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Solvency II
Implications for Mutuals

David Hare \ 16 May 2014

Agenda

Solvency II update

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- Solvency II in the UK & what we are seeing
- Have you considered…
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- ORSA: Requirements and high level implications
- Spotting genuine risk appetite frameworks

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- Emerging conduct risks
- Regulatory focus on behavioural economics

Solvency II Update

Solvency II in Europe

EIOPA will continue to develop technical standards, underpinning the Solvency II framework

Topic	Notes and implications
Omnibus II agreed in Trialogue	• Agreement on long-term guarantees package & confirmed implementation date of 1 January 2016. • Firms to re-start Solvency II projects to assess readiness and put in place plan for achieving full compliance in 2016. • Decide on valuation methodology for annuities and other areas of potential discretion.
EIOPA Interim Guidelines	• Some SII-like requirements apply during the preparatory period (1 Jan 2014 to 31 Dec 2015). • Areas covered are Systems of Governance, Own Risk and Solvency Assessment (ORSA), Internal Models and Pillar 3 reporting. • Firms to revamp their efforts to meet requirements during the interim period. Most significant efforts likely to be producing a FLAOR in 2014 and submitting annual and quarterly information no later than 22 weeks after 2014 year end and 8 weeks after end of Q3 2015 respectively. • Challenges around Pillar 1 calculations as technical standards are still to be published.
Technical Standards	• First set of Implementation Technical Standards published providing details on the approval process for matching adjustment, ancillary own funds, undertaking specific parameters, internal model application and SPVs. • In the coming months, EIOPA will publish additional technical standards which, among other things, will provide details on Pillar 1 calculations. • Where relevant, firms to prepare documentation for approval processes and monitor technical standards as they are published.

Solvency II in the UK

Solvency II is likely to dominate the PRA's agenda as it ramps up its efforts for implementation

Topic	Notes and implications
SS 4/13	• PRA issued a Supervisory Statement supporting EIOPA's Interim Guidelines. • The PRA is saying it will adopt a pragmatic approach. Compliance is not expected on day one during the preparatory period but incremental readiness needs to be demonstrated (e.g. ORSA). • Proportionality principle applies.
SS 5/14	• PRA issued a Supervisory Statement summarising its expectations in particular areas of concern regarding the calculation of technical provisions and internal models for general insurers. • Key areas of concern include calculation of the risk margin, use of historic data, use of third party models, and assumptions and techniques used in the internal model.
PRA's approach	• The PRA is focussing on firms that it believes are more likely to be successful in the application process. Some firms have recently been removed from the pre-application process. • Significant risks of not obtaining internal model approval from day one for firms that are not part of the pre-application process. All affected firms should have contingency plans for this. • Quality (rather than quantity) of documentation is key to the review process. • Deadline for SII transposition is 31 March 2015. Formal application for internal model use begins on 1 July 2015 but it could start as soon as transposition is completed.
PRA and NEDs	• Increasing focus on the NEDs' understanding of the internal model and their ability to challenge risk information. • NEDs to ensure that governance framework is fit for purpose.

What we are seeing in the UK market

Increased activity in Solvency II preparations

Many UK insurers invested heavily in Solvency II development a few years ago, but delays in firm guidance as to when implementation would be enforced led to many of these programs coming to a halt.

However, November's Trialogue agreement on Omnibus 2 provided much needed certainty around timetables: Solvency II will come into force on **1 January 2016**

We are starting to see our clients reassessing readiness and addressing gaps. There are only 20 months to go to implementation and, in addition, EIOPA Interim Guidelines introduced some guidelines similar to SII requirements that will promote early adoption. These came into force on 1 January 2014.

Have you considered….

Some relevant questions for mutuals (but not only mutuals)

Proportionality	Outsourcing	SCR Projections	Management Actions
SII requires that insurers have a well defined concept of proportionality – with assessments being performed to ensure methods are suitable for risks. Have you started this process?	Need to consider how outsourcing will be managed. For example, there is a requirement for asset data to be provided at a much more granular level than presently required External data and model requirements also a much more detailed understanding than previously may have been the case. Have you started the process to manage outsourcing arrangements in line with SII guidelines?	How are you intending to calculate the risk margin? Are you planning to do a full projection and recalculate the SCR at each point in time for risk margin purposes? This is an area which requires thought now in order to have the systems in place to perform SCR projections.	There is an increased focus on management actions under SII. SII requires firms to verify whether management actions are realistic given past experience. Have you considered this?

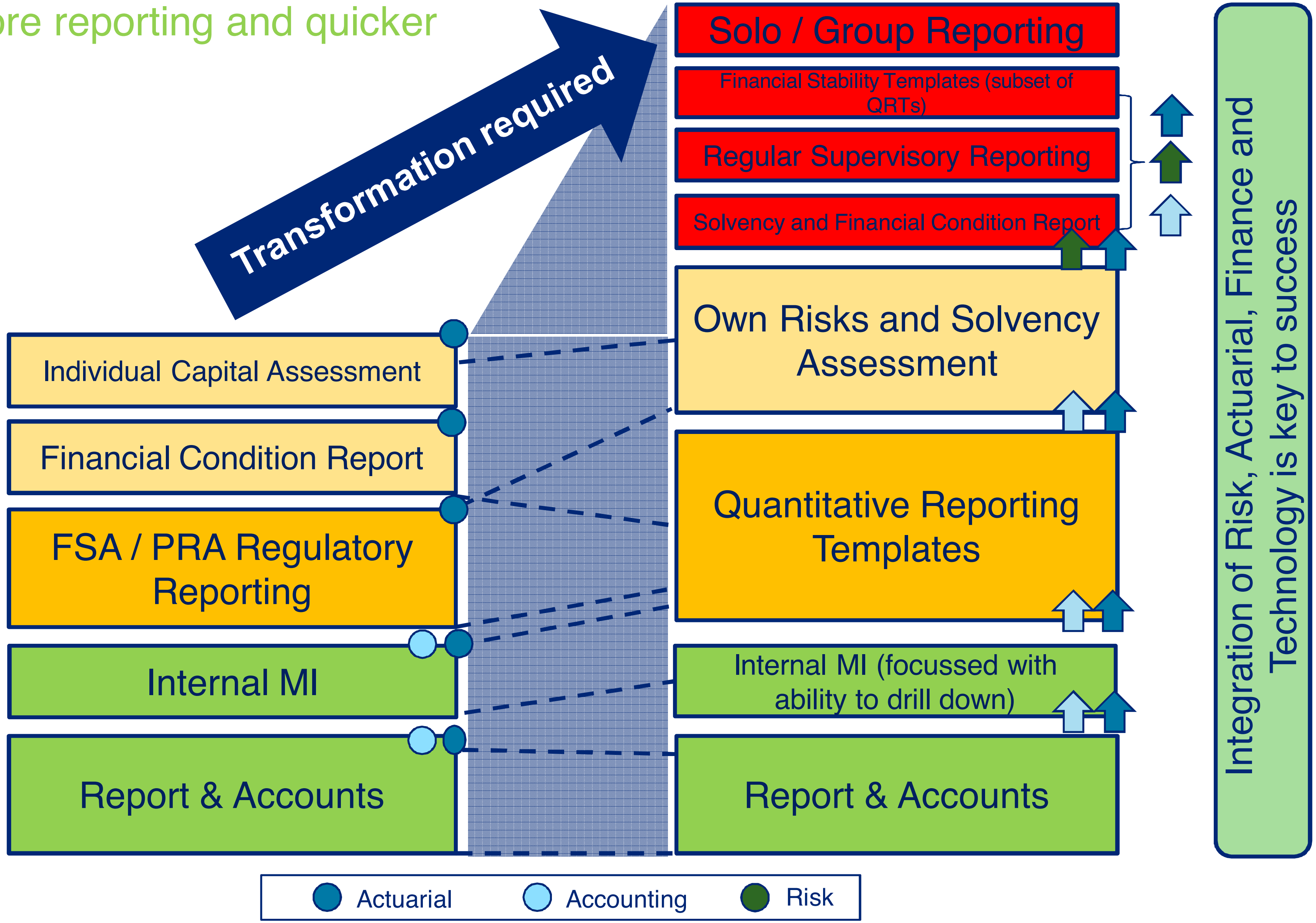
Have you considered…. (continued)

Some relevant questions for mutuals (but not only mutuals)

Ring-fenced funds	Risk-free rate	Transitionals	Documentation
SII requires firms to calculate a notional SCR for each ring-fenced fund. This will be of particular importance and relevance for mutuals with several funds. Have you considered the implications of this and started planning to meet the requirement?	The matching adjustment (MA) allows an increase to the risk-free interest rate used to discount cashflows, so reduces the value of liabilities. The volatility adjustment (VA) also allows an increase to the risk-free interest rate used to discount future cashflows, reducing liabilities Only one such adjustment may be applied for. Have you considered whether you will be applying for a MA or a VA to the risk-free rate?	Should you apply for any of the transitional arrangements introduced in Omnibus II, covering technical provisions, risk-free interest rates, or equity risk under Standard Formula? It is worth considering the effort that would be involved in putting any transitional arrangement in place.	Documentation will perform a key role in PRA reviews of SII adherence. Suitable documentation will also help support any future internal model approval process. Have you considered streamlining documentation in line with the PRA's request for quality not quantity?

What will need to change?

More reporting and quicker



System of governance

The system of governance supports the prudent management of the business through appropriate and proportionate systems, resources and procedures.

- Encourages insurers to develop and implement **internal risk management processes**.
- **Risk management** – identify, monitor, manage, and report on the risks to which the undertaking is, or could be, exposed.
- It includes specific requirements for formal **risk management, compliance, actuarial and internal audit functions.**
- Insurers are required to embed a robust risk framework and carry out an **Own Risk and Solvency Assessment (ORSA)** to determine their own capital requirement against which they manage the business.
- **Supervisory processes** are harmonised through common requirements.
- Supervisors can impose a **capital add-on** for **Governance** and **inadequacies in the SCR calculation.**

ORSA (Own Risk and Solvency Assessment)

SII requirements

Under Solvency II, insurers are required to embed a robust risk framework and carry out an Own Risk and Solvency Assessment (ORSA) to determine their capital requirement . The ORSA should be used as a tool for managing the business.

ORSA requirements are set out in the Solvency II directive. These require an assessment of, at least:

- **Overall solvency needs** taking into account the **specific risk profile**, approved **risk tolerance limits** and the **business strategy** of the firm
- The compliance, on a **continuous basis**, with the capital requirements......and with the requirements regarding technical provisions
- The extent to which the **risk profile** of the firm concerned **deviates significantly** from the **assumptions underlying the Solvency Capital Requirement** ......or with its **partial or full internal model**

In addition, there is a need for processes which **properly identify and assess the risks faced in the short and long term** and to which the firm is (or could be) exposed.

The directive states that the “ORSA shall be an **integral part of the business strategy** and shall be taken into account on an ongoing basis in the **strategic decisions** of the undertaking”.

ORSA

High level implications

Governance	Articulation of key roles and responsibilities within the ORSA framework
Cultural	Cultural shift to establish ORSA as part of management decision taking
Process	Process development to leverage existing practices, align with business planning, Internal Model cycles and the risk management framework
Methodology	Qualitative and quantitative methodology development including projections and linkage with the risk appetite framework
Technical	Supporting IT solutions
Implementation	Design, build, pilot, roll out
Report and disclosures	ORSA report. Supervisor and external disclosure development

Spotting genuine risk appetite frameworks

What questions should be asked?

Dimension	In mature, embedded risk appetite frameworks	In immature risk appetite frameworks
Breadth Does it cover all material risks? Or just the ones that are easy to measure?	The framework will cover financial and non-financial risks.	The framework will be weighted towards the risks that lend themselves to straightforward quantification but will remain silent on harder to measure risks.
Depth Does it integrate top-down direction with bottom-up insight?	The Board's risk appetite statement cascades down the firm and is translated into further risk statements around the risk drivers that make it easier to relate the overall appetite to the day jobs of people lower down the firm.	There may be a bland risk appetite statement but it is so generic that it can hardly be said to shape, guide or constrain behaviour.
Language and Culture Do staff use risk appetite concepts in their day jobs? Can they answer questions on how these concepts relate to them?	If you take front office employees and ask them what they think of the firm's risk appetite and how it applies to them, you will receive cogent responses.	Nobody outside the risk function will be able to tell you what risk appetite means or how it applies to their role.
Sponsorship Are the CEO, CFO or CRO active champions of risk appetite?	Senior executives can explain how and why they have gone about trying to embed risk appetite.	Senior executives pay lip service to the concepts, but fail to push them through.
Decision Making Can the Board or Executive give an example of the last time that risk appetite informed a business decision?	The Board and Executive can give examples of decisions that have been influenced by risk appetite; business risk owners can explain what risk objective they were supporting when they set particular bottom-up limits.	The Board and Executive will struggle to give a coherent answer; business owners will not be able to link their calibration of limits and triggers to specific risk or business objectives.
Remuneration Is the firm using risk appetite within its reward and remuneration plans?	Employees will be incentivised to help deliver a strong risk appetite culture and to remain within agreed risk appetite limits.	Some employees may be incentivised to remain within specific risk appetite limits, but coverage is patchy and in any case, the limits in question have weak linkages to firm-wide objectives.

Other ‘hot topics’

Conduct Risks

Key relevant risks

1. Product governance

The product lifecycle covers product design, sales, post sales and lifecycle review. Value for money assessments (value the customer derives from the product throughout its lifecycle) should form part of a wider product governance framework.

2. Technology

As well as being an emerging area of regulatory focus, the ways in which firms use technology to interact with customers is changing. Need to ensure that the current financial promotion rules are being applied in line with FCA expectations.

3. Information asymmetry

Information asymmetry describes the situation where one party in a transaction has additional or superior information to the other party. The FCA believes that poor outcomes often stem from this dynamic.

4. Incentives, conflict of interest and inducements

Although these are three separate initiatives, they are designed with the same core purpose to ensure that firms put customers at the heart of everything they do and are not unduly influence to act inappropriately.

5. Other relevant conduct risks

Firms' back-books cannot be used to support profitability so take care with cross-selling, targeting intertia, offering better terms to new customers and avoid making switching difficult.

Retirement income products and distribution may deliver poor consumer outcomes as consumers may not understand the options available to them at retirement.

The FCA will monitor consumers' understanding of potentially overly complex T&Cs, specifically:

- the degree of protection they have (e.g. on flood risk);
- obstacles to exit a product or service that are unclear; and
- complex terms making it difficult for consumers to compare products.

Regulatory focus on behavioural economics

Becoming “business as usual” at the FCA

- Behavioural economics considers how people make choices using insights from psychology and economics.
- “Consumer choice in retail financial products and services is particularly prone to errors” (FCA).
- Firms can exploit behavioural biases at the expense of consumers or use them to benefit consumers.
- Understanding how people make decisions can help to address market failures and ensure better consumer outcomes.

Behavioural economics in practice: recent FCA study on general insurance add-on products

	Add-on buyers are less likely…	… and more likely
Key Trends	• to consider whether they are already covered • to shop for alternatives • to be effective when they do shop around	• to be relatively price insensitive • to receive bad value for money • to show poor price recollection shortly after purchase • to state they had not thought about the purchase until the date of the purchase
Behavioural Economics Aspects	• Consumers do not always purchase on the basis of price and product coverage but value the ease of the process and peace of mind. • Add-on sales may inhibit the desire to shop around, especially if the primary product had a tedious purchase process. Consumers may consider the price of add-on products against the price of the primary product, rather than alternatives. • Sales may be based on consumer concerns that have increased during the sale process – e.g. the consumer may have a heightened perception of risk after purchasing a valuable item. • Opt-outs (pre-ticked boxes) introduce bias.	

Has your firm considered where it may be benefiting from behavioural biases at the expense of consumers and the extent to which business models rely on these practices?