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Solvency II Framework
IUMI Conference

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Global Regulatory Tendencies

Reliance on investment profits

Acceptance of negative technical results to obtain cash to invest in market

Risk management often no issue

Some fixed rules, limits, prudence

Self-regulation

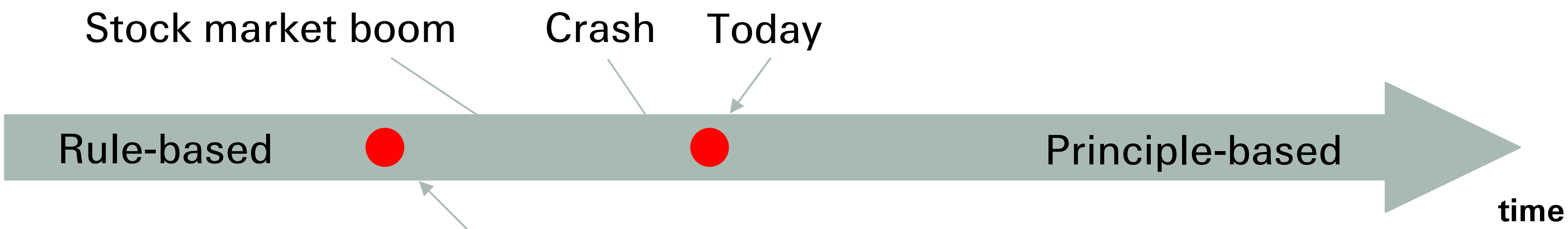
Still some loss making long-tail business in the books (life and non-life)

Smaller investment profits

Scarce capital

Explicit requirements on risk management, risk-based capital requirements, transparency

Strengthening of supervision



Cartels

Build-up of hidden reserves

Liberalisation

international expansion

Competition

Possibly more volatile results, better ALM, possibly different business models

Solvency II – aims of the projects

Solvency II project established by EU in 2001 and covers both direct insurance companies and pure reinsurance companies.

- The aims of the Solvency II project are to:
  - Set solvency standards to match risk and encourage proper risk control and be in line with IAIS requirements
  - Harmonise standards across the EU to avoid need for Member States to set higher standards
  - Bring assets and liabilities onto a "fair value" basis, if possible, consistent with IASB valuation
  - Set capital requirements to permit timely intervention by the supervisor
  - Have regard to Basel II for banks, with same "3 Pillar" approach – although definitions of Pillars not identical
  - Not be too onerous to operate for smaller companies.

The 3 Pillar Approch to Solvency II

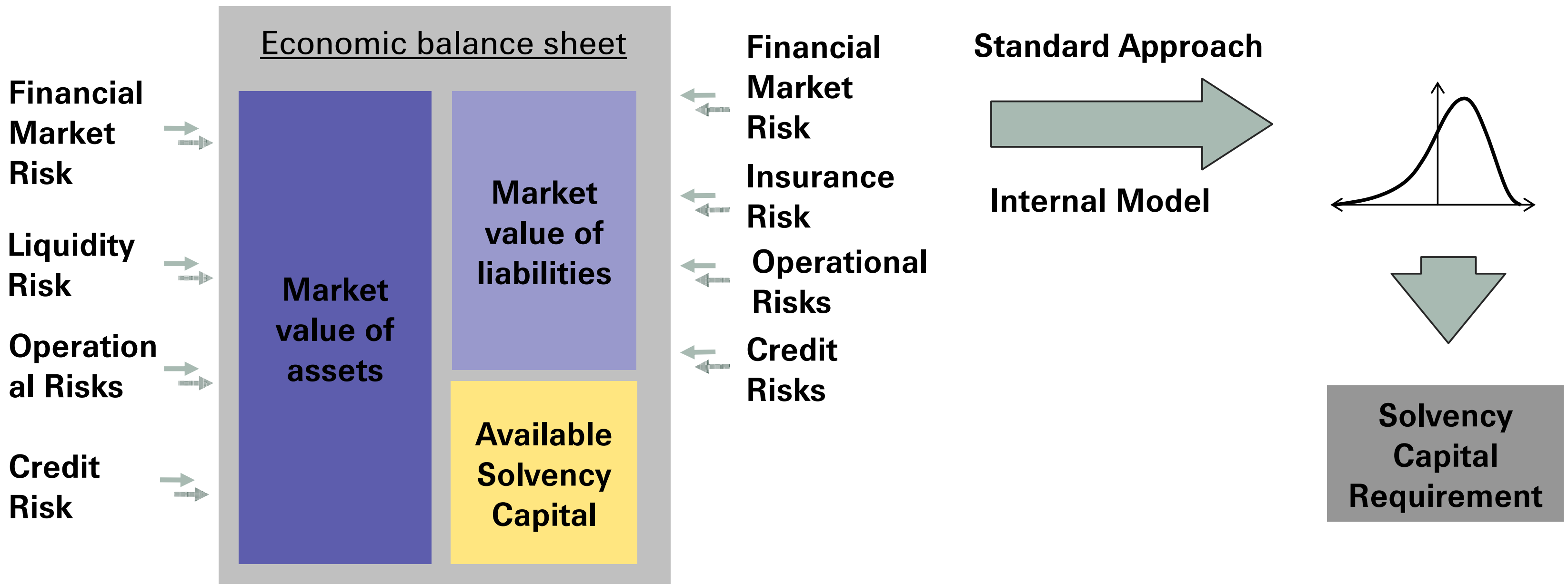
3 Pillar Approach

Pillar I	Pillar II	Pillar III
Quantitative capital requirements • Available capital: economic valuation of assets & liabilities • Required capital: standard risk model or internal risk models	**Supervisory review** • Strength and effectiveness of risk management systems • Risk governance (incl. allocation of responsibilities) • Documentation of system and controls (incl. policies, guidelines)	**Transparency** • Transparency on risks appetite and risk strategy • Public disclosure of methodology

Pillar I: An economic view on assets, liabilities and risks

Pillar 1

- All assets and liabilities need to be valued on a market consistent basis
- Available Solvency Capital is defined as Market Value of Assets minus Market Value of Liabilities
- All risks (and their interactions) that assets and liabilities are exposed to have to be considered



Pillar I:
Solvency Capital Requirement (SCR)

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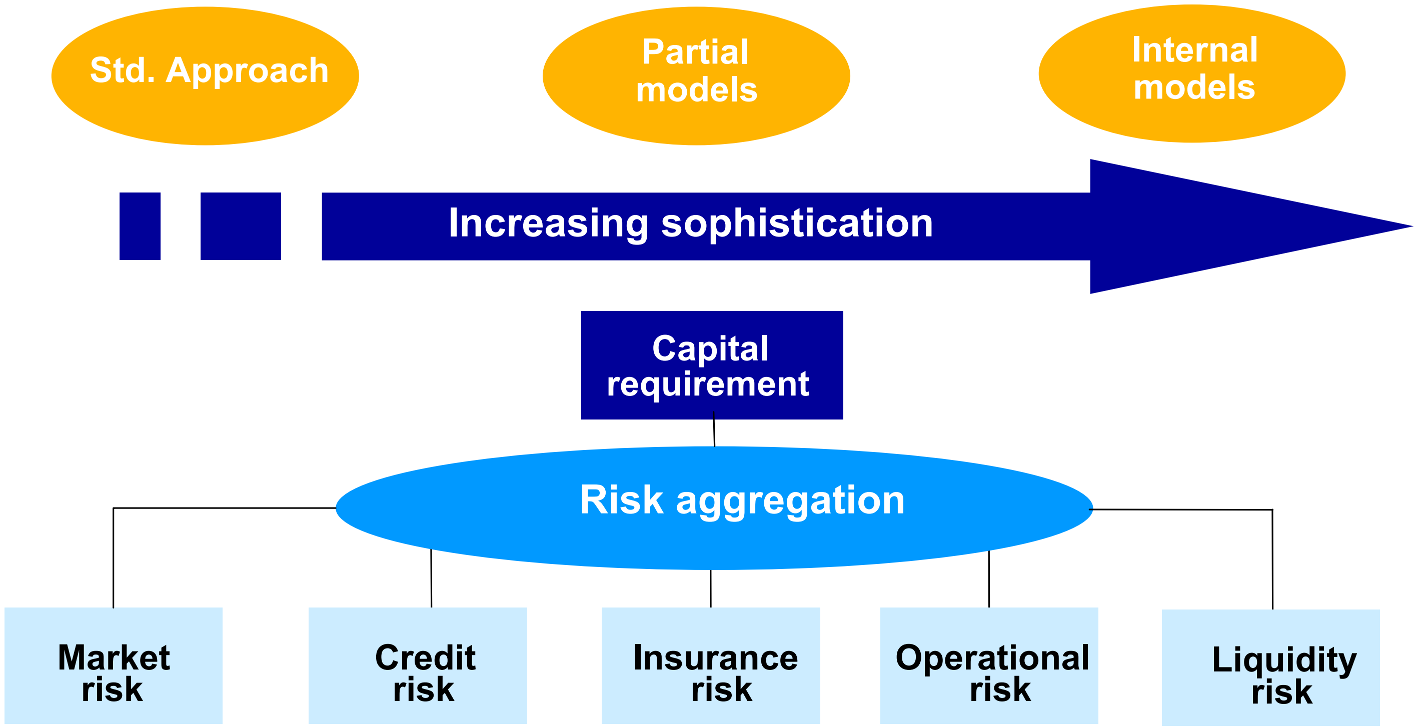
Pillar 1



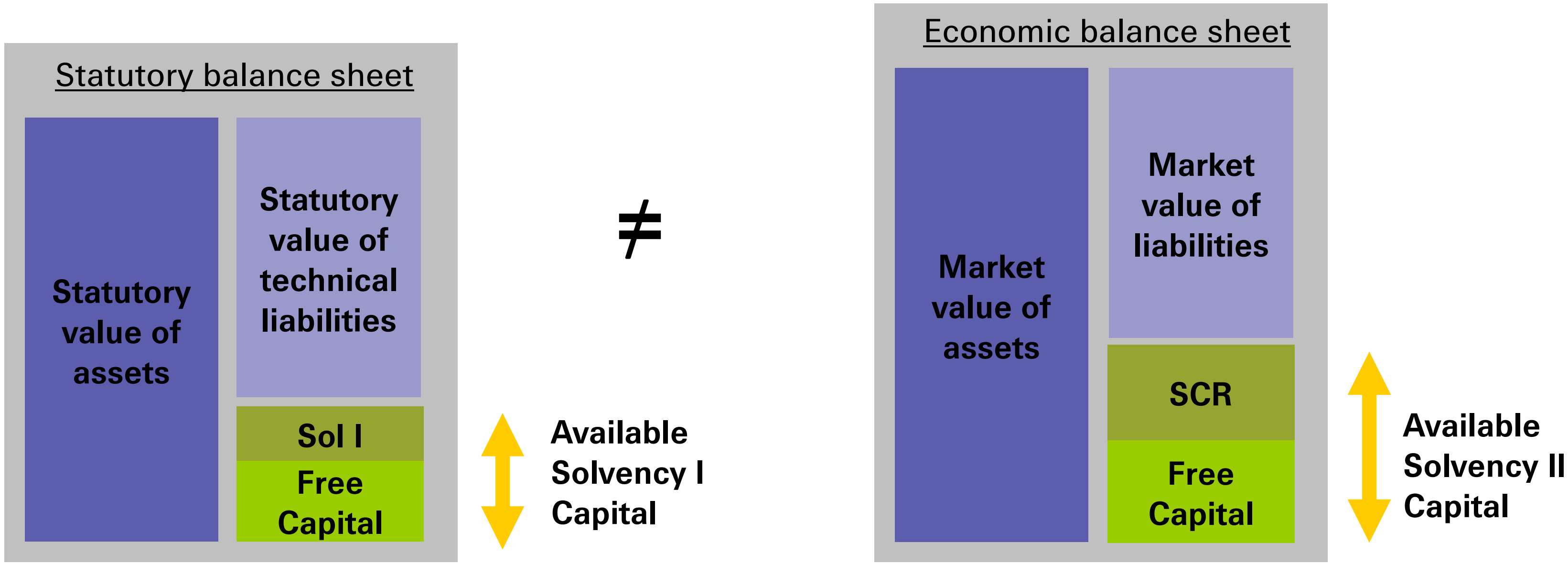
SCR is defined as the market consistent value of assets required above the market consistent value of liabilities to ensure that Available Solvency Capital remains positive to 1 in 200 confidence level measured over one year

Recognition of diversification and risk mitigation

Capital Adequacy

Comparing Solvency I and Solvency II positions

- A comparison of capital requirements and eligible elements is required under both frameworks
- The focus should not be on the required capital amounts but rather on the excess capital or capital adequacy ratios



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Results of the Swiss Field Test 2005

Pillar 1		

- SST introduced earlier as Solvency II (2008) first takeaways
- Field Test
  - The field test included all large and most mid-sized Swiss insurers as well as a number of smaller companies (~ 15 life, 15 nonlife and 15 health insurers)
  - The participants of the field test comprise approx. 93% of the provision in life and approx 85% of premiums in nonlife
- Key findings
  - Solvency II capital adequacy roughly in line with Solvency I capital adequacy (~10% -20% lower)
  - The Statutory Solvency Ratio is only a weak predictor for the SST Solvency Ratio
  - Financial market risk is often dominating (40%-80%)
  - Workload to implement was bearable

Solvency II – Current expectation on split of capital requirements

Risk categories defined by European Union (QIS III)	Capital requirement split for P&C based on QIS II findings	Capital requirement split for L&H based on QIS II findings
Insurance risk	65%	15%
Market risk	20%	65%
Counterparty default risk	5%	10%
Operational risk	10%	10%
Entire risk landscape	100%	100%

Based on the methodology applied in QIS II, insurance risk will be the key driver for P&C insurance companies

Based on the methodology applied in QIS II, market risk will be the key driver for L&H insurance companies

Findings from the QIS II process provide an indication on the anticipated split of capital requirements. The methodology has been recalibrated for QIS III, results available soon.

Solvency II – Recognition of risk mitigation instruments

	Regulatory risk landscape	Risk mitigation solutions	Regulatory considerations
Solvency I	Insurance risk	Reinsurance	■ Basically just based on insurance risk and volume based
Solvency II	Insurance risk	eg reinsurance, ILS, swaps	■ Instruments with material economic effect considered, irrespective of legal form or accounting treatment ■ Transactions need to be legally effective and enforceable across all relevant jurisdictions ■ Instruments need to be reliable and stable over time ■ Credit quality of risk mitigation provider must be considered ■ Need for direct claim on the protection provider and extent of cover clearly defined and incontrovertible
	Market risk	eg hedging, swaps	
		eg ILS, swaps, CDO	
	Operational risk	eg reinsurance, ILS, swaps	

This harmonised treatment of risk mitigation instruments is expected to encourage the development of new innovative risk mitigation solutions.

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Pillar II:
Risk management and supervisory control

Pillar 2

- (The effectivness of) risk management (RM) and RM tools within a company are the focus of interest:
  - Senior management responsibility
  - Risk Management Systems & controls
  - Operational Risk
  - Risk model, stress and scenario tests assumptions
  - Documentation !!
- Supervisory Process and intervention
  - Supervisory powers and measures (timing, extend, indicators etc)
  - Coordination of supervisory measures, control (eg peer reviews)
  - Role of external audit
  - Intervention levels

Pillar II:
Risk management and supervisory control

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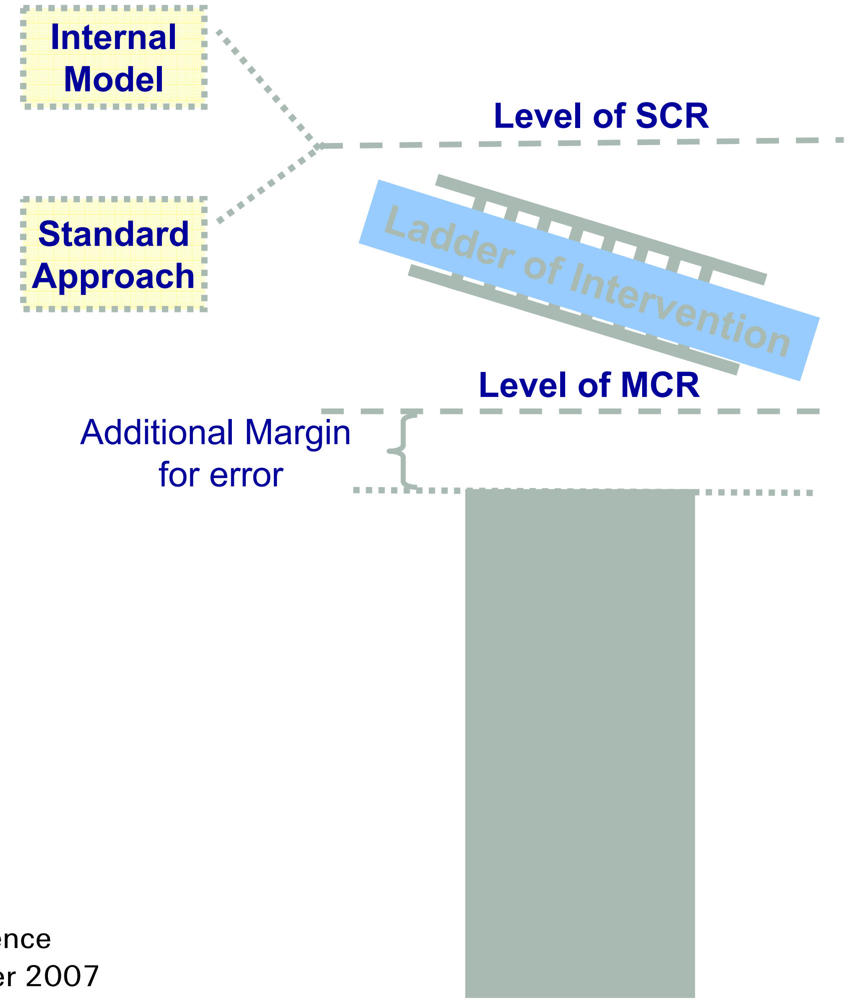

- **MCR/SCR** helps deal with variety of issues including pro-cyclicality
- **Solvency Capital Requirement (SCR)**
  - Target Capital that a group should aim to meet under normal operating conditions
  - Dropping below SCR always requires a plan of action but does not necessarily immediate action
- **Minimum Capital Requirement (MCR)**
  - Safety net and reflects a level of capital below which ultimate supervisory action would be triggered
  - Allows for unknown risks by ensuring intervention before assets reach estimated level of market consistent liabilities
- **Ladder of intervention** as Available Capital falls from SCR towards MCR

Pillar III: Disclosure

Pillar 3

- Supervisory disclosure
  - Risk Report
  - Losses under given scenarios
  - Valuation Methodology
  - Documentation of Risk Governance Processes
- Public disclosure
  - not yet defined