Evolution

- S&P expects that the maximum degree of reliance on internal models will start low and increase over time
- Factors that will increase reliance:
 - S&P's knowledge of (and comfort with) the individual company's model increases with successive reviews
 - S&P builds confidence in the range of industry practice over time
 - Industry practice converges (not necessarily to a single practice)
 - S&P builds confidence in the range of reasonable results of models over time

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Email: rob_jones@standardandpoors.com
Phone: +44 (0)20 7176 7041

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Appendix: S&P Commentaries

- **30 May 2007: Beware Solvency II: As The 2010 Implementation Date Looms Closer, European Insurers Should Ignore It At Their Peril**
- **31 May 2007: New Risk-Based Insurance Capital Model**
- **6 September 2007: Economic Capital Review Process For Insurers: Criteria Update**
- **12 March 2008: One In Four Of Europe's Insurers Could Face Major Strategic Decisions Under Solvency II**
- **28 April 2008: European Insurers Continue To Develop Their Enterprise Risk Management Capabilities**

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