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Solvency II Introduction

Prepared by Susanne Kaske-Taft

Presented by Anthony Hill

CSAF Meeting – Des Moines, IA
August 26-27, 2010

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Motivation for Solvency II

Altered situation for the insurance industry

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What's our industry facing today ?

Capital markets

- Low interest rates
- Volatile share markets
- Financial crisis

Creditor protection

- Increasing significance of rating
- Increasing importance of disclosure

Shareholder value

- More transparent accounting
- Call for greater returns

Underwriting

- Pressure on margins
- More volatile results
- Large losses and catastrophe claims
- Price deregulation

CAPITAL MANAGEMENT

(risk/return considerations)

becoming more important

Solvency capital	Rating capital	Risk adjusted capital	Available capital

What is Solvency II all about ?

WIKIPEDIA
The Free Encyclopedia

Solvency II

From Wikipedia, the free encyclopedia

Solvency II is the updated set of regulatory requirements for insurance firms that operate in the European Union. It is scheduled to come into effect late 2012.

Key message Swiss Re:

“Rather than a rigid, rule-based approach, Solvency II uses a risk-based assessment of the assets and liabilities, based on economic principles. This complements our approach of integrated risk management as well as effective asset/liability matching.

Solvency II will create state-of-the art risk management and bring greater transparency.”

Objectives of Solvency II

- Enhance policyholder protection
- Better match to the true risks of an insurance company
- Consistency across financial institutions
- Principle-based but without undue complexity
- Assessment of an insurer's overall solvency situation
- Basel-type three-pillar approach adapted to insurance
- Two-level approach to capital requirements:
  1. Solvency Capital Requirements (SCR)
  2. Minimum Capital Requirement (MCR)
- Harmonise quantitative and qualitative supervisory methods

Move towards economic-based solvency supervision

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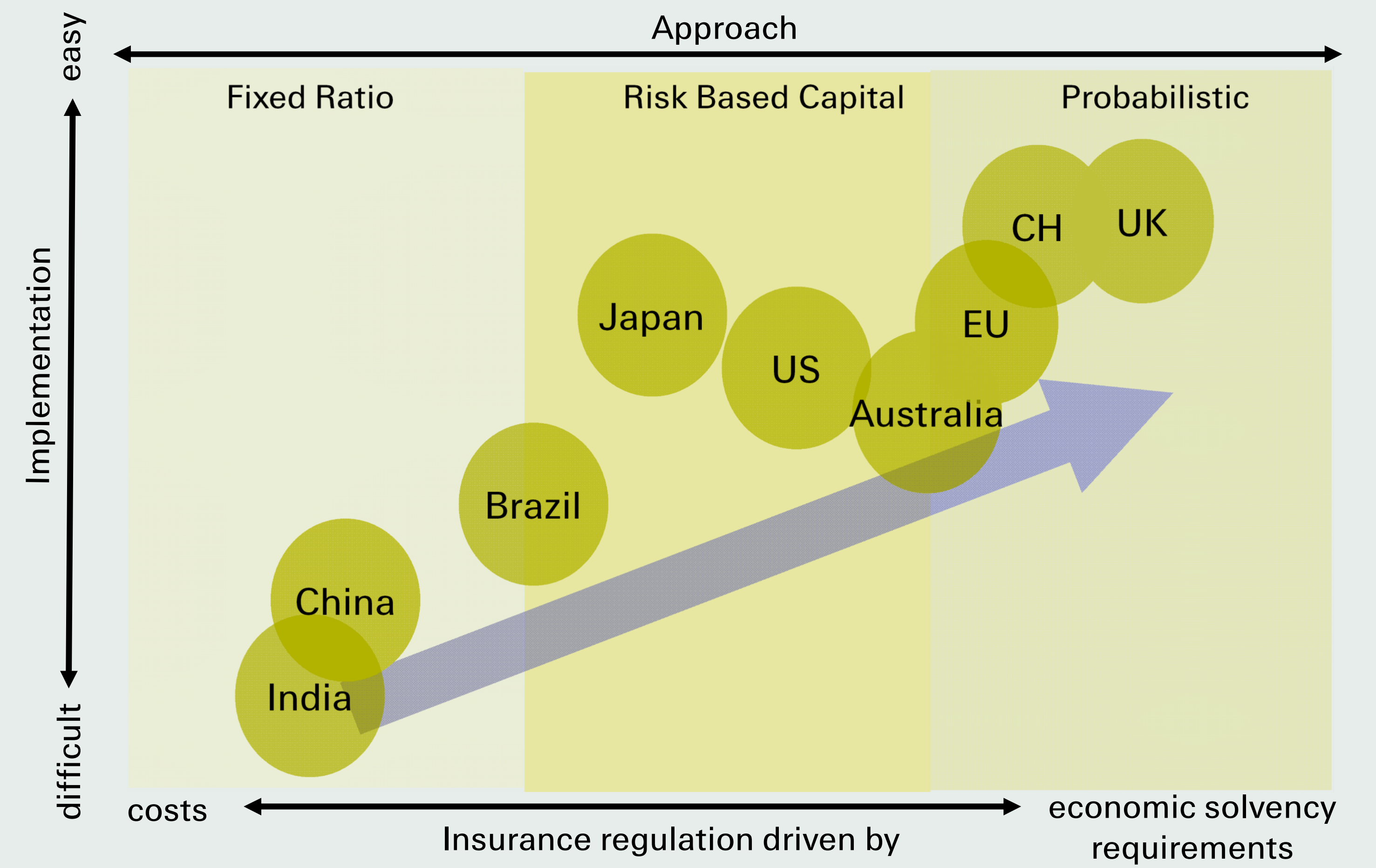
Solvency supervision in emerging countries is moving towards RBC, whereas Europe, including the UK and Switzerland, are using a model-based approach



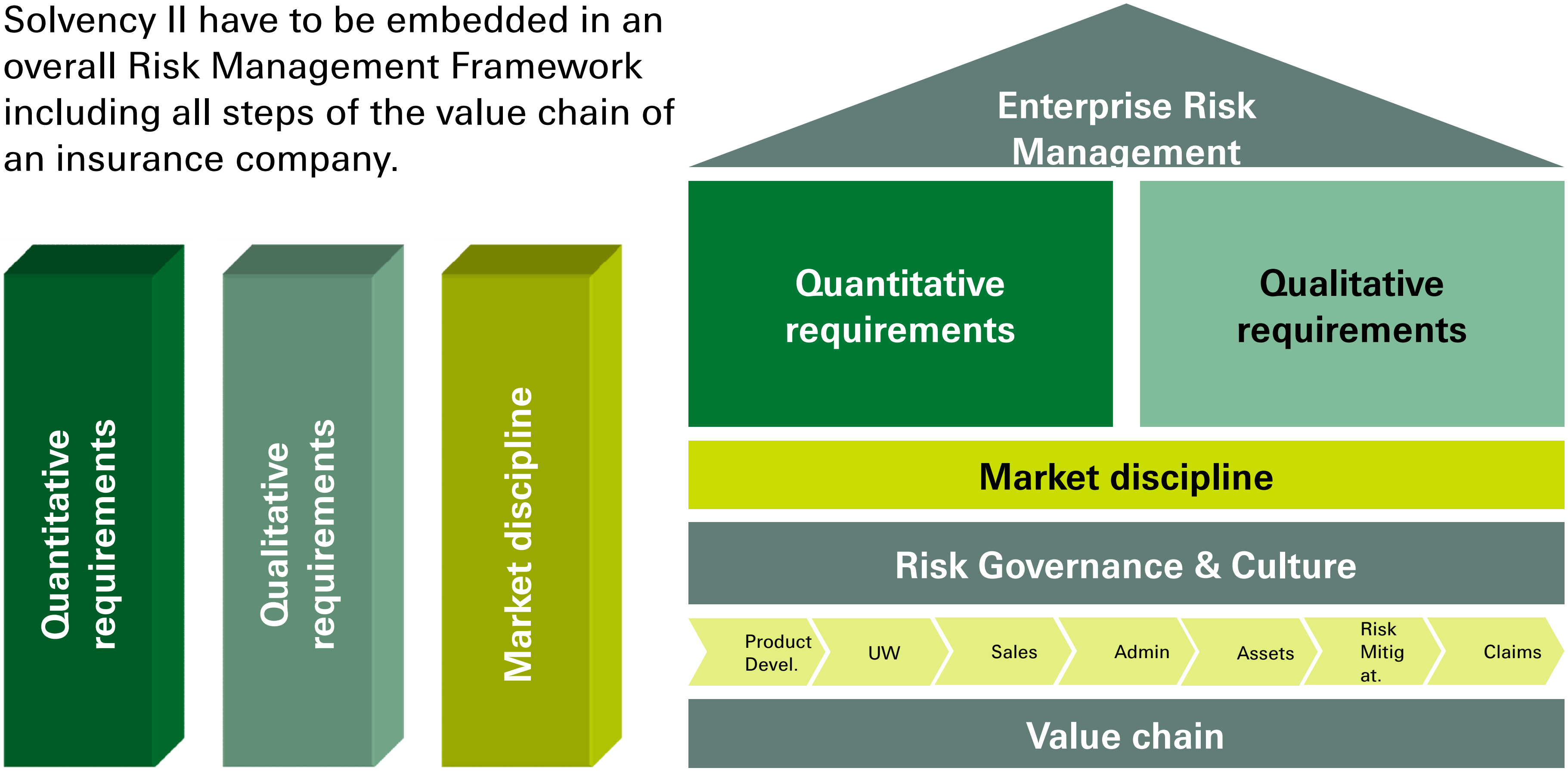
Objectives and key principles

Three pillar structure

Pillar I Quantitative Requirements	Pillar II Qualitative Requirements	Pillar III Market Discipline
▪ Minimum capital requirement ▪ Solvency capital requirement	▪ Corporate governance ▪ Internal control processes	▪ Supervisory disclosure
▪ Standard approach ▪ Internal model	▪ Risk management function ▪ Asset & liability management	▪ Public disclosure
▪ Risk dependencies		
▪ Risk mitigation	▪ Supervisory review process ▪ Supervisory powers	
▪ Technical provisions	▪ Safety measures ▪ Solvency control levels	

Implementation of Solvency II

The requirments of the three pillars of Solvency II have to be embedded in an overall Risk Management Framework including all steps of the value chain of an insurance company.



Solvency II – Key elements

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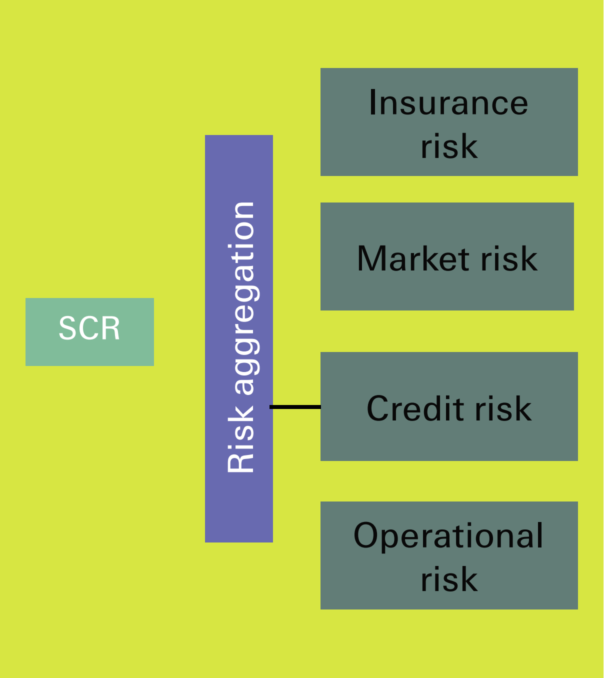
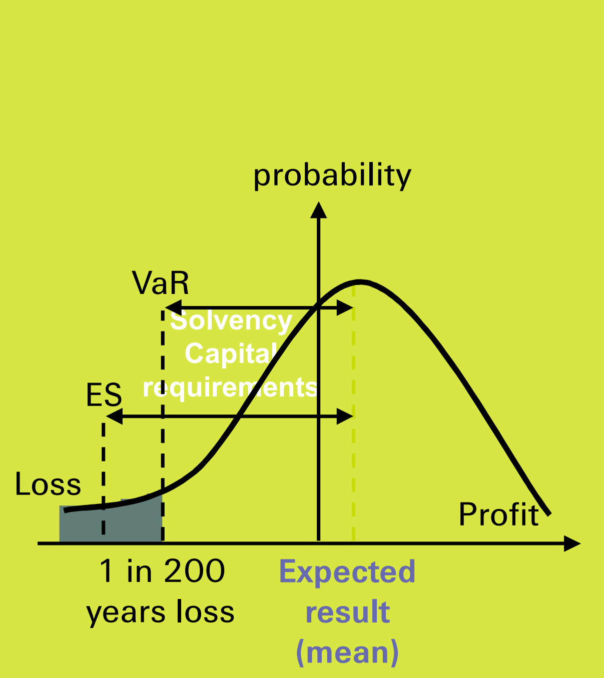
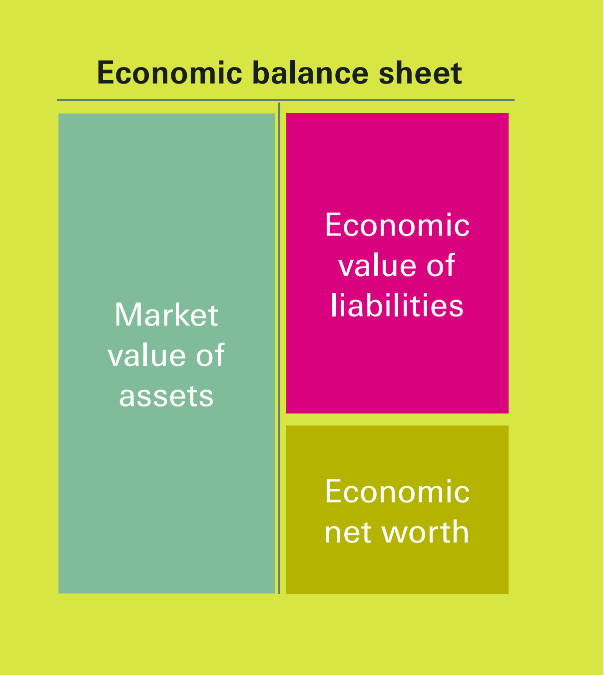
Consideration of all risk categories	Probabilistic risk measurement	Economic balance sheet







The Solvency I regime only considers the insurance risk and in some extent the market risk. Other risk categories are covered in different regulatory frameworks (eg Upper limits for investments in certain asset categories)

Solvency II risk measure will be based on a Value at Risk (VaR) level of 99.5% which is equivalent to a 0.5% target default probability, and specifies a time horizon of one year

- Introduction of market-consistent valuation of balance sheet items
- Increased volatility of balance sheet items expected

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The economic balance sheet
General principles

Market value of assets

- Wherever possible, market-consistent valuation is based on observable market prices (marking to market)
- If such values are not available, a market-consistent value is determined by
  - examining comparable market values,
  - taking account of liquidity requirements and other product-specific features
  - on a model basis (marking to model)

Market consistent value of liabilities

- Best estimate =
  Expected value of liabilities, taking into account all up to date information from financial market and from insurance
- All relevant options and guarantees have to be valued
- No explicit or implicit margins
- Risk margin as an explicit allowance

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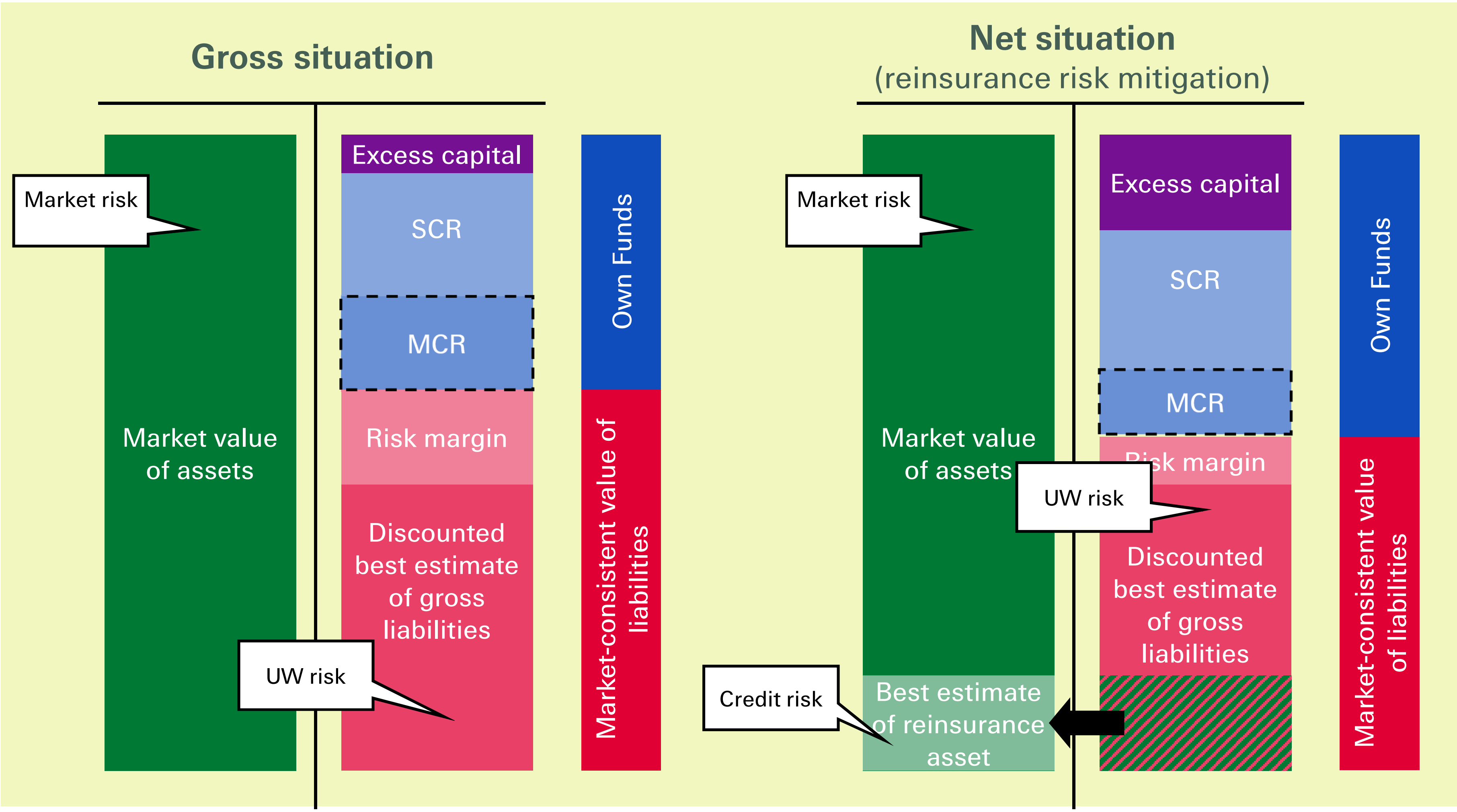
Solvency II – Economic balance sheet gross & net



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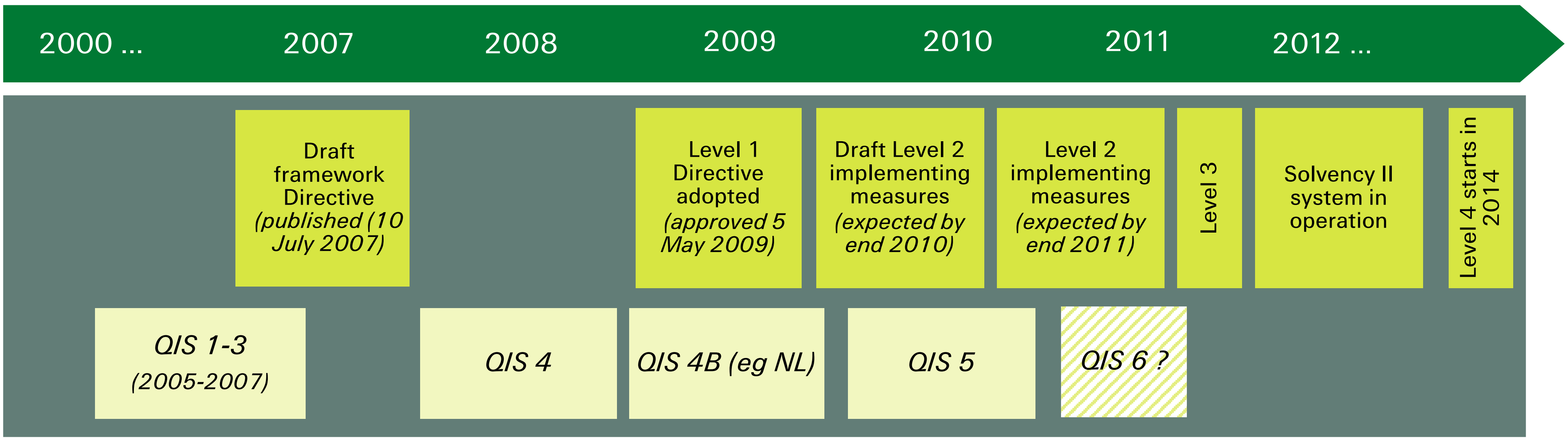
Timeframe and stakeholders

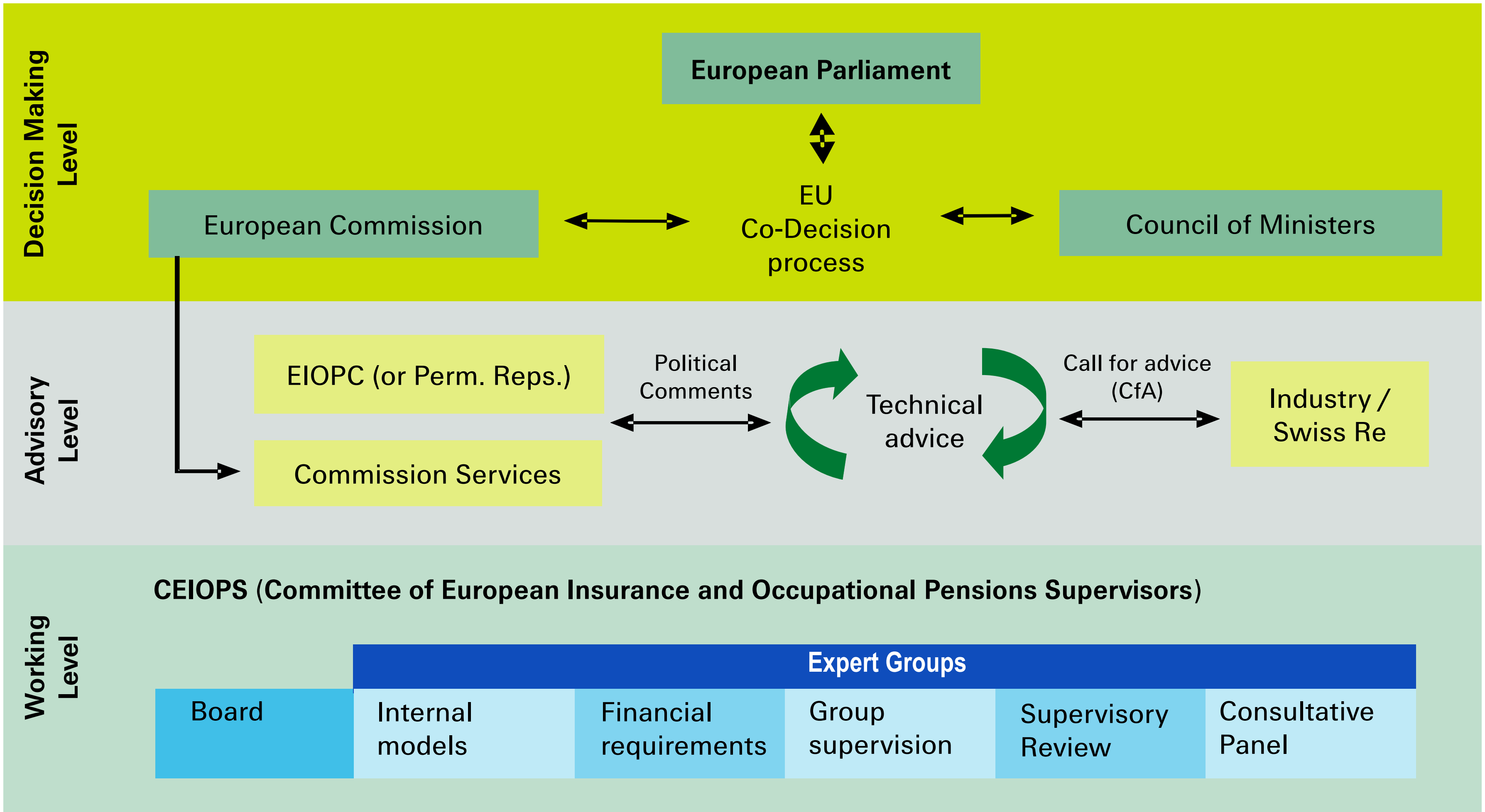
Solvency II - Timeframe



Directive enacted using the EU Lamfalussy Process

- Level 1: Framework Directive:
  Setting out basic enduring principles, or political choices, underpinning the solvency system.
- Level 2: Implementing Measures
  Formulating more detailed, technical rules.
- Level 3: Supervisory Standards
  Setting out guidelines for national supervisors to ensure a consistent interpretation and application.
- Level 4: Evaluation
  Enables the European Commission to monitor compliance and enforcement.

Solvency II stakeholders



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Comparison Solvency I & II

Basic principles of Solvency II compared to Solvency I

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The existing Solvency I regime

Fixed formula approach determining capital requirements based on insurance risks held

Capital requirements: Life

4% of net gross mat. provisions + 3‰ of net sum at risk

Capital requirements: Non-Life

Premium index: 16/18% of Net premiums earned or
Claims index: 23/26% of Net claims incurred

Key Conclusions

- Volumes of business to drive capital requirements
- Only insurance risk considered
- Partial recognition of reinsurance solvency relief to 50%/15%

The anticipated Solvency II regime

Economic framework taking into account the entire risk landscape and risk management framework

The principles of Solvency II

Pillar I Quantitative	Pillar II Qualitative	Pillar III Market Disclosure
- MCR / SCR - Diversification - Risk Mitigation - Assets/Liabilities	- Risk Governance - Supervision - Process/Control	- Supervisory Disclosure - Public Disclosure

Key Conclusions

- Volatility of business to drive capital requirements
- Insurance, market, credit and operational risk considered
- Broader recognition of risk reduction techniques (reinsurance)

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Objectives in comparison to Solvency I

	Solvency I	Solvency II
Consistency of regulatory framework	Regulatory arbitrage possible due to different local regimes	One consistent economic framework within the EEA*
Policyholder protection	**Policyholder protection based on mechanistic, unspecific formula**	**Policyholder protection based on economic principles and integrated risk approach**
Alignment of capital requirements with economic risk modelling	Rules do not reflect economically risk modelling	Rules require risk modelling on economic principals
Consideration of risk mitigation tools	Recognition of traditional reinsurance	Material economic risk transfer will qualify for capital relief
Introduction of mark-to-market valuation of balance sheet	Statutory approach with prudence reserves and investment regulations	Economic approach, plus additional market value margin for technical provision

* European Economic Area

Comparison of Solvency I & II

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Key elements of Solvency II	Solvency I	Solvency II
Risk landscape	Insurance risk	Insurance, market, counterparty default and operational risk
Risk models	One simple formula (fixed ratio approach)	Standard formula (factor-based approach) or internal model
Risk mitigation	Traditional and alternative reinsurance	Instruments with economic effect
Diversification	-	Consideration varies based on risk model used
Capital adequacy	Prudential valuation of balance sheet items	Market-consistent valuation of balance sheet items
Risk management framework	-	Requirements based on complexity of business mix
Supervisory review	-	Approval of risk models, ladder of intervention
Supervisory disclosure	-	Enhanced requirements for supervisory process
Public disclosure	-	Enhanced requirements for annual reporting process

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Quantitative impact studies (QIS)

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Intention of the EU

- To test the practicability of the technical specification of Solvency II in respect of the calculation of the new solvency capital requirements (SCR) and the minimum capital requirements (MCR)
- CEIOPS conducted so called Quantitative Impact Studies (QIS)
- The results of QIS are building an important part for the political discussion on the framework directive and the implementation process

What is a Quantitative Impact Study (QIS)

- "Test run" to prove the practicability of the draft Framework Directive of Solvency II
- CEIOPS asks the national supervisors to invite the national insurers, insurance groups and reinsurance companies to carry out calculations in line with the draft directive
- The undertakings participating in the QIS have to complete a spreadsheet and a questionnaire summarizing the results
- The participants are also invited to provide feedback on the practicability of the calculation
- The results have to be submitted to the national regulators
- The national regulators provide a consolidated version to CEIOPS in a respective timeframe

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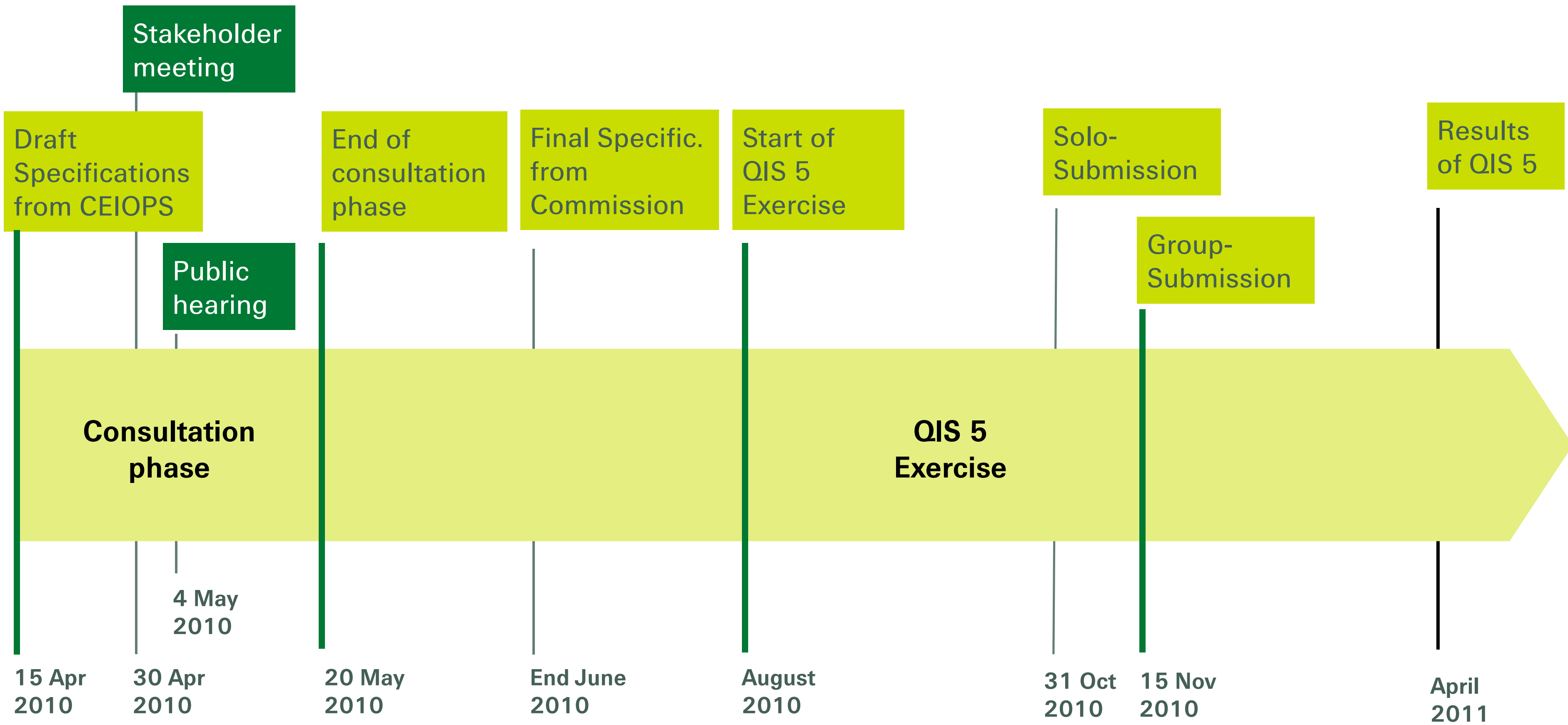
QIS 5 – High level milestone plan



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QIS 4 versus draft QIS 5

Key features:

- EU Commission (not CEIOPS) will release the specifications for QIS 5 (draft specificatoins released on April 15)
- Refinement of Group Calculations
- Complete remodelling of P&C Cat model for the Standard Formula
- Enhanced recognition of non-proportional reinsurance in the Standard Formula

Key concerns of the industry addressed in draft QIS 5:

- Excessive calibration of parameters in the Standard Formula would lead to an
  - unreasonable increase in required capital
  - unreasonable decrease in available capital
  - what would lead to a material decrease in the solvency ratio for the whole industry
- Even though these concerns have been addressed in draft QIS 5, the industry must remain alert to ensure no backlashes arise

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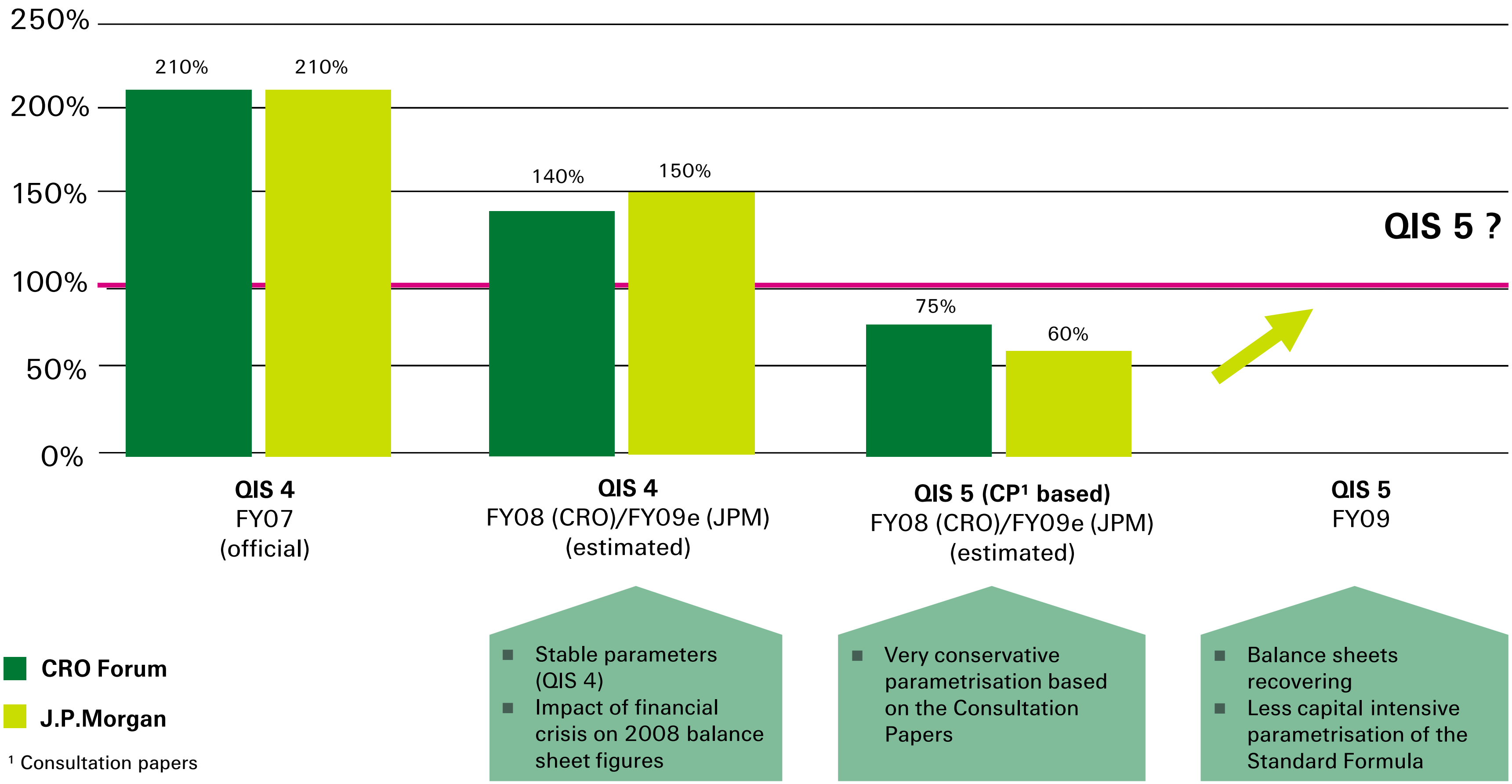
Solvency II – Impact on solvency level

Solvency ratio – industry wide (EU)



- Stable parameters (QIS 4)
- Impact of financial crisis on 2008 balance sheet figures

- Very conservative parametrisation based on the Consultation Papers

- Balance sheets recovering
- Less capital intensive parametrisation of the Standard Formula

[1] Consultation papers

Solvency II and the financial crisis

The economic environment – is in its deepest post-World War II recession

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- The downturn is global: the International Monetary Fund (IMF) projects output to decline in countries representing three quarters of the global economy
- The number of business insolvencies and corporate bond defaults are rising rapidly. All major economies and all sectors are affected
- Capital costs are high; access to capital markets is restricted
- The economic outlook is highly uncertain; risks are biased to the downside
- Profitability in credit insurance has deteriorated.

Crisis reinforces the case for Solvency II

Banking versus insurance – Systemic crisis versus solvency issue

Fundamental difference between banks and insurance companies

Insurance:

- Cash in first, claims payment at a later date
- Credit or asset crisis second order effect through assets

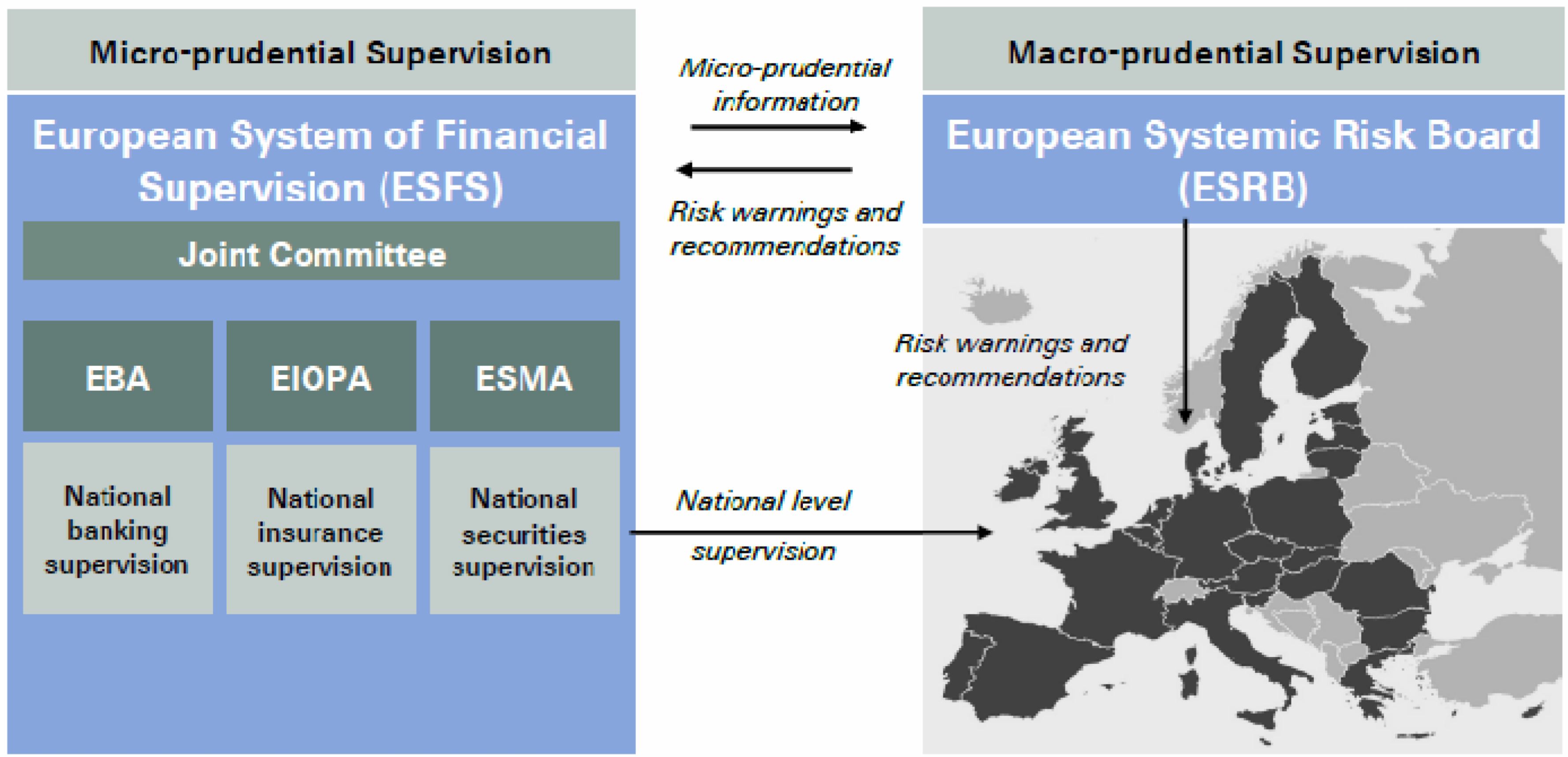
Bank:

- Cash out first, get interest and payback at a later date
- Withdrawals (run) had a direct effect on the credit and asset crisis

Issues	Insurers	Banks
Main problem	Losses on investment portfolio and on shareholder capital	Interbank market collapsed
Operational problems	Business as "normal": cover provided and claims paid	Banking system close to collapse
Trust in the system	No indication for policyholders losing trust – no run on insurers	Run on the bank prevented by Central banks' guarantees
Government support	Confined to very few cases	Broad intervention of central banks and governments

Outcome of the financial crisis

New EU supervisory architecture will strengthen European authorities and introduce new layer of supervision



Conclusions

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Conclusions

- Solvency II will lead to a more encompassing picture of an insurer's solvency position
- Economic principles and encompassing risk assessment will allow the unambiguous identification of the insurer's risk landscape
- Capital-saving effect of diversification and risk transfer will become measurable
- This will
  - foster a holistic and forward-looking appreciation of risk
  - eliminate false incentives to take risks
  - enforce risk-adequate pricing and focus on economic value creation, ie strict enforcement of a risk/return focus
  - require up-to-date data information and risk management systems
- Overall, Solvency II will lead to a more transparent, professional and thus more secure insurance market.

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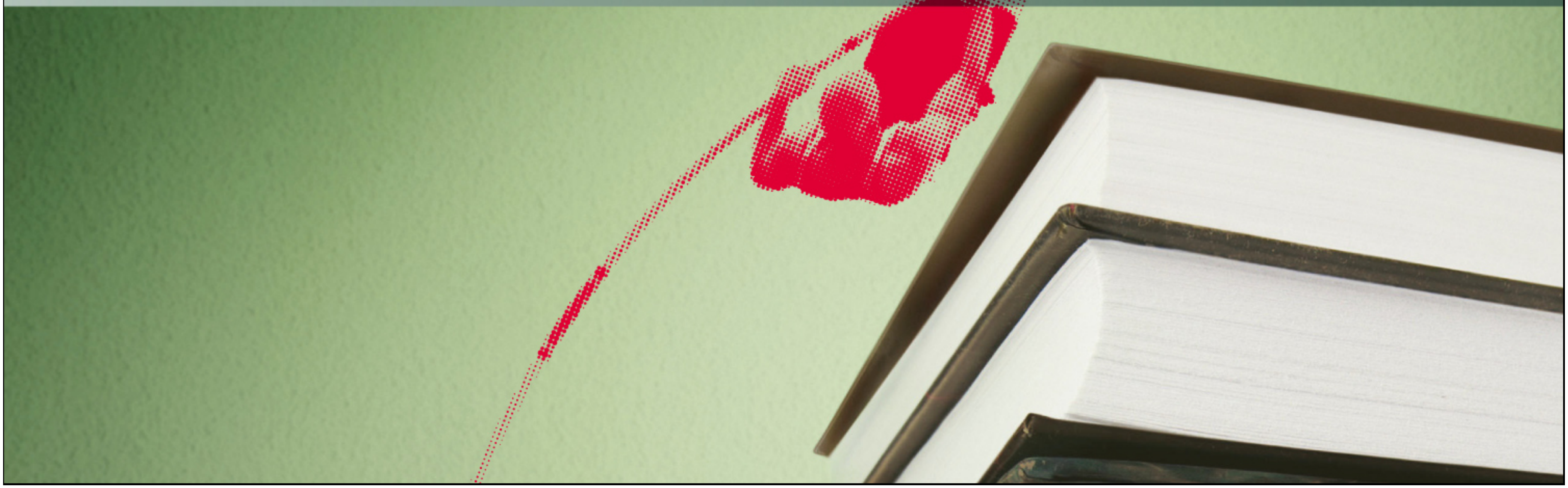
Thank you

Susanne Kaske-Taft
susanne_kaske@swissre.com
+41 43 285 3964

Anthony Hill
anthony_hill@swissre.com
913-676-5224



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