



Solvency II

FGAP/ALMA SUMMER CONFERENCE

The Challenge Ahead :

Exit from the Crisis and the New Operating Environment

What are the Key New Regulations?

Solvency II

4th June 2010

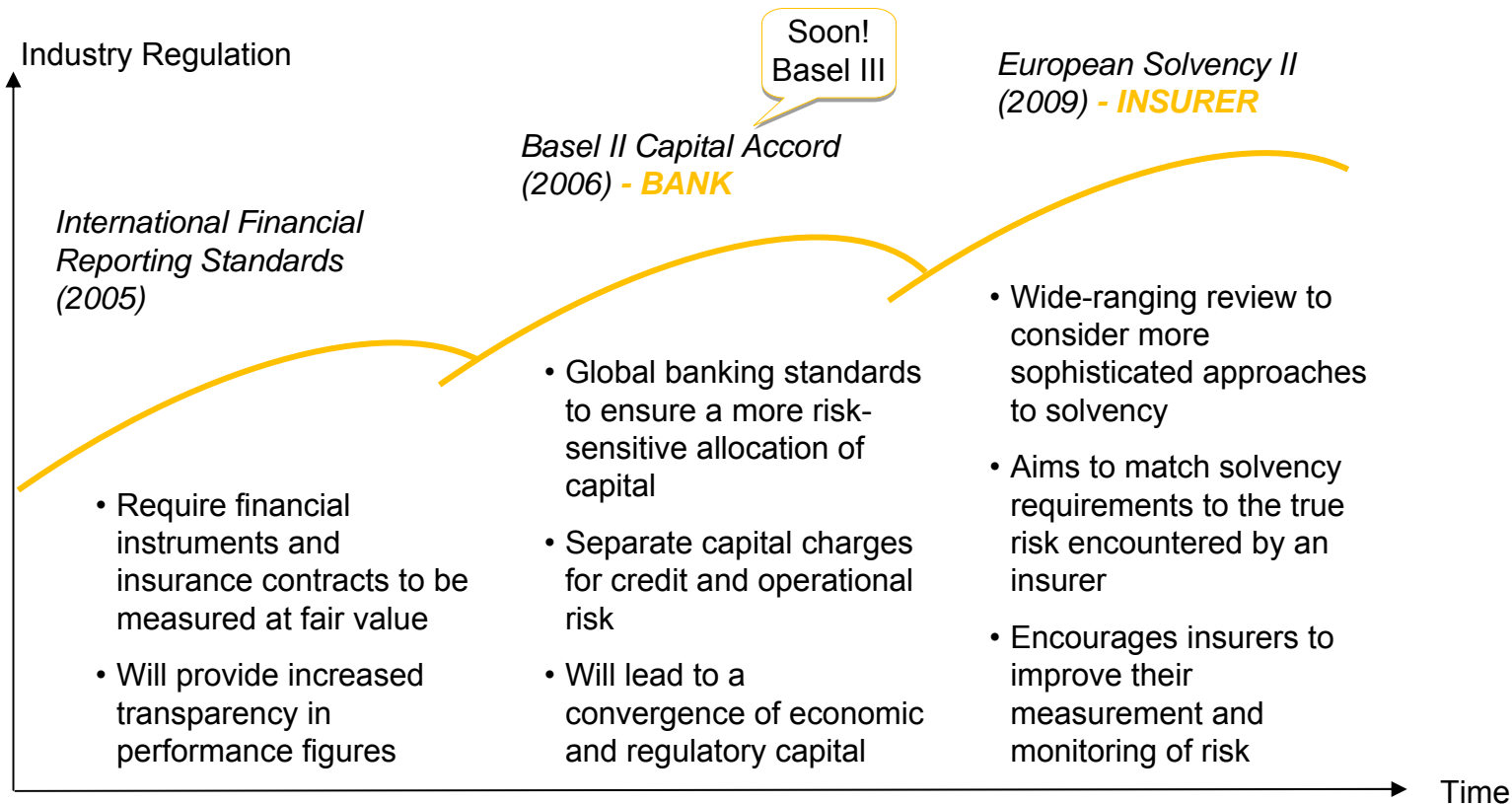
Agenda

1. **Introduction to Solvency II**
2. **Key Issues**
3. **Outlines**
4. **Expected Strategic impacts**
5. **Some discussion topics**
6. **Conclusion**

1 – Introduction to Solvency II

The Regulatory Landscape from a bancassurer 's point of view

Europe is facing the prospect of increasing regulatory upheaval across banking and insurance



1 – Introduction to Solvency II

Focus on Lamfallusy process

- Solvency II is the outcome of a lengthy process (Lamfalussy) aiming at a thorough revision of the Solvency regulatory framework for European insurers.
- The Directive has been voted in April 2009 by the European parliament : it appears as a timely and appropriate answer to the economical crisis.
- We now are entering a phase of discussion on the implementation details.

		Texts and objectives	Developped by...	Adopted by...	Timetable
Lamfallusy Process	Level 1	Framework Directive Conceptual framework including: • A 3 pilar structure • P1: Var 99.5% 1 year	European Commission	Joint decision by Council and Parliament, on proposition by the Commission (after consultation)	July 2007: Proposition of Directive by the Commission May2009 : Adoption by the Parliament and the Concil
	Level 2	Detailed technical implementation measures	European Commission	EIOPC	April 2009 : first series of CP July and fall 2009 : 2nd and 3rd series of CP
	Level 3	Interpretative recomandations	CEIOPS	CEIOPS	
	Level 4	Valuation	European Commission	European Commission	

2 – Key Issues

- **Two main Issues :**

- Defining capital needs in relation with Companies' Risks (using either a standard formula, an internal model or a mix of the two).
- Defining capital needs in absolute terms for the whole sector.

- **Knowing that :**

- so far, the calculations of the capital have been different between European countries.
- during the economical crisis, the Insurers hadn't needed any government financial support contrary to most of Banks.

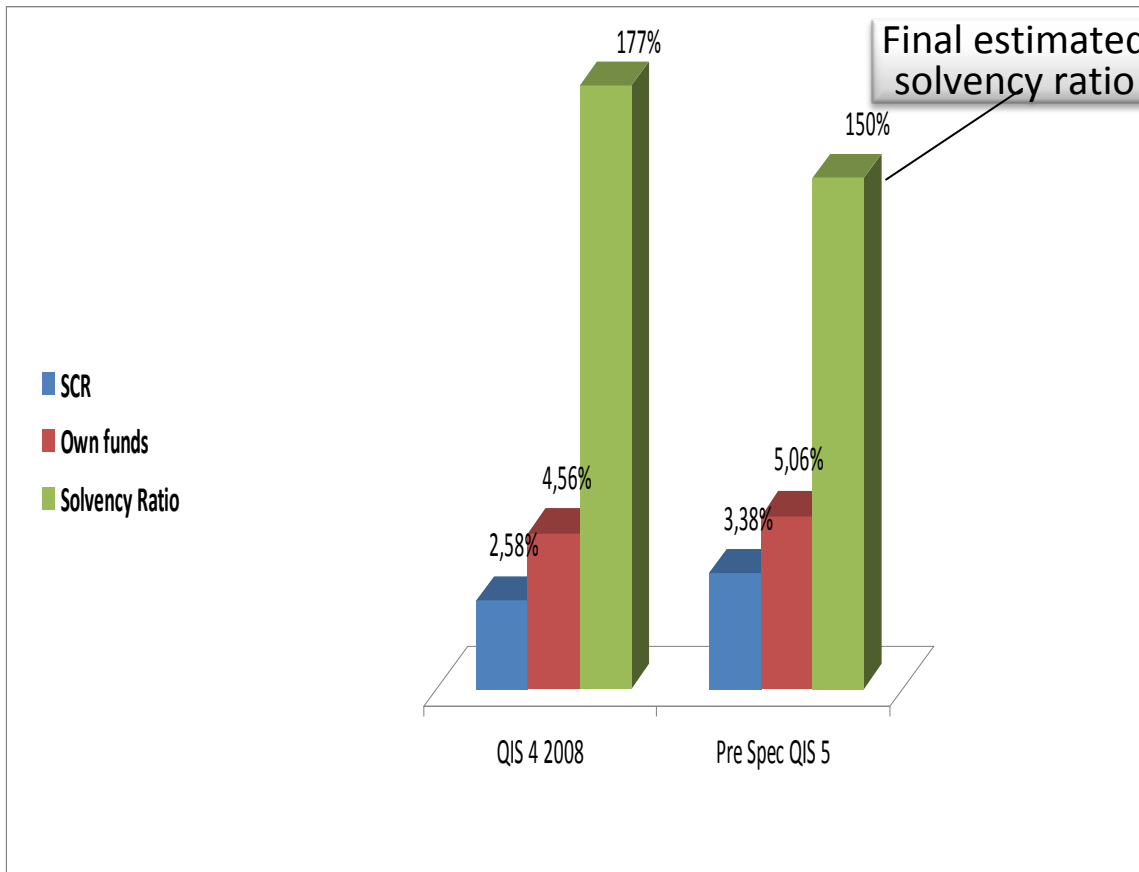
3 – Outlines

- **Each insurance company has to define its capital needs in relation with the undertaken risks (financial, operational, ...).**
- **The quantitative impact studies 4 (QIS4) on which were based the principles of the directive showed that European insurers were adequately capitalized.**
- **Conversely, CEIOPS' final pre-specification on Level 2 implementation measures (QIS5) have somewhat strengthened the risk weightings :**
 - Standard formula
 - Internal Model method

3 – Outlines

Example

Expected impacts for life companies



- **The context in which QIS5 were stated was influenced by :**
 - The negative impact of the financial crisis
 - The process of discussion in itself between regulatory authorities having different experiences who, instead of searching common denominator have added their concerns.
 - An additive approach of risks for a business where ALM implies a dynamic balance.
 - A preference given to a normative procedure (standard formula versus the use of an internal model).
- **If adopted unchanged by the commission, the final advice from CEIOPS would result in a significant increase in capital requirements as compared to QIS4 recommendations.**

3 – Outlines

Focus on financial reforms and their interaction

- **Broadly speaking, the two main roles of a bancassurer are :**
 - insurance products developer and distributor
 - Asset manager
- **Basel III would probably require more capital of the European banking system.**
- **Solvency II will likely have a similar impact on the insurance sector.**
- **In addition, banks that hold a majority stake in an insurance company will have to modify the way their subsidiary equities would be discounted from their own T1.**
- **In addition, IFRS IV phase 2 accounting rules, are not stabilized yet, increasing the lack of visibility over the prudential regulatory environment for the whole finance industry.**
- **As a result, the interaction between these different on going financial reforms would result in massive capital raisings that the equity markets seem at the moment reluctant to satisfy.**

4 – Expected impacts

- **The reform will impact Insurers in different areas :**
 - Product /pricing policy
 - Refinancing of the activity
 - Asset allocation

4 – Expected impacts

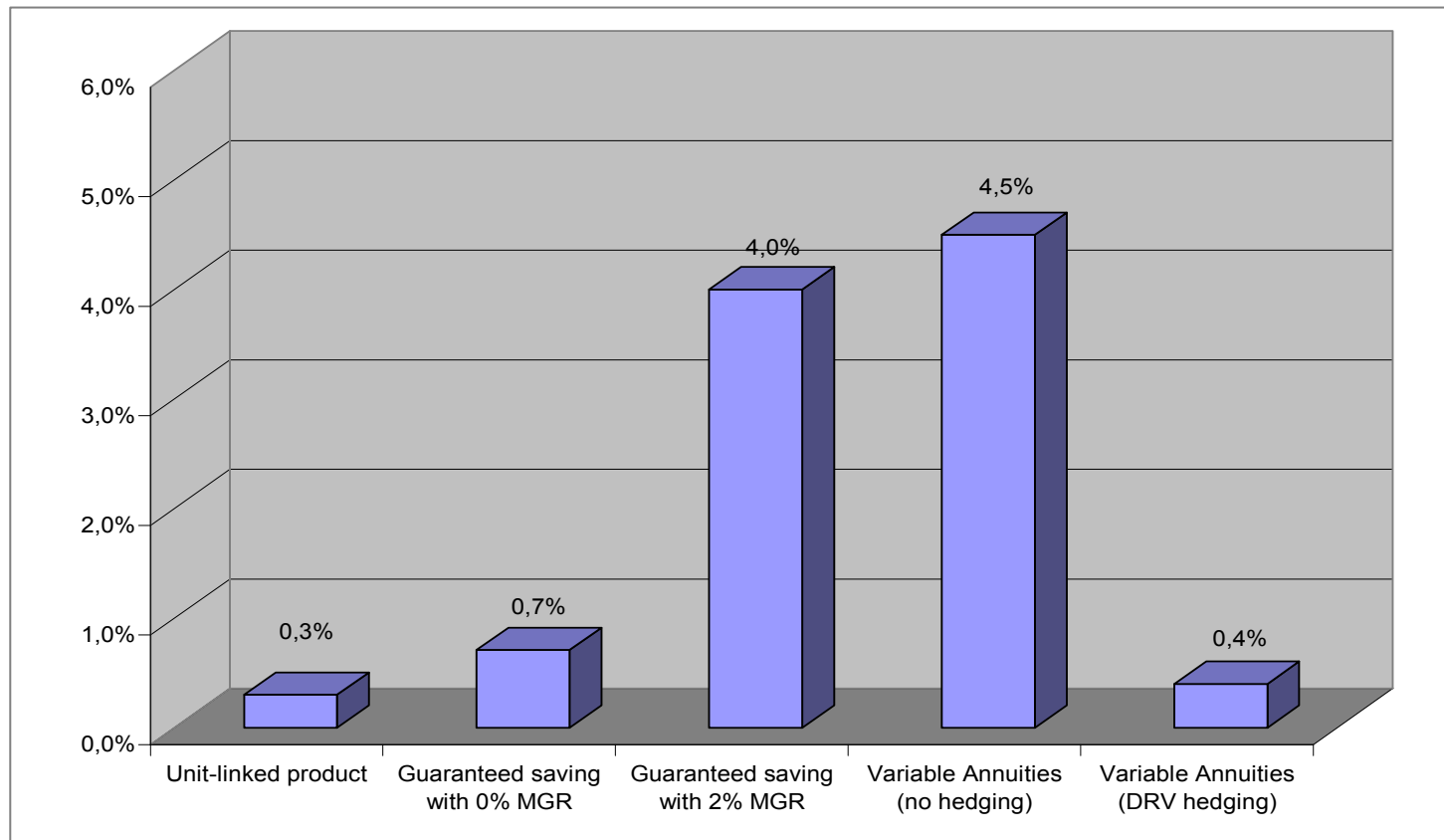
Product /pricing policy (1/2)

- **Solvency II will impact insurers' product development in two ways :**
 - Own funds requirement is from now on closely linked to the level of risk attached to the contracts i.e. to the warranties and options of the contract.
 - The reform could modify the competition landscape. In particular, in the countries with capitalization pension system because pension funds are submitted to a specific Directive.
- **As a result, an increase in pricing is to be expected on certain range of products/warranties.**
- **The new product offers will be depending more importantly from the required capital than in the past...**
- **Diversification of risks between complementary contract portfolios (for example savings and pensions portfolios) would allow companies to minimize the need for capital, thanks to the opposite sensitivity to interest rates risks, of these two kind of portfolios.**

4 – Expected impacts

Product /pricing policy (2/2)

Capital charge per product type

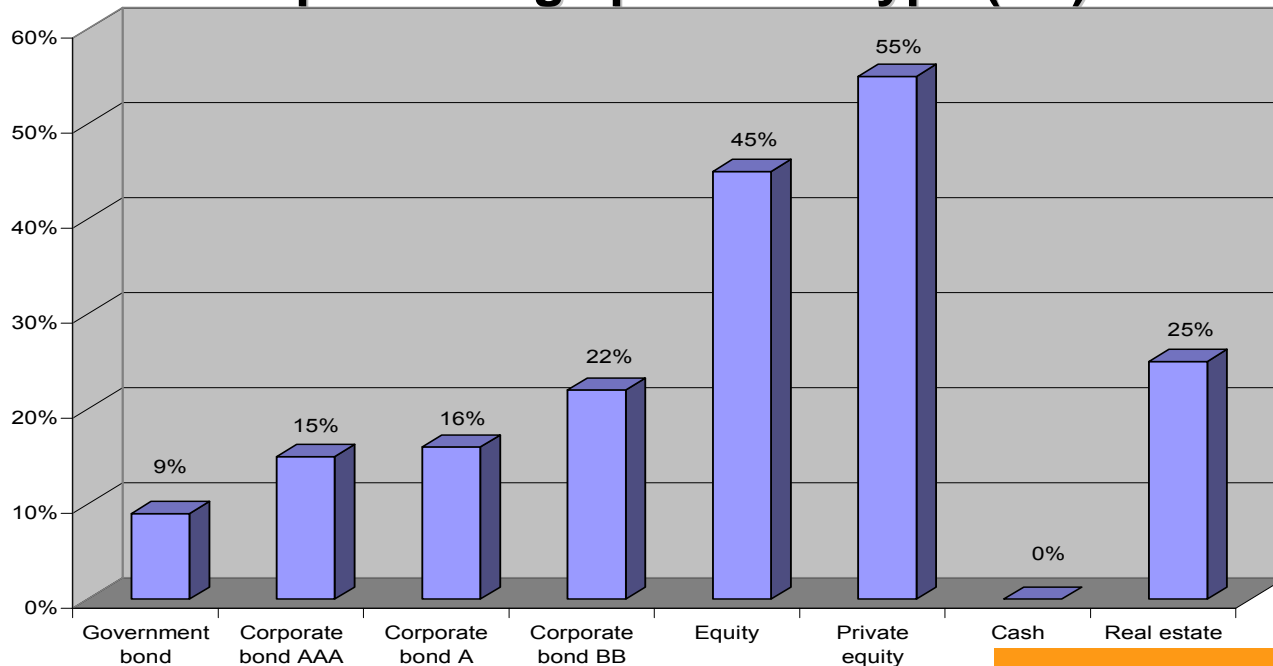


4 – Expected impacts

Asset allocation (1/2)

- The Directive's principles lead to levels of capital directly linked to the asset allocation strategy.
- One of the major effect being the penalization of investments in equities and to a lesser extent in real estate.

Capital charge per asset type (FA)



4 – Expected impacts

Asset allocation (2/2)

- **Consequently, insurers would have to reduce (somebody have already made the move) their exposure to equities, exerting downward pressure on the markets and limiting cash inflows into them over the coming years.**
- **Delivering attractive yields to their customers would become more challenging, due to the low interest rates current environment.**
- **More importantly insurers will experience increased imbalances in terms of ALM with difficulty to match assets & liabilities durations as well as to optimise the risk/reward profile of their portfolio.**

4 – Expected impacts

Refinancing of the activity

- Increase of amount and quality of Tier 1.
- Increase the quality of tier 2.
- Decrease the amount and increase the quality of tier 3.

LIMIT STRUCTURE		
	QIS4	FA - CP 46
SCR	Tier 1 \geq 1/3	Tier 1 \geq 50%
	Tier 3 \leq 1/3	Tier 3 \leq 15%
MCR	Tier 1 \geq 50%	Tier 1 \geq 80%

SCR : Solvency Capital Requirement

MCR : Minimum Capital Requirement

- **These stricter limits reflect CEIOPS concerns about the capacity of some hybrid capital instruments to absorb losses.**

5 – Some discussion topics

- **For a life insurance company (focused on savings) the main issues to discuss at this stage with the regulatory authorities are as follows :**
 - In terms of asset allocation, the penalization of investments in equities and in corporate bonds would have a strong negative impact on the financing of the economy.
 - The impact on the management and development of products.
 - The imperfect field of competition between life insurers and pension funds resulting from the reform.
 - In terms of product lines, the disadvantage to bear long term risks like pensions or dependence for which the need is growing quickly among European populations.

6 – Conclusion

- **The Solvency II Directive has been welcomed by the whole Insurance industry thanks to its sound and useful risk approach.**
- **The Lamfalussy process based on open discussion between all the European actors (insurers, regulators, ...) is a strong point to preserve the insurance industry balance.**
- **But ... the problem of the calibration of the capital requirement still remains overestimated because probably of a too analytical (additive) and bureaucratic approach.**
- **Fortunately, the insurance industry can expect that the European Commission - which has the final cut – will eventually provide adequate and pragmatic decisions (as QIS V did) enhancing Insurance industry to keep its innovative capacity.**