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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**

2.

STANDARD &POOR'S

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

5.

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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!**

6.

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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?**

7.

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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

8.

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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?

9.

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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

10.

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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)*

11.

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Solvency II: Impact On Ratings

12.

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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?**

13.

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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**
• Capital adequacy	
• Reserves	
• Reinsurance ceded	
7. Investments and Liquidity	**Pillar 1**
8. Financial flexibility	**Pillar 3**

14.

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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

ECM Example Of Proposed Calculation

AA rating level	Standard & Poor's charges
Credit Risk	200
Market Risk	500
Non-life risk	200
Life risk	150
Diversification	(50)
TOTAL	**1000**

AA rating level	Company's charges
Credit Risk	100
Market Risk	300
Non-life Risk	250
Life Risk	300
Operational Risk	150
Diversification	(300)
TOTAL	**800**

Credibility factor is 20%

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

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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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**