AFM NED Conference – Solvency II Business as Usual

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What am I going to talk about

Solvency II
- What are the key components and how do they fit together
- Risk, capital, pricing, management actions

Investment
- Impact of Solvency II on investment for smaller mutuals
- Corporate governance

Products
- Product reviews
- Profitability as part of Solvency II

Risk & Capital
- Risk measurement tied to Capital
- ORSA showing future business plan and capital + Risk
- Reporting

Key components of Solvency II

- Technical provisions
- Solvency Capital Requirement
- Risk management
- Board control and governance
- Reporting to the public

Technical provisions are….

Market consistent

Best estimates

Allow for the cost of capital

Allow for future discretionary benefits

Allow for future management actions

Solvency Capital Requirement….

- Value at risk at 0.5% probability level over 1 year
- Linked to BBB level of default
- Similar model to rating agencies
- Expected sometimes to break
- Lower target of MCR needs to be protected against failing

Investigations into experience

- Mortality
- Morbidity
- Lapse
- Surrenders
- Expense

Investment strategy and solvency for with-profits offices

- Liabilities and assets under Solvency II are on a realistic basis
- Liabilities allow for investment scenario in the risk free rate in the future and the current value of assets now
- Bonuses and surrender values should allow for this scenario
- Management actions and the PPFM really affect this

Valuation of Liabilities

- MCEV technique
- Day 1 value is embedded value on sale of product
- Value of liabilities should be basis for sale value
- Terminal bonus, MVRs and guarantees all directly valued
- Underlying guarantees valued on risk free rate basis
- Expected future bonus on the Solvency II scenario directly valued
- Manage according to the Solvency II balance sheet
  - Addition to own funds means making an embedded value profit
- Capitalises all changes in assumptions immediately
  - Care needed on profit and loss calculation to identify impact changes in software, method, basis from actual management actions
- Liability stresses for Insurance Risks can feed directly into risk register

Management actions

- Liability values are very sensitive to management actions assumptions
    1. Cost of capital risk margin allows directly for what board could do
    2. Movement in liability values for changes in terminal bonus, MVR and speed in moving reversionary bonus
- Risk free rate basis for guarantees means that, if matched, guarantees are covered.

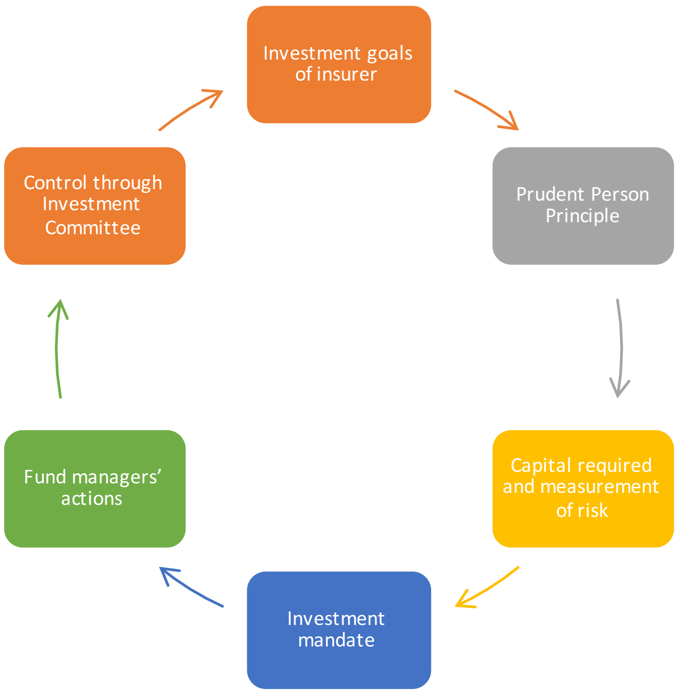
Example firm 1

- With-profits firm that normally only determines bonus annually
- Unlikely to reduce surrender values for small movements in share values (only if near full Solvency II stress occurs)
- Unlikely to reduce terminal bonuses in short term
- Market falls by 15% on equities and gilt yields drop to 1.75%
- Result – stress has to be absorbed by own funds
- Therefore, trigger points or derivative programme in place to protect fully against movement in assets
- Likely either very conservative investment strategy or very high free assets
- Is this in accordance with literature, treating customers fairly, PPFM

Example firm 2

- Very active approach to interim bonuses – changed within a year based on expected investment return
- Active MVR policy, return shared between terminal and reversionary with terminals being mirror image of MVR
- Surrender values on conventional with-profits changed rapidly
- Market falls by 15% on equities and gilt yields drop to 1.75%
- Result – stress initially absorbed by changing liability value to allow for lower bonuses, lower terminals and applying MVRs
- Therefore, triggers and derivatives at lower levels purely to protect guarantee position
- Higher equity exposure for same free assets
- Is this in accordance with literature, treating customers fairly, PPFM

Corporate governance of investment



Issues

- Education of board – NED skill set
- Need for investment consultant or can this be done by specialist NED
- Information from fund manager
- Look through not just an annoyance for Solvency II
- Need to understand / challenge
- Frequency and quality of investment committee meetings

Product reviews

Fit for purpose

- Customer needs
- Other products

Profitability

- MCEV Impact – day 1 tech provisions
- Too profitable?

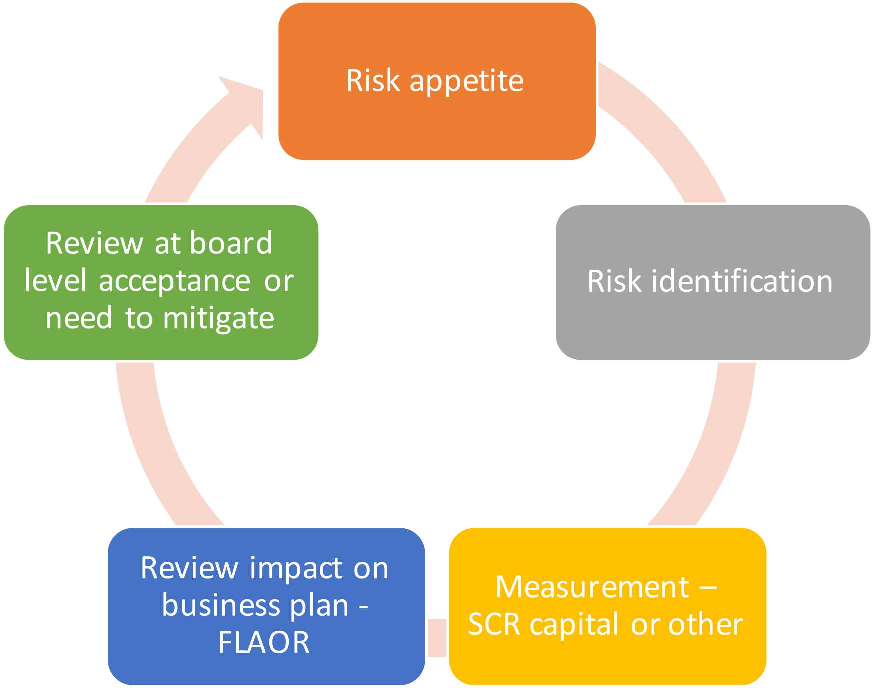
Literature

- Explain risk properly
- Explain needs being met properly
- .....

Issues

- Rolling cycle of product reviews
- Actuarial part could be driven from day 1 technical provisions
- Experience investigations tie in
- Stage:
    - Initial review to see if need for more in depth review and whether revamp or completely new product type
    - In depth may require customer testing – focus groups
    - In depth much more expensive than initial review

Risk measurement



Risk measurement

SCR at extreme level

BAU levels

10% level of risk for market movements

Mitigators at different levels

Management actions

Appetite for risk at different levels

Issues

- Education of board – NED skill set
- Need for risk manager and NED specialist on risk?
- Control properly exercised through risk committees
- Better MI and better discussion required
- Need to split audit from risk?

ORSA

- Risk management, risk appetite and controls
- FLAOR – previously FCR
- Reverse stress tests
- Risks that cannot be measured?

Public disclosure – the SFCR

- Business and Performance
- Systems of Governance
- Risk profile
- Valuation
- Capital Management

Risk Profile

- Risks split qualitative and quantitative
- Risk exposure including off balance sheet and spvs.
- How the risks have changed, how assets are invested
- Material risk concentrations
- Expected profit in future premiums
- Risk sensitivity measurement and how

Systems of Governance

- Structure of Board and committees
- Remuneration policies and practices
- Fit and proper policy – skills expertise etc for functions
- Risk management system – strategies, processes and reporting
- Information on the ORSA
- Internal control systems (IA)
- How Actuarial function is organised

Business and performance

Structure of organisation

Underwriting performance aggregate and material line of business

Performance of Investments

Expense Information

Anything else that has material impact

Capital Management

Amounts of own funds by tier of capital including analysis of change

Policies and processes for managing own funds and timescale of business planning period

SCR / MCR coverage plus transitionals

SCR split by risk module and simplifications and internal model split by classification of risk

Use of internal model and any integration for partial internal model – differences standard formula and internal model

Any non compliance with MCR and significant non-compliance with SCR over the period – origin and consequences

Valuation

Separately, material classes

Value of assets, bases, methods, main assumptions

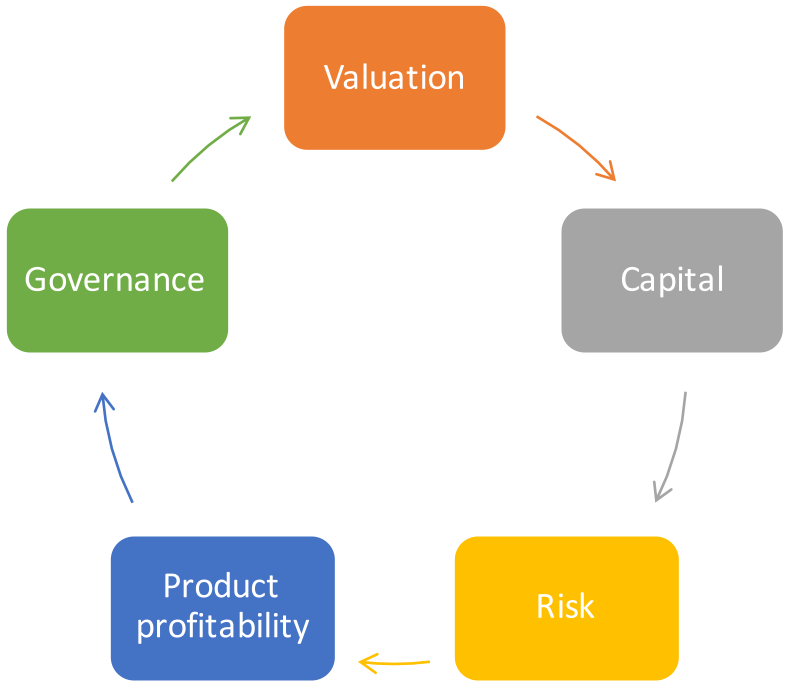
Value of technical provisions, bases, methods, main assumptions

Other liabilities – bases, methods, main assumptions

For all, need uncertainties, differences on line by line basis with accounts

Information on volatility, matching, transitional risk free, transitionals

Solvency II links up……



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