Solvency II – An Introduction

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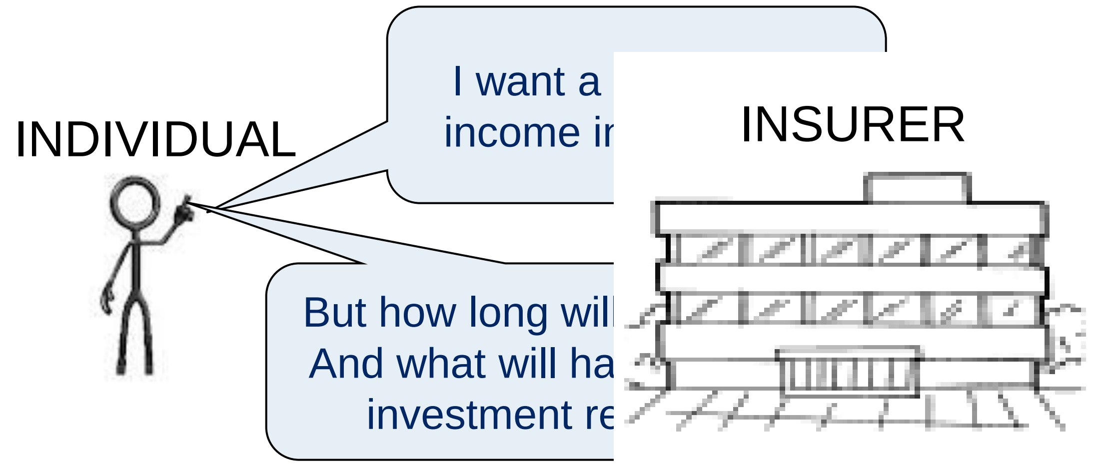
Standard Life

Overview

- Risk
- What is Solvency II?
- What does Solvency II look like?
- Methods of calculation
- Potential Impacts of Solvency II

Risk



A Clearly defined customer need

Opportunity to meet customer need

Risk

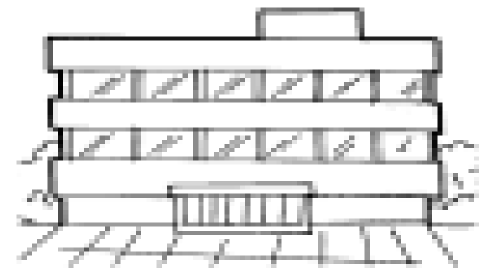
INDIVIDUAL

I hope they are good for it!

Invest in an annuity

Risk transfer

INSURER



Guaranteed income for life from insurer

SOME RISKS FOR INSURER

- **LONGEVITY**
- **MARKET**
- **EXPENSE**
- **OPERATIONAL**

To protect the customer the Insurer needs to hold capital against the risks it runs

What is Solvency II?

What is Solvency II?

“Solvency II is probably the most significant change in the regulation of insurance and reinsurance companies ever introduced, impacting both the regulatory capital requirements but also the governance systems and risk management frameworks.”

- Source: PriceWaterhouseCoopers article on Solvency II

What is Solvency II?

- The Solvency II Directive is being introduced by the European Commission
- Affects all EU-wide insurance and reinsurance companies
- Compliance is mandatory
- It will completely replace the existing solvency regulations
- The expected ‘go live’ date is 1 January 2014

What is Solvency II?

PURPOSE

• Improve protection for customers by requiring firms to adopt a ***risk-based approach to determining how much capital they need to hold***

HOW?

• Principles (not rules) based regime

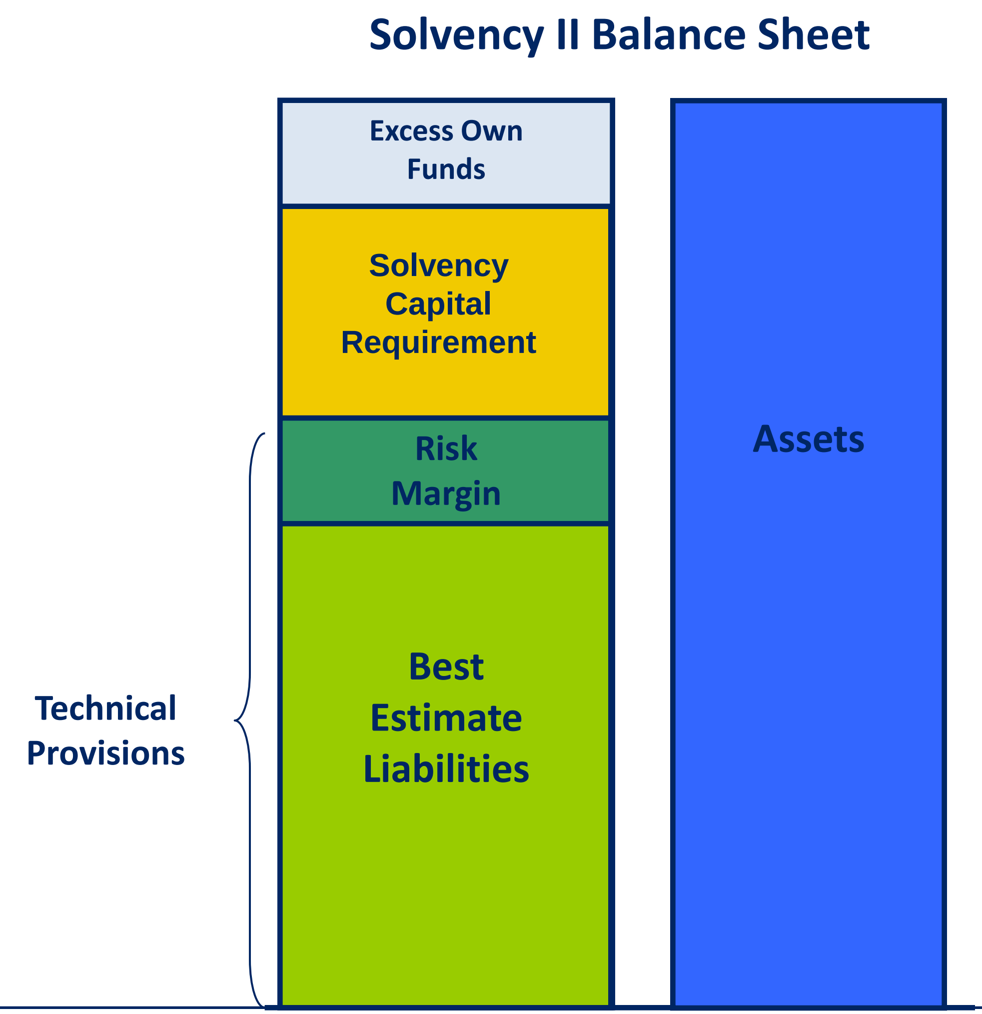
• Matches risks to capital

• Therefore encourages good risk and capital management

• Disclosure to the market and regulators

What does Solvency II look like?

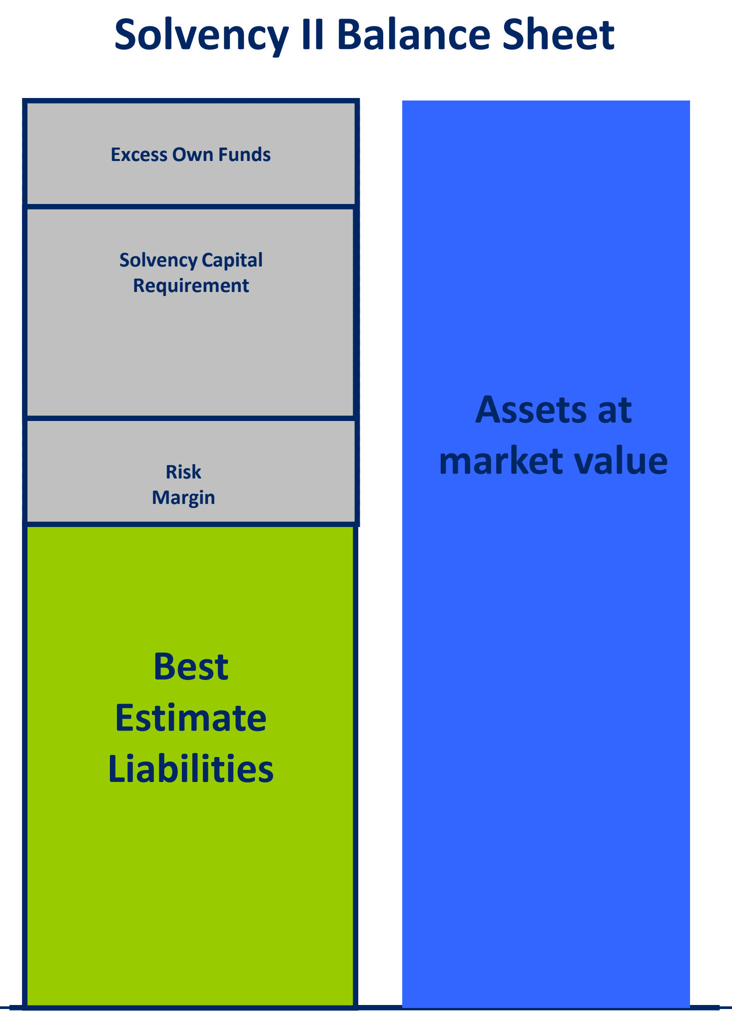
The Solvency II Balance Sheet



Assets and Liabilities

- Assets = Market Value

- Best Estimate Liabilities = No Prudence



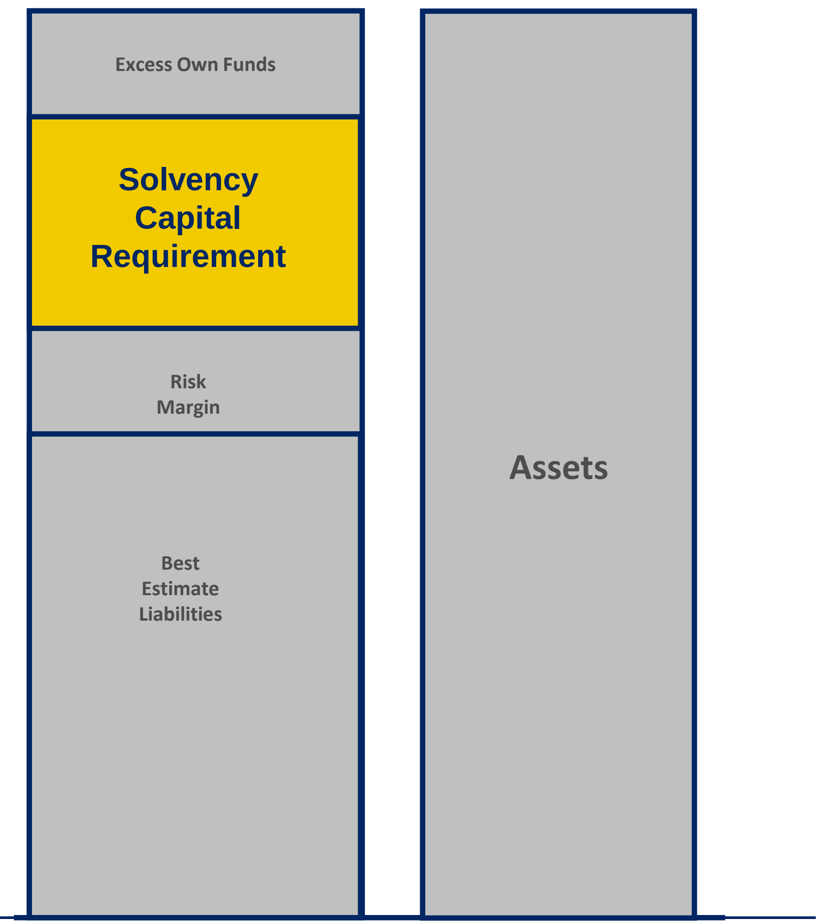
The Solvency Capital Requirement

Solvency Capital Requirement – The capital required to enable the firm to withstand 99.5% of possible scenarios happening over the next year (i.e. a 1 in 200 year event).

Scenario rank
1
2
3
4
.
.
.
994,999
995,000
995,001
.
.
.
1,000,000

Solvency Capital Requirement

Solvency II Balance Sheet



Examples of Risks

Financial

- Equity
- Credit
- Property
- Interest rates
- Foreign exchange

Insurance

- Persistency
- Longevity
- Morbidity/ Mortality
- Expense

Operational

- Process execution
- Customer products & practices
- Security
- Fraud
- Regulatory & Legal
- People
- Business Interruption & System Failure
- 3rd Party failure

Other Risks

- Liquidity
- Intangible asset
- Group Specific

How do the risks interact?

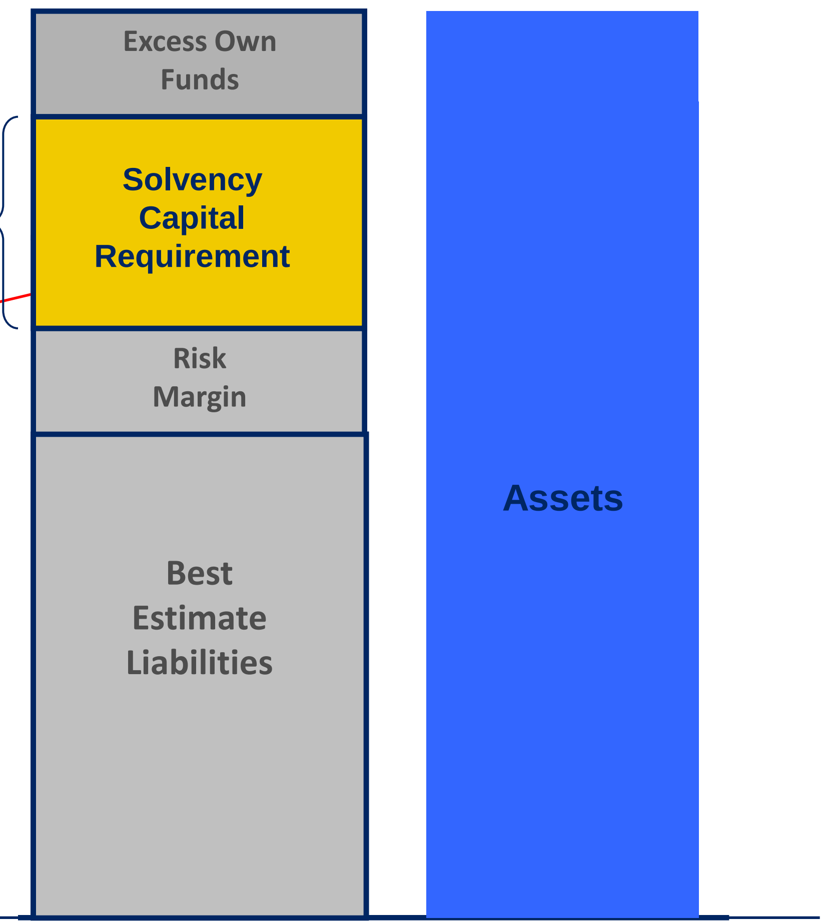
The Solvency Capital Requirement

The **Solvency Capital Requirement** acts as a threshold for regulatory intervention

Solvency II Balance Sheet

Solvency Capital Requirement (SCR)

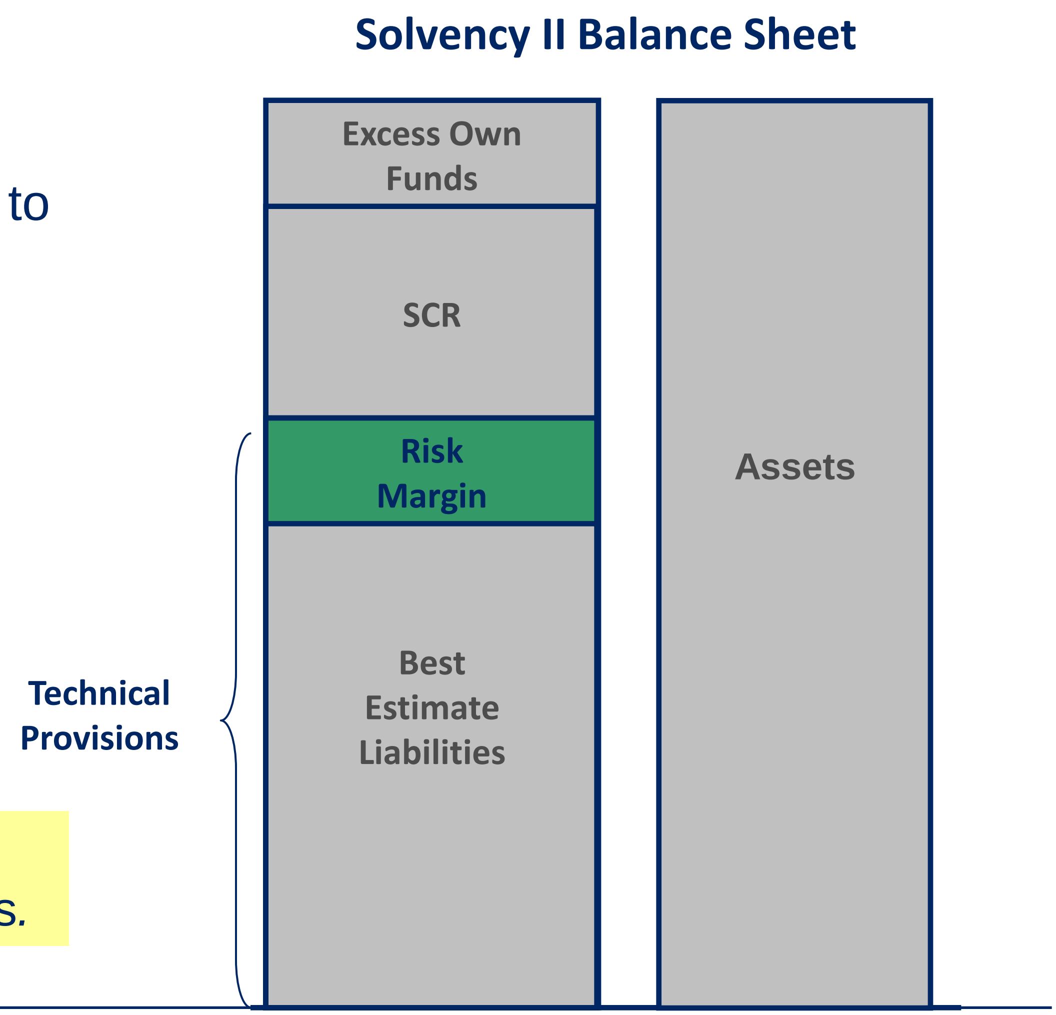
Minimum Capital Requirement (MCR)



Risk Margin

Risk Margin – an amount sufficient to support the transfer of assets and liabilities to another entity

Customers are protected – firms hold enough capital to cover most scenarios.

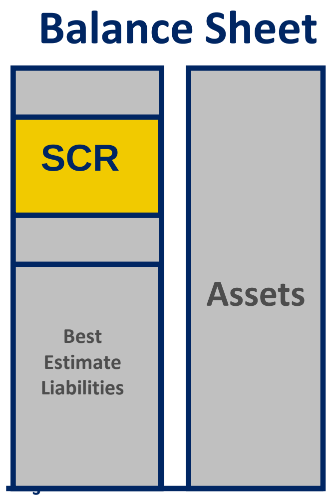


SCR: Internal Model or Standard Formula?

- **Standard Formula** approach
  - Prescribed approach
  - Common to all firms – “one size fits all”

OR

- **Internal Model** approach
  - Tailored approach
  - Firm specific Risk Profile
  - Subject to supervisory approval
    - Demonstrate meets exacting statistical standards
    - Embedded into the firm’s governance and is a key tool in decision-making



Benefits of Internal Model

- Capital requirements are driven by the “real” risks
- Risk and capital management is at the heart of decision-making
- Reputation for large companies

What Impacts could Solvency II have?

- Solvency II will be embedded in the running of insurance businesses:
  - Senior management will have in depth understanding of Solvency II
  - Results will be regularly discussed
  - Results will support decision making and setting business strategy

- Capital requirements could change – impact on share price?
- Potential change in products available to customers
- Change in reporting
- Ultimately more protection for customers

Summary

- Taking on risk enables companies to meet customer needs
- Solvency II aims to protect customers though improved risk management and capital adequacy requirements
- Compliance is mandatory
- Expected ‘go live’ date is 1 January 2014
- Effective risk management:
  - Protect customers from adverse events
  - Good for shareholders by keeping cost of capital down

Questions