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A Revolution in Insurance Company Supervision: Solvency II

Rob Jones

Agenda

- How effective will Solvency II be?
- Will there be more insolvencies under Solvency II?
- How transparent will Solvency II be?
- Will Solvency II be highly politicised?
- Are supervisors and insurers ready?
- Will Solvency II result in market consolidation?
- How does Solvency II compare with the S&P's rating approach?
- How will Solvency II change S&P's rating approach?

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How Effective Will Solvency II Be?

- **Too early to say due to:**
 - Political influence
 - Calibration of standard model (Pillar 1)
 - Development of Pillars 2 and 3
 - Execution by EC
 - Execution by member states
 - Execution by supervisors

- **Potential for more intelligent and risk-sensitive supervision**

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Will There Be More Insolvencies Under Solvency II?

- **Track record in continental Europe is good**
- **Difficult to maintain under Solvency II**
- **Political decision needs to be taken regarding tolerance of insurer failure**
- **EC has working hypothesis of risk of ruin probability of 0.5% based on one-year horizon**
 - Greater level of risk tolerance than that of many European supervisors and governments historically

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How Transparent Will Solvency II Be?

- **We don't know**
- **Supervisory returns currently not public documents other than U.K. and Ireland**
- **More public domain information under Solvency II Pillar 3**
- **Pillar 2 capital loadings may not be public**

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Will Solvency II Be Highly Politicised?

- **Yes**
- **But consultation is happening well in advance of implementation**
- **The potential political consequences of Solvency II :**
 - Policyholder guarantee schemes to respond to the insurer insolvencies under Solvency II
 - Pricing will be increasingly risk sensitive with more risks becoming uninsurable or unaffordable (earthquake, flood or construction defects)
 - Greater disincentives for insurers to hold equity investments
 - Lower equity content in insurance products offered to consumers
 - Limiting future retirement financing through pension products

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Are Supervisors and Insurers Ready?

Supervisor readiness:

- 1 UK
- 2 Switzerland
- 3 Netherlands, Denmark
- 4 Germany, France, Italy, Spain

Companies' readiness: Similar except CRO Forum members

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Will Solvency II Result In Consolidation?

- It will accelerate consolidation
- Consolidation is already advanced in many markets
- In much of Continental Europe consolidation still has a long way to go
- But regardless of Solvency II, survival depends on:
 - being good at what you do, *and either*
 - having scale and/or diversity, *or*
 - having a defensible niche
- Added transparency

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Direct Market Impacts

- **Capital requirements to increase substantially but partly covered by available capital**
 - *No industry-wide capital raising, but some will need to. Some owners will have the capacity and willingness to contribute new capital, others will not.*
- **Pillar 1 diversification and size 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*
- **Risk management capability and sophistication required to respond to Solvency II is demanding**
 - *Systems overhauls may be needed, actuarial skills are in short supply*

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

- **Converging But Differentiated Approaches**
- **Some common interests with supervisors**
- **"A rating is a rehearsal for Solvency II"**
- **Some companies use rating process purely as a management discipline**
- **Eight elements**

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Elements of S&P Analysis Mapped to Solvency II

1. Management & corp. strategy	Pillar 2
2. Enterprise risk management	Pillar 2
3. Industry risk	N/A
4. Competitive position	N/A
5. Operating performance	N/A
6. Capitalisation	Pillar 1
• Capital adequacy	
• Investments	
• Reserves	
• Reinsurance ceded	
7. Liquidity	Pillar 1
8. Financial flexibility	N/A

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Pillar 1 Type Analysis

- **Capital adequacy model operated in Europe since 1997**
- **Third enhancement launched 14 November 2006**
- **Results of credible internal EC models (as part of strong ERM) will influence our view of capital adequacy**
- **Consistent with the incentives built into Solvency II**

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Pillar 2: ERM Evaluation Components



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How Will Solvency II Change S&P's Rating Approach?

- **Overall approach unlikely to change**
- **However:**
 - Understand any concerns the supervisor has arising from Solvency II supervision
 - Supervisory view of capital adequacy will become more important
 - Industry risks will change

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