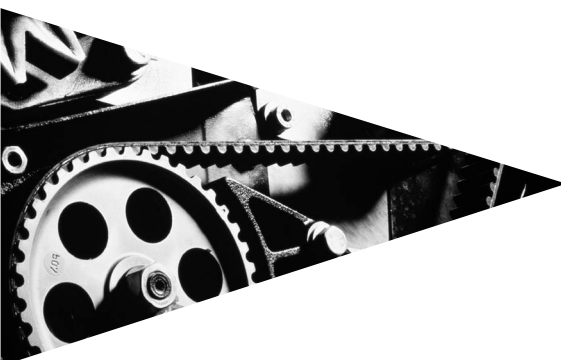


Solvency II

QIS 4 update



Shifting the focus from consultation to implementation

Executive summary

Since late 2005, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has involved the insurance industry in a consultation process to test the impact of proposed Solvency II regulations. These Quantitative Impact Studies (QIS), which are performed by companies on a volunteer basis, are being run by CEIOPS at the request of the European Commission. They are the primary means for testing the design of the future European Standard Formula, as well as the main route for determining the correct calibration. They are also instrumental in collecting data on the potential impact of the new regulations.

In this report, we will provide an update on lessons learned from QIS 1, 2, 3 and also highlight new issues that companies will need to address in QIS 4.

The potential framework for Solvency II is now well developed so that the changes being tested in QIS 4 will seem less significant than earlier versions. For companies engaged in the consultation process – and those that have yet to take the important steps – this is an ideal opportunity to test Solvency II specifications and assess their impact on your business.

Update on the QIS process

Addressing the issues in QIS 4 requires an understanding of what has been accomplished to date. QIS 1 was intended to test an approach for setting technical provisions, while QIS 2 focused on a methodology for assessing capital. QIS 3 centered on improving the calibration of the standard formula for Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR) calculations.

CEIOPS approved an interim draft of the QIS 4 specifications on 21 December 2007. The Coordination Group had until 15 February 2008 to offer its views and then passed the draft on for final approval. QIS 4 will run from April to July 2008. It is expected that the results will be released in November 2008 and that the directive will be adopted by the European Parliament and Council in 2009.

Ahead of this launch, CEIOPS also released Consultation Paper 23 (CP23), which gives guidance on how to determine the technical provisions (best estimate and risk margin) when a company is missing data and/or expertise. These simplified methods will also be tested in QIS 4, which aims to address concerns with CP23.

The main objectives of QIS 4 are to test:

- ▶ Simplifications for smaller insurers (the principle of proportionality)
- ▶ Simplified approaches to estimating technical provisions
- ▶ Further refinements to the calculations and calibrations of the SCR standard formula

Lessons learned from QIS 3

QIS 2 participation was good, but QIS 3 was even better. In fact, participation almost doubled compared to the previous study. This shows the high interest from companies for Solvency II and the importance of taking part in such exercises to prepare for full implementation.

QIS 3 was the first study to focus specifically on calibration, and it has provided a wealth of information on a wide range of elements of the Solvency II proposal. For some elements, multiple approaches were tested.

The main objectives of the QIS 3 were to:

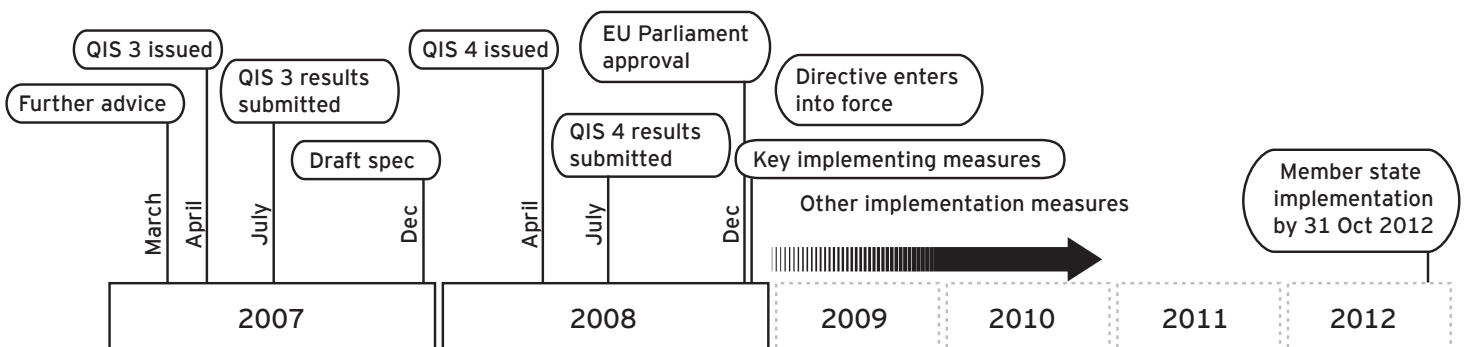
- ▶ Measure the financial impact of the adoption of QIS 3 specifications on balance sheets

- ▶ Collect feedback from the participants on the practicality and suitability of the calculations
- ▶ Test the effects on insurance groups (as opposed to solo entities) for the first time

Financial impact on insurance company balance sheets

The numerical results of QIS 3 provided some interesting insights into the potential impact of Solvency II on the regulatory balance sheets of insurance companies.

- ▶ Technical provisions tended to decrease, with the release of the prudence margin in Solvency I being greater than the additional risk margin under Solvency II.
- ▶ This tended to be more than matched by an increase in the capital requirements and, on balance, the overall solvency ratio tended to decrease. This was most significant for non-life insurance companies, where the solvency ratio decreased for the majority of participants. Life insurance companies showed a combination of increases and decreases in the solvency ratio.
- ▶ QIS 3 showed 98% of firms meet the MCR and 84% of firms meet the SCR, so a large-scale capital injection is unlikely. However, some reallocation of capital may be needed, reflecting the increased risk sensitivity of the proposals.



This is an ideal opportunity to test the Solvency II specifications and assess their impact on your business.

In addition to the CEIOPS assessment, the Chief Risk Officer (CRO) Forum, an industry body representing the CROs of the 13 largest European (re)insurers, benchmarked the results of QIS to the internal models of its members. It found that the QIS 3 specification tended to result in an SCR of about 40% higher than internal models, largely due to differences in the calibration of the insurance risk SCR. This highlights the fact that companies can still benefit from taking part in further consultations to align these calibrations.

Feedback on practicality and suitability of calculations

QIS 3 results were largely well received and the participants were generally positive about moving toward market consistent valuation and risk-sensitive solvency requirements. However, there were a few key areas that participants felt should be addressed:

- ▶ Risk margin – It was suggested that the risk margin approach should be more clearly defined and that market risks should be excluded to avoid double counting. QIS 4 addresses these issues by providing guidance on simplified approaches for projecting the SCR and changing the specification to exclude market risks. Participants felt that the 6% cost of capital rate was too high; however CEIOPS has not addressed this in QIS 4, pending more industry research into an appropriate factor.
- ▶ Reduction for profit sharing – The method proposed for assessing the risk-absorbing ability of future discretionary profit sharing (known as the KC) was strongly criticized because of the complexity of the QIS 3 specification. This method was based on calculating all SCR components assuming no change to discretionary profit-sharing benefits in stress scenarios, aggregating these and then reducing the overall SCR by a factor to reflect the risk-absorption capability of future profit sharing. The calculation of this factor proved to be problematic and QIS 4 has moved to a

calculation of SCR components “net” of management actions, which is more aligned with current market practice.

- ▶ Operational risk SCR – The QIS 3 feedback was that the formula was insufficiently risk sensitive, includes an inappropriate charge on unit-linked business and does not diversify with other risks. While the formula and diversification benefit have not been changed in QIS 4 (CEIOPS stated that this was better addressed under Pillar II), the charge for unit-linked business has now been based on expenses, rather than reserves, which aims to address the industry feedback.
- ▶ Lapse risk SCR – QIS 3 included an assessment of lapse catastrophe risk, based on a mass lapse of 75% of the company unit-linked portfolio. This was criticized as being too onerous and has been reduced to 30% in QIS 4. The new rate is now extended to apply to all businesses where there is a surrender strain on lapse.
- ▶ MCR – The approach set out for the MCR was believed to be too volatile and impractical, and demonstrated a counterintuitive relationship with the SCR for many life insurers. QIS 4 is now proposing a “linear” approach, which is less risk sensitive.

CEIOPS has made it clear that this is an area in which the QIS 4 methodology is by no means a final view on the potential methodology.

The fact that most issues were addressed by CEIOPS in QIS 4 highlights how the consultation process allows the industry to contribute to the overall form of future Solvency II requirements.

Issues for insurance groups

QIS 3 was the first consultation to address the issues related to management of insurance groups.

A key criticism from members of the industry was that the QIS 3 treatment of insurance groups did not allow for adequate geographical diversification

benefit. The approach to subsidiaries outside of the European economic area was also challenged.

To address this, QIS 4 has requested a series of different calculations so that various approaches can be investigated for group diversification. One of these is an approach that assumes consolidation of non-EEA entities and aims to apply more consistent standards and include diversification benefits.

Simplified approaches

CP 23 provided guidance on proxy calculations for the technical provisions, and these approaches are to be tested in QIS 4. These are simplified market-consistent valuation methodologies that are aimed at overcoming the problem of a lack of data, or of a lack of actuarial expertise in assessing technical provisions, for less material lines of business. In addition, QIS 4 will provide simplified formula-based proxy calculations for the SCR.

The key aim of these proxies is to provide simple estimation techniques to avoid disproportionate calculation effort for small lines of business. The criteria for application of these techniques is that liabilities must be simple by nature and not exceed €50 million for life (€10 million for non-life) or 15% of the total technical provisions or SCR of the company.

A further use of these techniques is in the projection of the SCR in future time periods as proposed by the risk-margin calculation for those who cannot project the SCR. This can be a good alternative to the formula-based SCR runoff.

Further refinements

QIS 4 contains a number of additional changes from QIS 3 in addition to those

suggested by the industry. Most of these are relatively minor changes to the SCR assessments (such as for the market risks), although some are significant enough to warrant mention.

In QIS 3, swaps were the favored proxy for risk-free rates as opposed to government bonds. QIS 4 now appears to favor the use of AAA-rated government bonds, although entities may deviate from this (e.g., use swaps) if they believe that this is more appropriate. Current practice in market-consistent embedded value reporting tends to favor swap rates because of the existence of more liquid swap markets.

Guidance has also been provided on the valuation principles for different assets, and this has effectively brought company pension schemes into the scope of QIS 4. The specification states that the IAS 19 treatment of a pension fund is an acceptable proxy and brings surpluses and deficits onto the balance sheet.

Conclusion

Solvency II is all about improving risk management and rewarding already existing good practice. Updating risk management processes and practices takes time. The bottom line is that insurers need to start preparing now for when Solvency II comes into force.

QIS participation is a key way to not only influence the debate but also to assess your own level of preparedness to implement the standards. Many companies are now using the QIS as a catalyst to launch a full-scale gap analysis into their Solvency II processes and capabilities.

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