Solvency II Progress

Presentation and discussion

Insurance Committee

Prague – 21 October 2011

Headlines

- Application of SII delayed to 1 January 2014 with non-zero risk of further slippage
- Euro crisis has considerably complicated elements of Pillar 1 valuation and capital requirements
- Respective roles and attitudes of European institutions such as to border on the unworkable
- Pillar 2, including the actuarial function, remains generally well-conceived and deserves our active support
- Application of SII framework to IORPs is coming along well although details will be challenging
- Stakeholder groups important as ‘influence channel’ for Groupe

Should Groupe Consultatif be taking a more visible stance on issues?

Working Group Reports

Thanks to the team

- Dylan Brooks
- Mark Chaplin
- Vincent Dupriez
- Alan Joynes
- Esko Kivisaari
- Colin Murray
- Annette Olesen
- David Paul
- Henk van Broekhoven
- Gerard Vandenbosch
- Said Younsi

Working Group Reports

Timetable

- Draft Level 2 text to be transmitted by Commission to Parliament within 2/3 weeks
- Omnibus 2 expected to be voted out of ECON in November
- Trilogue expected to result in agreed version of Omnibus 2 by 2/2012
- Level 2 text as improved by lawyers to be published 4/2012
- Parliament has 6 months to consider Level 2 text
- Implementation by member states still scheduled for 1 January 2013, although some protest. IM approval enabled
- Commission to clarify reporting obligations timetable
- Application to firms still scheduled for 1 January 2014
- Directly linked to progress (or lack of it) in restoring eurozone financial stability

Discount rates etc.

- Draft text of Commission ‘compromise’ received 20 October
- In the real world:
  - euro-denominated government bond yields continue to diverge sharply
  - Highly-rated government bond yields are at historic lows
  - Renewed banking system tensions reflected in increased LIBOR-OIS swap spreads
  - Huge uncertainty re outlook for growth and inflation
- Commission has proposed a ‘risk-free’ rate with additional ‘matching’ or ‘counter-cyclical’ premium(s) coupled with rapid extrapolation to a macroeconomically-based ultimate rate
- We are moving away from anything recognisable as a ‘market-consistent’ balance sheet. This is a regression from the work of the joint task force (although that work was not perfect).
- Urgent need for impact assessment in the context of various market scenarios
- Potentially significant unintended consequences for asset allocation
- Implications for standard formula stresses yet to be thought through
- All the same issues will recur more strongly in the pensions context

Extrapolation – a gamble?

- Commission is proposing a faster rate of convergence with an ultimate macroeconomically-based forward rate than would normally be regarded as market-consistent
- If eurozone issues are resolved and European economic growth returns to its historic trend trajectory then this will likely be seen as useful temporising
- If Europe falls into Japanese-style low growth and near-deflation then the abandonement of market-derived disciplines will likely be seen as complicit weakening of policyholder security
- Groupe should make clear that the stakes are high

Resolving the muddle

- It may be common ground that there are two distinct challenges in measuring adequacy of assets for solvency purposes – avoiding procyclicality and taking account of the heterogeneous characteristics of liabilities
- These may have become mixed up and should be disentangled
- Avoiding procyclicality
  - It is natural for life insurers to have longer liabilities than assets and therefore vulnerable to interest rates below equilibrium levels
  - Swap rates can become decoupled from bond rates generally and especially for certain countries
  - Exceptionally because of clientele effects, market values can deviate from the plausibly rational
  - It may be better to respond to this by requiring 'mark to model' asset valuation in certain rare cases rather than varying the valuation of liabilities
- Liabilities replicable by illiquid assets
  - A liability which is both predictable as to amount and timing and illiquid in the hands of the policyowner may be replicable by an illiquid asset and is appropriately valued accordingly
  - This basis of valuation should be independent of the ssets actually held.

Group stance

- Ignorance and distrust between member states, between supervisory community and industry, between industry and investors are leading to proposals which have the potential to increase rather than reduce systemic risk
- Markets have demonstrated a consistent capacity to wrongfoot politicians (and many investors)
- Groupe should advocate clarity of principle with high degree of intelligent flexible implementation by European institutions (including ESRB)
- Are we part of the problem or part of the solution?

Contract boundaries

- Distinction between existing and new contract is an issue imported from accounting (IFRS). Example is contract with right but not obligation to make further payments of premium
- We would be neutral (in terms of best estimate provision) as between estimating probable policyholder behaviour or assuming that contract terminates neutrally immediately
- EIOPA/Commission appear to want provision for future maintenance expenses with no future premiums which seems unbalanced and inconsistent with best estimate
- Some linkage with exaggerated sensitivity on the part of some supervisors re discontinuance risk

Sovereign Risk

- Market values of government bonds for several countries reflect an unknown degree of risk of default or restructuring.
- Some firms prefer ‘mark to model’ to ‘mark to market’ for weaker sovereigns
- Some heterogeneity in feasibility of redenomination of bonds in the event that a country leaves the euro
- Extremely difficult for firms / supervisors to assess objectively the risk associated with the debt of their own government
- Groupe has been silent – general stance is that actuaries should be alert to any risk which may affect the capacity of a firm to discharge liabilities in the currency of the liability domicile

Actuarial Function and Guidelines

- New pre-consultation materials this week
- May be a need to clarify stance on conflicts of interest within function and vis-à-vis other functions
- Develop a line on proportionality
- Require comment on secular trends? (loss processes, dependencies)
- Relative value of own and external data? Proportionate approach to credibility?
- ‘Estimates’ preferable to ‘assumptions’?
- Require explicit discussion of materiality?
- Stronger emphasis on transparency of reporting?
- Consistency with recent evolution of Level 2 a concern
- Lessons from accounting and auditing standards?
- Industry stakeholders’ views?
- Active field testing desirable

ORSA

- EIOPA planning public consultation to commence November
- Likely to follow closely earlier pre-consultation which (rightly in our view) focused on process and principles
- Groupe summer school theme
- Parallel development in USA
- Real demand from actuaries for educational materials and standards to educate themselves and supervisors
- Irish planning online tool for SME’s
- EIOPA IRSG discussion in December – committed to contributing actively
- Other national developments?
- Next steps for Groupe?

Reporting by firms

- Pre-consultation on reporting templates in 2010
- Challenges in finalising templates while substance of Level 2 still fluid
- EIOPA hoping to go for public consultation once draft Level 2 text has been finalised
- Controversy on detailed reporting of assets by firms large and small
- Parallel discussion on technological protocols to support reporting
- ESRB appetite for data relevant to systemic issues
- EIOPA IRSG to discuss at December 2011 meeting
- Significant work for 'Pillar 5' working group

Non-life calibration

- Groupe participated in a joint working group with EIOPA and stakeholders to recommend calibrations for standard formula for non-life business (thanks to David Paul)
- Comments to EIOPA
  - Adequacy of collected data? Disclosure?
  - Stratified averaging of results OK
  - Heterogeneity by member state inadequately disclosed
  - Implication for consideration of use of USPs by relatively specialised firms
  - Welcome commitment to impact assessment and future review

Issues in the Parliament

- Delegated acts or regulatory technical standards?
- Treatment of SME’s
- Counter-cyclicality – capital requirements or provisions?
- Audit requirements
- Interaction of internal model and standard formula
- Equivalence

IORPs

- Pensions Committee colleagues have been engaging very actively with EIOPA directly and through OPSG
- Project team has been fully involved with a principal interest in consistency of application of SII concepts to pensions balance sheets
- EIOPA is planning to consult on a ‘holistic balance sheet’ embracing:
  - Benefit discretions
  - Contingent assets
  - Sponsor covenant
  - Guarantee schemes (eg PPF)
- Deadline for EIOPA response to Commission CfA likely to be extended by 2 months to February 2012

EIOPA IRSG

- Four meetings so far in 2011, with one more to come
- Focus gradually improving with more substance and less process
- December meeting will concentrate on ORSA and reporting
- Modus operandi will be to create sub-groups to deal with particular work domains (reporting back to main group)
- A ‘steering group’ may also be desirable
- Likely to be extremely busy in 2012 with Level 3 materials
- Other issues have included consumer protection and ECJ judgement
- Co-opt other actuarial voices
- BEUC criticism
- Heavy workload for Groupe nominees in 2012

Other developments

- Banking / insurance interface attracting ESA attention
- EIOPA a more independent voice?
- SST implementation in face of industry resistance because of very low interest rates
- NL academic research on implications of incomplete markets and risk margins
- IMD proposal February 2012 (to embrace PRIPs)
- Nat Cat research study and conference
- Guarantee schemes paper from Parliament 2012
- EIOPA / Joint Committee work on consumer protection

Looking forward

- High volume of Level 3 consultation to come in 2012
- Continuing need for informal (e.g. working group meetings and pre-consultations) and formal (stakeholder group) interaction with EIOPA – and other stakeholders. Resource balance an issue
- Macro concern that Pillar 1 SII has under political pressure substantially departed from IAA solvency assessment model and may be irreconcilable with IFRS
- What should Groupe Consultatif be standing for?