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2013 Conference
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4th to 6th December 2013

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Regulatory developments in life assurance

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Milliman LLP

5 December 2013

Agenda

- The world of international regulation
- The Solvency II saga
- The IAIS and global minimum capital standards
- Principles-based reserving in the US

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- **The world of international regulation**
- **The Solvency II saga**
- The IAIS and global minimum capital standards
- Principles-based reserving in the US

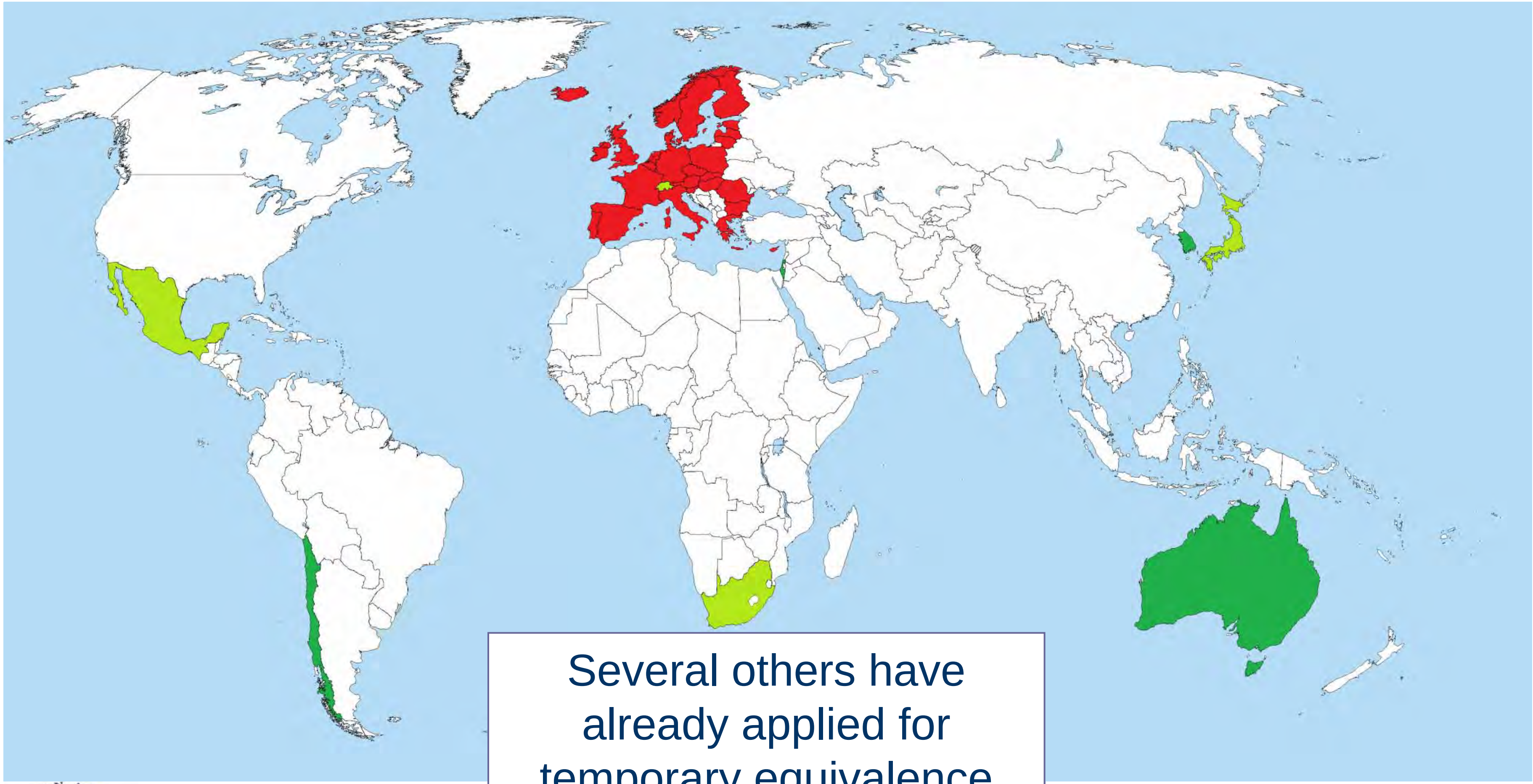
The world of international regulation

From 2016 (at the earliest) all insurers and reinsurers in EEA countries will need to comply with Solvency II requirements

The world of international regulation

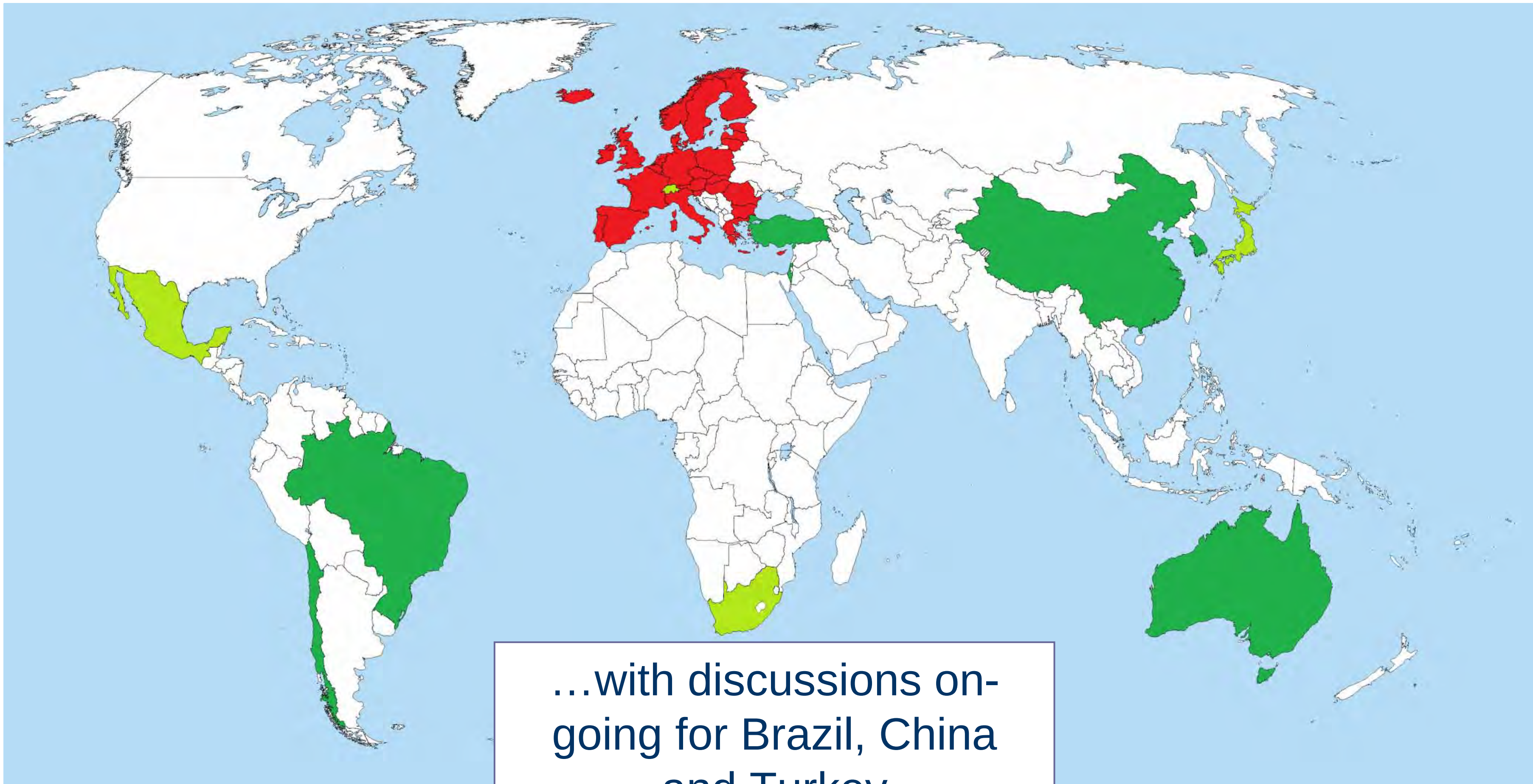
Several countries are specifically developing a Solvency II-style regime

The world of international regulation



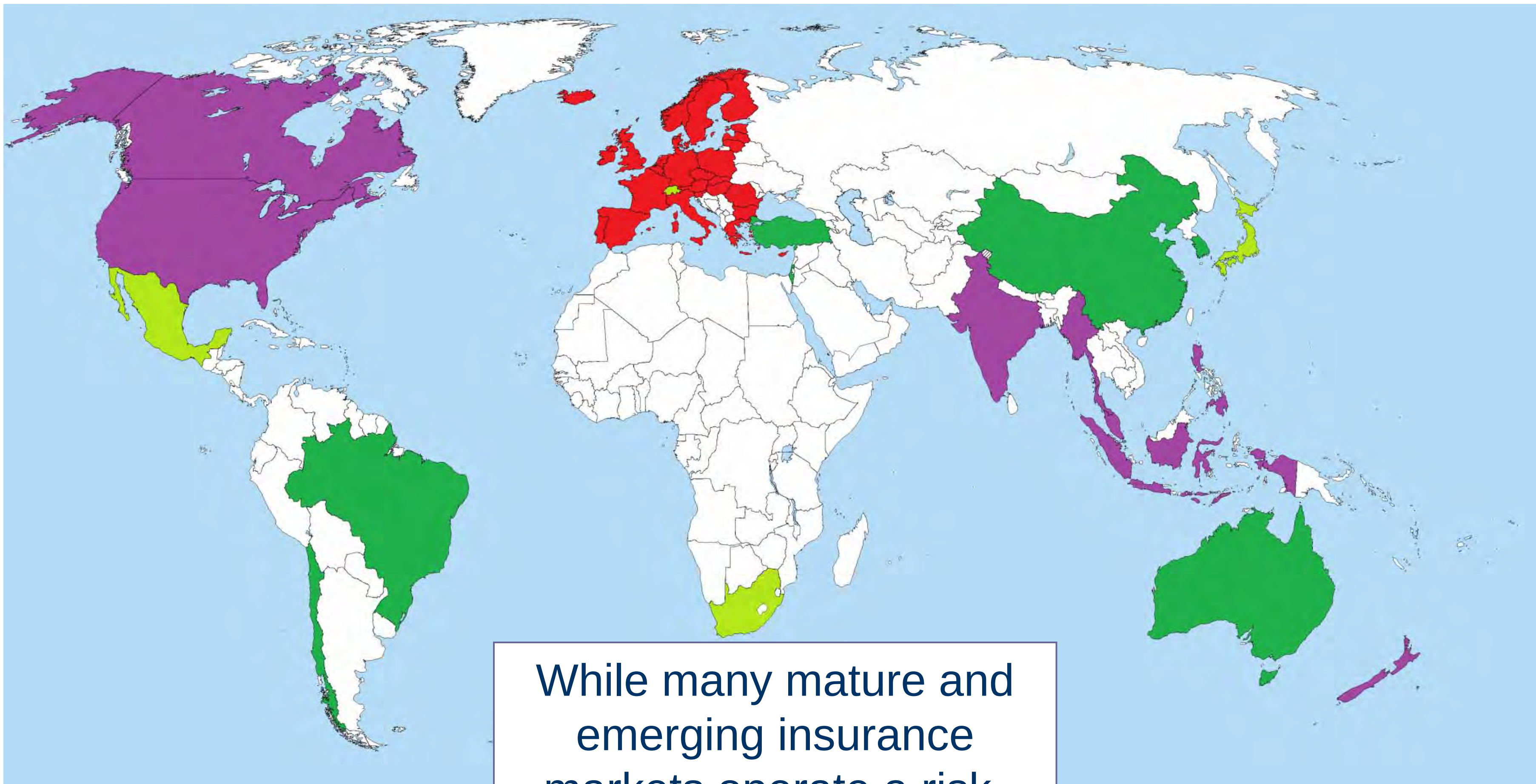
Several others have already applied for temporary equivalence with Solvency II…

The world of international regulation



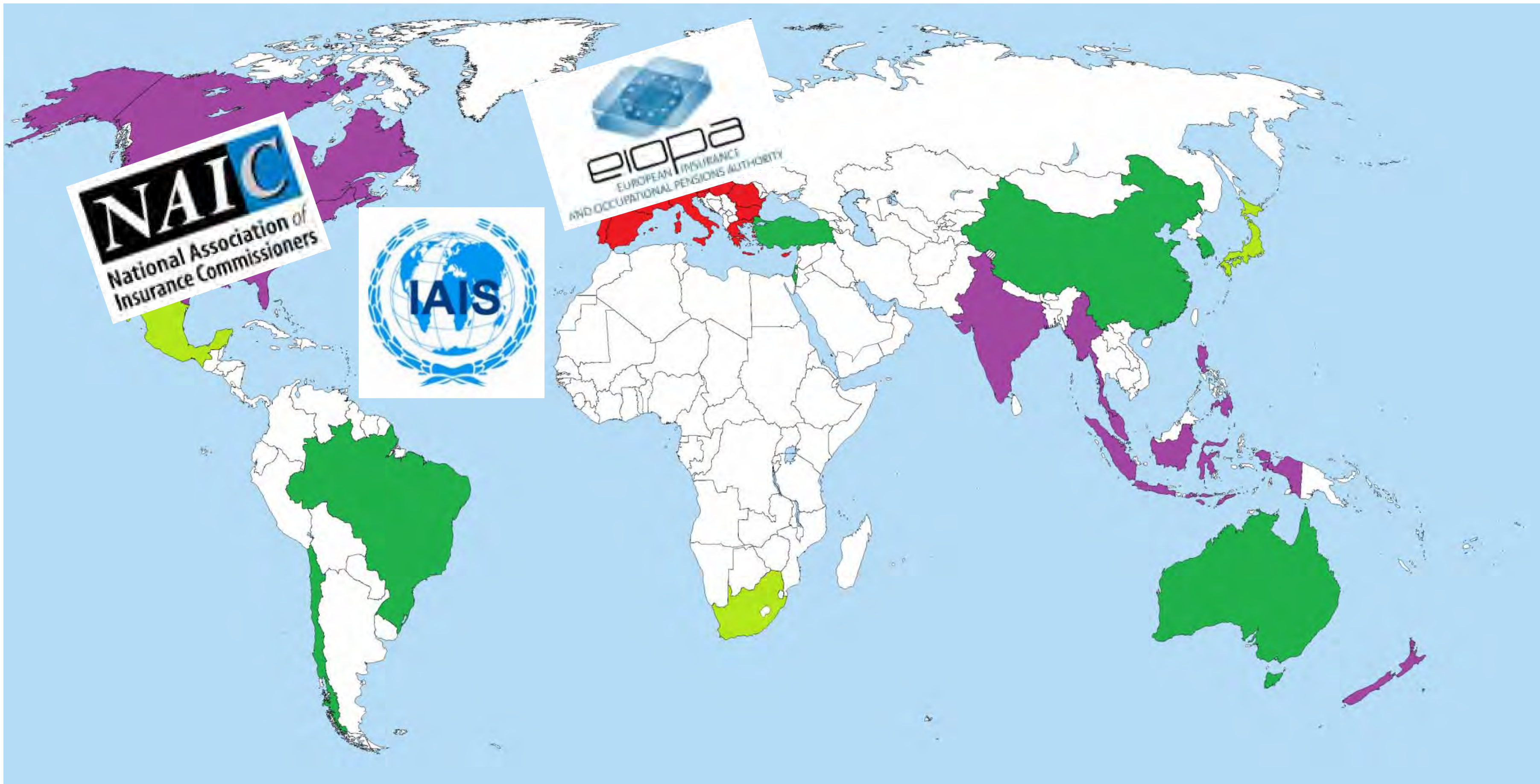
…with discussions on-going for Brazil, China and Turkey

The world of international regulation



While many mature and emerging insurance markets operate a risk-based capital regime

The world of international regulation



Regulatory regime summary (1/2)

Jurisdiction	Factor -based	Movement to a risk-based approach	Already risk based	Comments	Valuation basis
Argentina	X	No clear target			Generally market value for assets, Book value for reserves
Australia			1 year-VaR approach Scenarios and factors	Internal models allowed	Fair value
Brazil			Factor-based for each risk	Market risk to be defined for end of 2014	Mixture of book and market values for assets, book value for reserves
Chile	X	No clear target			Book values
China	X	Targeted 2016		Consultation process ongoing to introduce risk-oriented framework (C-ROSS)	Mixture of book and market value for assets, book value for reserves
Colombia			Factor-based for each risk		Generally market value for assets, Book value for reserves
Europe (EEA)	X	Targeted 2016			Solvency II will introduce full market valuation
Switzerland			Tail Value at Risk, 99% confidence		Market valuation for assets and reserves

Regulatory regime summary (2/2)

Jurisdiction	Factor -based	Movement to a risk-based approach	Already risk based	Comments	Valuation basis
Hong Kong	X	Targeted 2016/17		Consultation underway to introduce RBC framework	Market value for assets
India	X			Supervisors target 150% solvency ratio	Assets valued close to book values GPV for liabilities
Indonesia			Factor-based for each risk	Current phasing-in of revised RBC (from 2013). Supervisors target 120% solvency ratio	Book value for HTM assets, market value for others GPV for liabilities (from 2013)
Japan			Factor-based for each risk	Supervisors can intervene when the ratio is lower than 200%	IFRS equivalent for assets, Book value for reserves
Mexico	X	Targeted 2016			Generally market value for assets, Book value for reserves
Singapore			Factor-based for each risk since 2005	Looking to introduce 'RBC2'; in consultation phase	Market value for assets GPV for liabilities
USA			Factor-based for each risk	Companies usually hold 300% of the RBC	Mainly IFRS

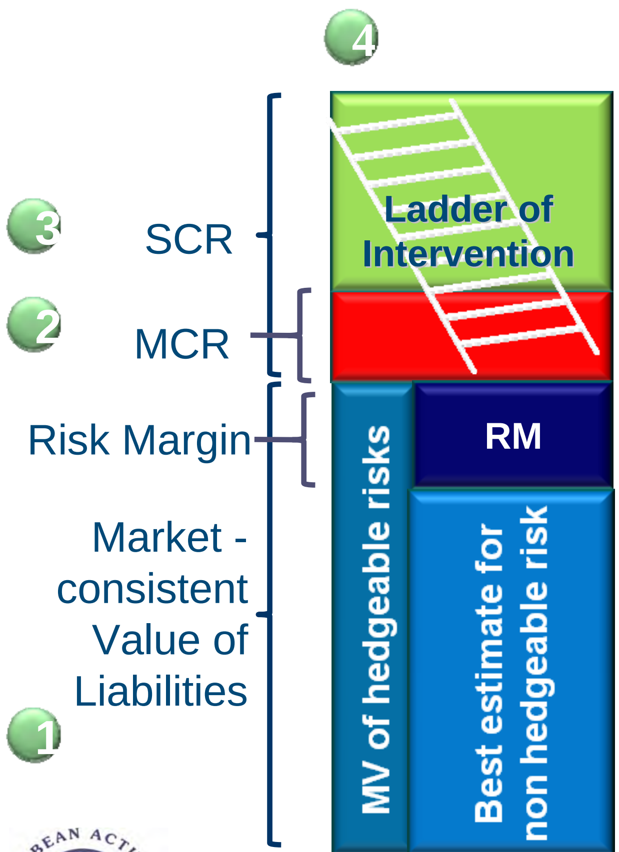
Solvency II

- New regime expected to come into force in January 2016
- Will apply to all insurers and reinsurers registered in the EEA
- No gold plating by individual state regulators
- Solvency II is a risk-based regime covering much more than capital adequacy alone

Solvency II

- Solvency II framework structured around 3 core components:
    - Pillar 1 covers the quantitative requirements, i.e. *how much capital should the insurer hold?*
    - Pillar 2 covers the governance and risk management requirements, i.e. *how is the business run?*
    - Pillar 3 relates to the reporting and disclosure requirements
- Aims:
    - Market consistency ✓
    - Harmonise regulatory standards across Europe ✓
    - Provide an early warning system to supervisors ✓
    - Strengthen policyholder security ✓
    - Promote improved risk management ✓

Solvency II Pillar I – Key Components of financial requirements



1 Market Consistent Value of technical provisions

- Market value for hedgeable risks and Best Estimate plus Risk Margin for non-hedgeable risks

2 Minimum Capital Requirement (MCR)

- Reflects a level of capital below which ultimate supervisory action should be triggered
- Calculated on factor basis, corridor of 25%-45% SCR

3 Solvency Capital Requirement (SCR)

- Target capital which should enable firms to absorb significant unforeseen losses over a specified time horizon
- The standard calculation can be replaced by the use of internal model under supervisory validation

4 Ladder of Intervention

- Solvency II should guarantee a ladder of intervention if the available capital falls below SCR
- Concept of transferability of Technical Provisions in extreme situations

Solvency II building blocks & hierarchy

Level	Description	Purpose	Responsibility of
1	Directive	Sets out overall framework	Council and Parliament
2	Delegated Acts*	Provides greater level of detail on specifics	Commission with advice from EIOPA
3	Guidelines & Implementing Acts	EU-wide technical standards and regulatory guidelines to ensure consistency	EIOPA
(4	*Enforcement*	*Ensure full and correct implementation by Member States*	*Commission)*

*** Formerly known as "Implementing Measures"**

Level 1 and impact on Levels 2 and 3

- Text of Solvency II Framework Directive adopted in April 2009 (Level 1)
- A draft "Omnibus II" appeared in January 2011 that proposes to amend some sections of the 2009 Directive and align with EIOPA regulation
- Difficulties with agreeing on appropriate measures to address issues for products with long-term guarantees have delayed finalisation of Omnibus II and led to significant delays in the Solvency II project
- Finalisation of Level 1 is required before other Levels can be publically consulted on - in order to keep momentum, informal pre-consultations and non-public discussions are taking place on Levels 2 and 3
- Provisional agreement was given to the Omnibus II Directive by the trilogue parties (European Parliament, European Commission and Council of the European Union) on 13 November 2013

Level 1 - issues for products with long-term guarantees

- Delays in finalising Level 1 have been caused primarily by discussions on how to treat products with long-term guarantees
- Covers a range of long-term products with interest rate guarantees
- Characterised by highly predictable cashflows and no strain on surrender
- e.g. annuities
- Often backed by high quality fixed interest asset portfolios held to maturity
- As holding to maturity, asset cashflows are only affected by default rates and not spread volatility
- Changes in liability cashflows generally would not <u>force</u> insurers to sell assets early
- Products with long-term guarantees provide essential social benefits, such as retirement provision, in many countries

Level 1 - issues for products with long-term guarantees

A package of measures has been included in the Level 1 text to address these issues:

- **A matching adjustment (MA)** to be applied to the discount rate used to value annuity-style liabilities backed by hold-to-maturity assets to mitigate the impact of spread movements on the balance sheet.
  - Calculated as the spread over risk-free rates on the matching assets less an allowance for defaults (the fundamental spread).
- **A volatility adjustment** applied to the discount rate used to value all other business to enable the industry to cope during distressed market conditions.
  - Calibrated as 65% of the risk-adjusted spread over risk-free of assets in a representative portfolio.
- **An extrapolation methodology** to extend the risk-free rate beyond the point at which values can be determined from deep, liquid and transparent market data.
- **Transitional arrangements** for existing life insurance business to adjust to Solvency II over a period of 16 years (subject to supervisory approval).

Expected Solvency II Timeline

From Regulation…

13 Nov 2013	1 Jan 2014	Feb 2014	End 2014	2015
Trilogue provisionally approve Omnibus II	National supervisors to implement EIOPA interim measure guidelines	Omnibus II Plenary vote to finalise Level 1	Finalisation and approval of Level 2 delegated acts	Finalisation and approval of Level 3 technical standards

Member states to adopt Solvency II requirements into national legislation

… to Supervision

1 Jan 2014

1 Jan 2015

31 Mar 2015

1 Jan 2016

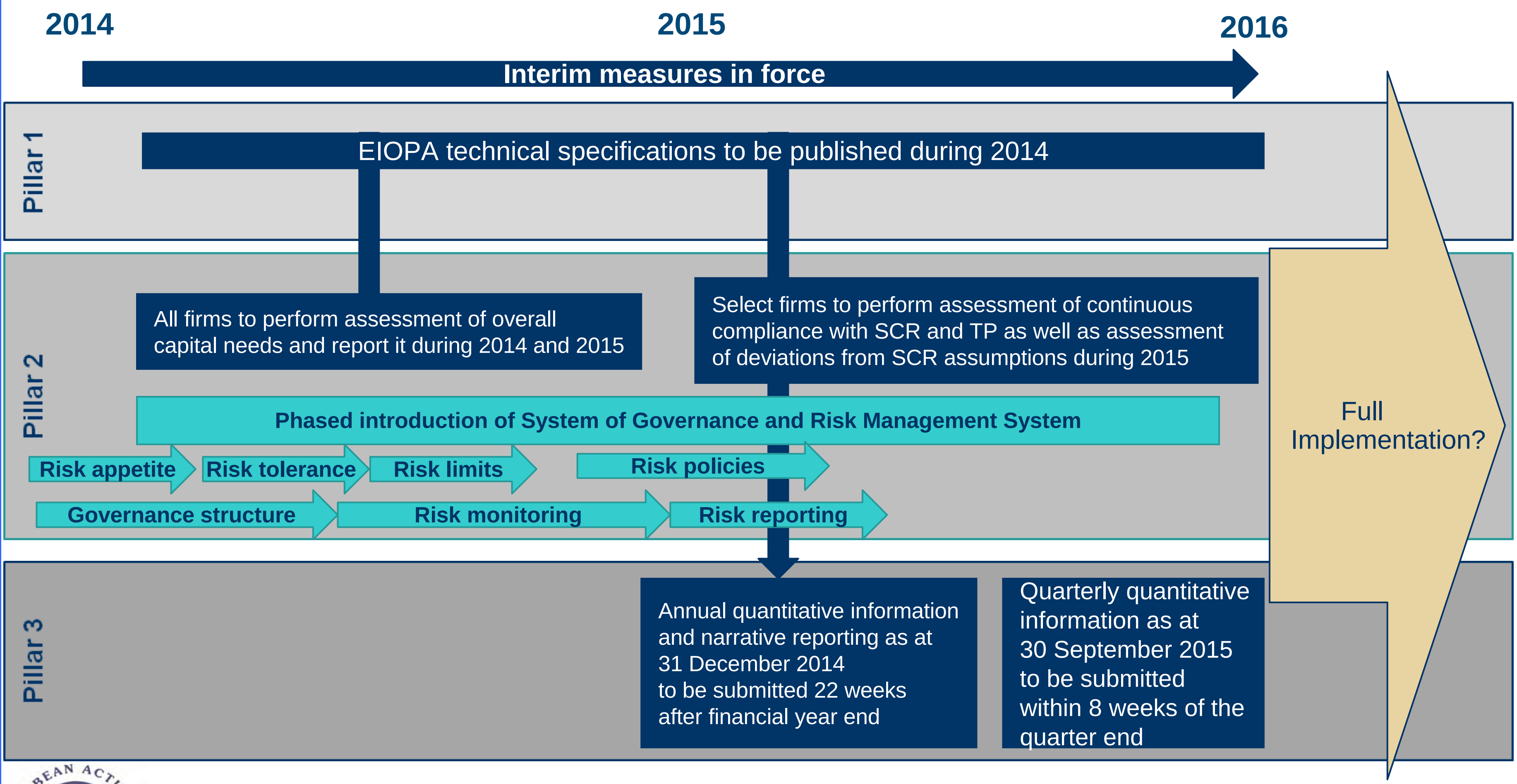
16 years of transitional measures

Phasing-in of Solvency II via interim measures

Firms need to provide evidence of (phased) compliance with interim measures over 2014 and 2015

Likely application of Solvency II (insurance companies need to fully comply with the requirements – subject to transitional measures)

Solvency II Interim Measures



Solvency II - equivalence

- Assessment of equivalence determines which countries have a regulatory system which provides enough policyholder protection that companies will not have to comply with both Solvency II and local regulations
- **Temporary equivalence** is aimed at third country reinsurance and may be granted for 5 years where a third country has committed to adopt an equivalent solvency regime and to engage in the equivalence process.
- **Provisional equivalence** covers group solvency and supervision and may be granted for 10 years (with the possibility to extend for a further 10 years) where the third country can demonstrate it has (or may adopt) a solvency regime capable of being assessed equivalent (no commitment to engage in equivalence process).
- This provision would allow the US to be considered as an equivalent regulatory regime, allowing European firms with US subsidiaries to use local regulatory methods when calculating group solvency requirements.
- This will also provide flexibility to develop pragmatic solutions for other regulatory regimes to ensure that European groups are not disadvantaged when operating in third countries.

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- **Principles-based reserving in the US**

IAIS and the ORSA

- Many of the global developments stem from the International Association of Insurance Supervisors (IAIS).
- The IAIS requires an Own Risk and Solvency Assessment (ORSA) as part of Insurance Core Principle 16 (ICP16) on ERM, adopted in October 2010
- The inclusion of an ORSA requirement within the ICPs has resulted in an effective worldwide requirement for an ORSA, albeit one that can vary in certain respects from country to country.

Examples include:

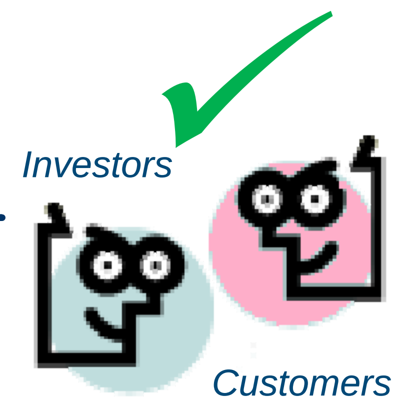
- Australia – where the first ORSA submissions have already been lodged.
- Across Europe (via Solvency II) – the preparatory guidelines will introduce an ORSA requirement during 2014 for most large European insurance companies
- The US – the first ORSA reports are scheduled to be produced before the end of 2015.

The ORSA - overview

- The ORSA aims to reveal the linkages between capital and risk within a firm.
- The ORSA is company specific and should include identification and assessment of all material risks the company is exposed to.
- ORSA overview:

– Top down process owned by the Board
  - Board needs to know what risks the Company is running
  - Has it sufficient capital for the next 3-5 years?
  - Enhance awareness of relationship between risks and capital

– Link between capital, risk management and strategy
  - Is the company comfortable with the risks it is running?
  - Has it enough capital?
  - Should it review its strategy?



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Global systemically important financial institutions

- Globally systemically important financial institutions (G-SIFIs) were introduced at the request of G20 leaders following the 2007-2012 financial crisis
- G-SIFIs are defined by the Financial Stability Board (FSB) as:

"institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries."

- Global Systemic Insurance Institutions (G-SIIs) are one class of G-SIFIs
- International Association of Insurance Supervisors (IAIS) published a set of policy measures including:
  - recovery and resolution planning requirements;
  - enhanced group-wide supervision; and
  - higher loss absorbency (HLA) requirements.

IAIS – G-SIIs

Based on an initial assessment, 9 G-SIIs identified by FSB 18 July 2013

IAIS – G-SIIs expected timeline

July 2013

- Designation of G-SIIs based on the IAIS methodology (annual updates each Nov, beginning 2014)
- For designated G-SIIs, implementation commences of resolution planning and resolvability assessment requirements and enhanced supervision, including group-wide supervision.

End 2013

- FSB to agree on the timeline for finalisation by the IAIS of a comprehensive, group-wide supervisory and regulatory framework for IAIGs, including a quantitative capital standard.

July 2014

- Crisis Management Groups (CMGs) established for the initial cohort of designated G-SIIs.
- FSB decide on the G-SII status of, and appropriate risk mitigating measures for, major reinsurers.
- Systemic Risk Management Plans to be completed by G-SIIs designated in 2013.

By 2014 G20 Summit

- IAIS to develop backstop capital requirements to apply to all group activities, including non-insurance subsidiaries.

End 2014

- Recovery and resolution plans, including liquidity risk management plans, for G-SIIs designated in 2013 to be developed and agreed by CMGs.

End 2015

- IAIS to develop implementation details for HLA.

Nov 2017

- Definitive list of GSIIs

Jan 2019

- G-SIIs designated in November 2017 to apply the HLA requirements.

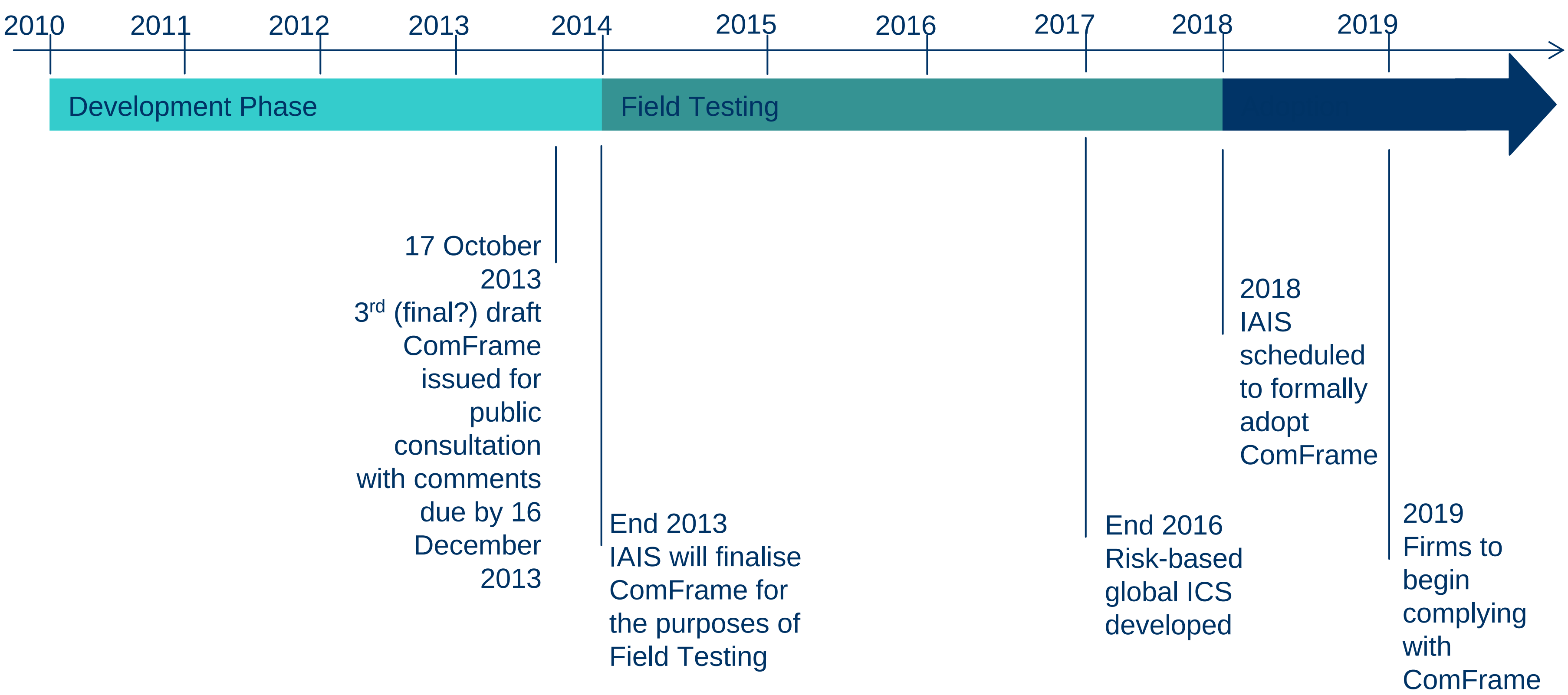
IAIS - ComFrame

- Common Framework for the Supervision of Internationally Active Insurance Groups - to be implemented by all IAIS members
- Aims to foster global convergence of regulatory and supervisory measures and approaches for Internationally Active Insurance Groups (IAIGs)

ComFrame is structured in three Modules:

1. **Scope of ComFrame** includes the criteria and process for the identification of IAIGs by supervisors, the breadth of supervision of IAIGs (which legal entities are included) and the identification of the group-wide supervisor.
2. **The IAIG** contains the requirements an IAIG will need to meet.
3. **The Supervisors** covers the process of supervision, highlighting the role of the group-wide supervisor and other relevant supervisors' responsibilities within the process. The module covers the supervisory process, enforcement, cooperation and interaction requirements.

IAIS – ComFrame Timeline



But not everyone is moving the same way…

- While many countries are displaying moves towards a principles-based style of regulation, recent developments in the US indicate that not everyone is convinced…
- In response to concerns from New York regulator that firms writing Universal Life with secondary guarantee (ULSG) products at a national level within the US were under reserved…
- …NAIC Joint working group developed a modified "principles-based reserving" (PBR) approach as a temporary measure until PBR becomes effective
- New York regulator carried out an analysis and the ULSG reserves as at 31 December 2012 increased much less than expected under the modified rules
- As a result, the New York regulator has disallowed this modified interim reserve basis and has resolved not to implement full PBR arrangement and has cautioned the NAIC to *"seriously rethink its march towards implementation of PBR"* stressing that:

"In its current form, PBR represents an unwise move away from reserve requirements that are established by formulas and diligently policed by insurance regulators in favor of internal models developed by insurance companies themselves"

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