Baltic Actuaries' Seminar – What's coming to us, actuaries?

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Topics

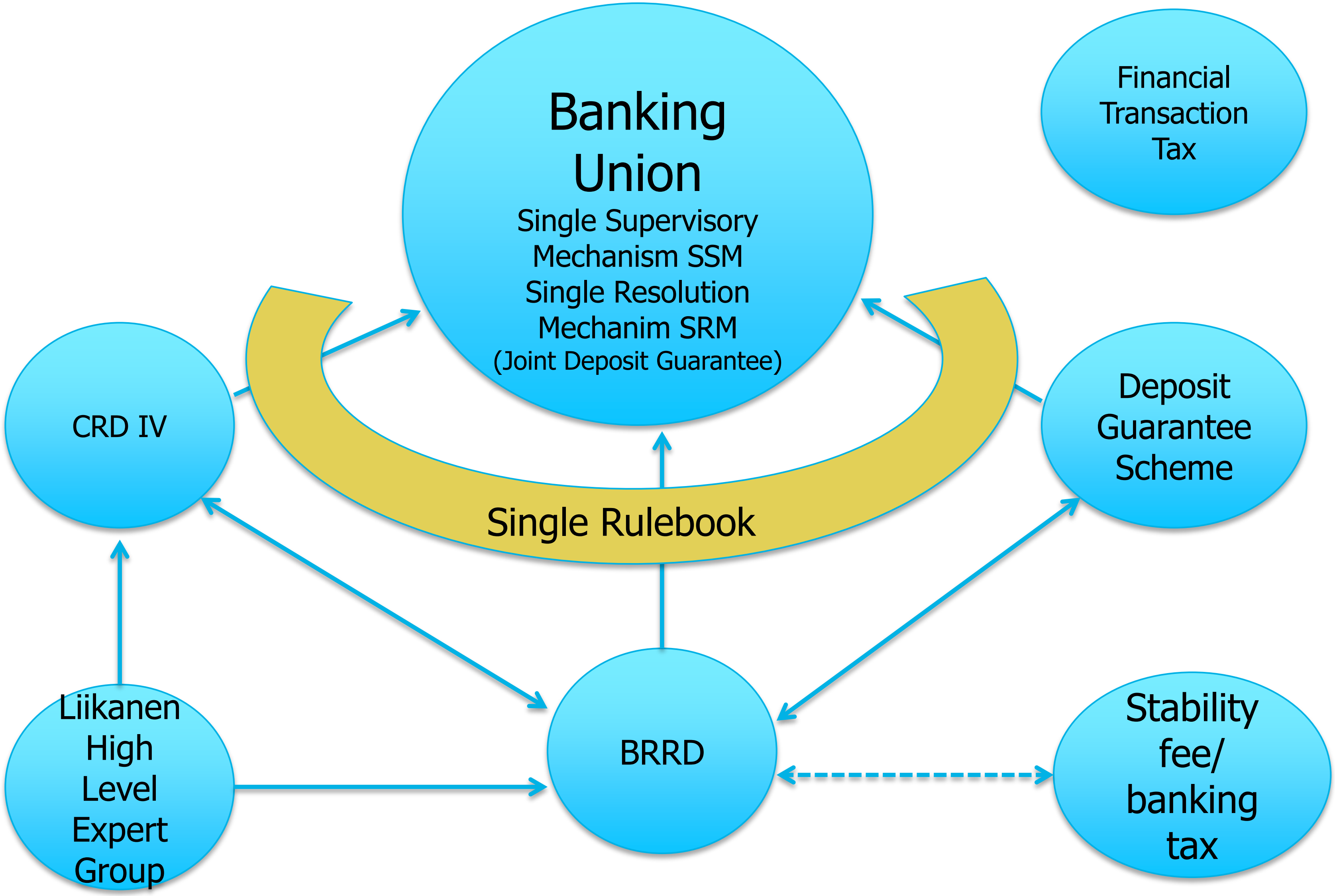
- Tour d’Horizon about potential developments from EU, ESA, IASB, IAIS et al (25 minutes)
- IAIS development ICS/BCR (20 minutes)
- Proportionality; applications for smaller companies (25 minutes)

TOUR D'HORIZON ABOUT POTENTIAL DEVELOPMENTS FROM EU, ESA, IASB, IAIS ET AL

Table 1: Current international arrangements in global financial architecture

	International organisations	State-to-state contact groups	Trans-governmental networks	Bilateral and regional networks	Private standard setting and opinion making bodies
Examples	IMF World Bank WTO OECD BIS	G-7 G-8 G-10 G-20	BCBS IOSCO IAIS FSB	FMRD RRD HLMFI ECRDC ERDFS EUI	IASB S&P
Characteristics	• Treaty-based • Large secretariats • Policy administration • Limited policy making	• Protocols • No secretariats • Policy-making	• MOU/informal • Small secretariats • Information sharing • Policy coordination • Policy administration	• MOU/informal • No secretariats • Information sharing • Policy coordination	• Private sector experts
Regulatory tasks	• Sovereign loans • Economic development • Technical assistance • Standards enforcement	• Crisis response • Regulatory initiatives • Networks creation	• Rules and standards on prudential aspects of banking • Securities • Insurance	• Approximation of rules and standards • Mutual recognition • Market access provision	• Technical standards
Examples of achievements	• FSAP	• Creation of BCBS • FSB	• Development of sectoral prudential standards	• Opening of Russian market • IFRS roadmap	• IFRS • New supervisory tools

Banking Union



SUMMARY OF REGULATORY MANDATES

	Level 2		Level 2,5		Level 3
Legal basis	TFEU Art 290	TFEU Art 291	EIOPA regulation Art 10, TFEU 290	EIOPA regulation Art 15, TFEU 291	EIOPA regulation Art 16
Mandate	**Commission**		**Commission endorses EIOPA's drafts** (Comission has limited powers to reject/amend the draft)		**EIOPA**
Scope	The framework directive must be changed or amended	To safeguard uniform implementation	Technical standards complementing delegated acts	Technical standard complementing implementing acts	Establish consistent supervisory practices, and to ensure the consistent application of Union law
Endorsement process	- Proposal from the Commission - Parliament and Council 3-4 months	- Proposal from the Commission - consultation of Member States - EU regulation awaited on the procedure	- Commission endorses EIOPA's draft within 3+1 months - Parliament and Council 3+3 months / 1+1 months	- Commission endorses EIOPA's draft within 3+1 months	No formal endorsement
Terminology	**Delegated Act**	**Implementing Act**	**Regulatory technical standards**	**Implementing technical standards**	**Guidelines or recommendations**
Form	Commission decision: **Probably EU regulation**		**EU regulation or decision**		Published by EIOPA

Financial Stability Board and G20 name nine insurers as systemically risky

- The Financial Stability Board (FSB) has, together with the Group of Twenty (G20) biggest economies, identified nine insurance companies that, in their view, are deemed potential risks to global financial stability and should be subject to additional rules and oversight. The nine companies include Allianz; American International Group; Assicurazioni Generali; Aviva; Axa; MetLife; Ping An Insurance of China; Prudential; Financial Inc (US); and Prudential Plc (UK).
- The International Association of Insurance Supervisors (IAIS) said it will develop straightforward, basic capital requirements to be applied to all group activities of G-SIIs (global systematically important insurers). They will be finalised by the end of 2014.
- After public consultation, the IAIS will develop by the end of 2015 the implementation details for HLA (high loss absorption) that will apply to designated G-SIIs starting from 2019. The IAIS will also consult on related issues such as the scope of the G-SII group on which HLA will be assessed

IFRS 4

- Expected to be applied from the start of 2018 – only 21 years after the start of the project
- Also IFRS 9 expected to be applied at the same time
- Publication of IFRS4 expected beginning of 2015
  - Unlocking the contractual service margin resolved in March 2014
  - Effects of discount rate changes either through profit/loss or in Other Comprehensive Income in March 2014
  - Open issues: participating contracts, presentation of insurance contract revenue, some other issues where the IASB thinks it has enough information without consulting stakeholders

New umbrella – long term financing?

- Long Term Financing Communication from the Commission March 2014
  - Banks
  - Insurance companies
  - Pension funds -> IORP proposal
  - Private savings accounts
  - National Promotional Banks
  - Export Credit Agencies
  - Equity and corporate bond markets
  - Securitisation
  - Covered bonds
  - Private placement
  - Etc.

Rules of Principles based?

IAIS DEVELOPMENT ICS/BCR

Why should we care?

- Because EIOPA is committed to apply to all European insurers and modify S II if necessary
- Similar to European banking regulation: Basel rules were designed for large multinational banks but EU used them as the blueprint of the Capital Requirements Directive

Bernardino 9.4.2014

The introduction of global capital standards in the insurance field should help prevent regulatory arbitrage, increase financial stability, guarantee a level playing field and strengthen international supervisory coordination, for the benefit of the economy at large, including financial institutions and consumers.

Solvency II: a total balance sheet approach, clear and transparent target criteria for calibration of capital requirements, explicit recognition of risk diversification and consideration in capital requirements of all the material risks to which the group is exposed.

As for the development of the Insurance Capital Standard (ICS), we would need an evolutionary approach. The basic sound principles of Solvency II should be applied internationally. This means that the international capital standards should incorporate the fundamental principles underlying

In this context, Solvency II could be viewed as a practical implementation of the ICS, but going forward we should be open to make adjustments to it if that is needed. Groups should be subject to only one capital regime.

Proposed BCR formula

- The determination of capital required for the BCR is currently envisaged to be presented as six factors applied to six exposures reflecting the main categories of activity, namely
  - Traditional Life insurance,
  - Traditional Non-Life insurance,
  - Assets,
  - Asset-Liability Matching,
  - Non-Traditional (NT) insurance and
  - Non-Insurance (NI).
- The BCR mandate requires consideration of all these items and the approach also addresses the BCR principle requiring that major risk categories should be reflected. Insurance is typically a long term liability driven business and this drives the need for managing the assets to reflect their relationship to the liabilities.

Proposed BCR formula – details (1)

- For each of the insurance activities, the amount is computed as the product of a factor and a risk weighted exposure.
- These risk weighted exposures are calculated as weighted sums of more granular factors with their associated exposures.
- The BCR required capital is currently:

$$\text{BCR required capital} = \propto \times [\beta_1 \text{Traditional Life} + \beta_2 \text{Traditional Non-Life} + \beta_3 \text{Asset} + \beta_4 \text{ALM} + \beta_5 \text{NT}] + \gamma \times \text{NI}$$

BCR formula – details (2)

- α and • •are scalars to adjust the overall BCR level and potentially target a specified confidence level. These factors allow the BCR required capital, overall, to be calibrated to a desired level.
- β1, β2, β3, β4 and β5 are fixed risk weight factors reflecting relative riskiness between activities.
- Traditional Life is the risk weighted amount of traditional life insurance liabilities measured by their current estimate liabilities or other relevant measures
- Traditional Non-life is the risk weighted amount of traditional non-life insurance liabilities measured by their current estimate liabilities or other relevant measures

BCR formula – details (3)

- Asset is the risk weighted amount of assets. At a minimum inclusion of Assets is necessary to address NI and possibly NT. The need to address off-balance sheet exposures is also noted.
- ALM is the indicator of asset-liability mismatch
- NT reflects the risk weighted amount of non-traditional insurance activities measured by their current estimates and/or other relevant measures
- NI reflects the charges provided by sectoral rules. For example, Basel requirements.

Valuation approaches

- A major challenge to achieving the principle of global comparability of the BCR is overcoming differences in valuation approaches.
- The primary valuation basis for the Traditional Life and Traditional Non-Life exposures will be Current Estimates of liabilities.
- The primary valuation basis for assets will reflect their ‘fair values’.

NT and NI activities

- An important aspect of the BCR is its reflection of NT and NI activities. For NI activities sectoral rules will be used.
- For example, regarding banking activities, it needs to be determined which of the Basel III Leverage Ratio or the fully risk-based Basel Accord is most appropriate for the BCR.
- Issues of this type will be addressed during field testing.

Conclusions

- BCR preparations quickly proceeding
- Simple factor based model with confidence level of 85 % - comparable to MCR
- Valuation a huge problem!
- More important is what will come of the ICS which will aim to the level of SCR
- Will S II be in line with the ICS as such or will it need modifications?

PROPORTIONALITY; APPLICATIONS FOR SMALLER COMPANIES

Proportionality Principle

- Solvency II, Article 29.3-4 (**General principles of supervision**)
- ”Member States shall ensure that the requirements laid down in this Directive are applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking”
- ”The Commission shall ensure that implementing measures take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular to small insurance undertakings”
- Recital 19:
- “This Directive should not be too burdensome for small and medium-sized insurance undertakings. One of the tools by which to achieve that objective is the proper application of the proportionality principle. That principle should apply both to the requirements imposed on the insurance and reinsurance undertakings and to the exercise of supervisory powers”

Omnibus II

- *in Article 29, paragraph 4 is replaced by the following:*
  - *"4. The delegated acts and the regulatory and implementing technical standards adopted by the Commission shall take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular in relation to small insurance undertakings.*

    The draft regulatory technical standards submitted by EIOPA in accordance with Article 10 to 14 of Regulation (EU) No 1094/2010, the draft implementing technical standards submitted in accordance with Article 15 thereof and the guidelines and recommendations issued in accordance with Article 16 thereof, shall take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular in relation to small insurance undertakings."

Materiality

- IFRS Conceptual Framework, Qualitative Characteristic 11:
  - ”Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.”

Proportionality vs. materiality

- Materiality not mentioned in the Solvency II directive (but is mentioned in the draft delegated acts)
- Proportionality starts more from looking at the characteristics of the entity whereas materiality starts from end results
- Proportionality does not allow not doing something prescribed in the directive but allows to do it in a less burdensome manner
- Materiality can even give permission not to do something

Materiality in draft DA's

- Article 210bis: ”For the purposes of this Section, a change or error in the outputs of the internal model, including the Solvency Capital Requirement, or in the data used in the internal model shall be considered material where it could influence the decision-making or the judgement of the users of that information, including the supervisory authorities.”
- Article PDS1bis: ”The information to be disclosed in the solvency and financial condition report should be considered as material if its omission or misstatement could influence the decision-making or the judgement of the users of that document, including the supervisory authorities.”
- Article SRS1bis: ”The information submitted to supervisors should be considered as material if its omission or misstatement could influence the decision-making or judgement of the supervisory authorities.”

Advice to the European Commission on the Principle of Proportionality in the Solvency II Framework Directive Proposal (CEIOPS-DOC-24/08)

Article 12

- ”The principle of proportionality applies to all the provisions in the Directive and, as a consequence, to all future implementing measures. The proportionality principle should be applied in a coherent way across the three pillars as well as the group provisions. Where simplifications with respect to quantitative Pillar I requirements are applied, its implications on the supervisory review process, on the insurer’s ORSA and on disclosure requirements under Pillar III need to be considered. Moreover, the proportionality principle is being applied regardless of whether the principle of proportionality is explicitly mentioned in a provision or not. The mention of the principle of proportionality in certain Articles should not lead to the conclusion *a contrario* that it does not apply or applies less where it is not explicitly mentioned”

Article 19

- ”In assessing what is proportionate, the focus must be on the **combination of all three criteria** to arrive at a solution that is adequate to the risk an undertaking is exposed to. For instance, a business may well be smallscale but could still include complex risk-profiles, or, on the contrary, it may be large-scale with a simple risk-profile (uncomplicated, supporting only limited risk). In the first case, it should not be allowed to use simplified methods, while the possibility may be considered in the second case under very specific circumstances.”

Article 20

- ”So, while it will probably tend to be the small and medium-sized undertakings which will find relief in the application of the proportionality principle through simpler ways of meeting supervisory requirements, it is actually imprecise to talk of proportionality as size-based. Consequently, CEIOPS does not plan to find a definition for small and medium-sized undertakings and develop a whole set of simplified requirements to be applied to these SMEs. However, some simplified Pillar I requirements may depend for their applicability on size factors.”

Article 21

- ”Undertakings have to provide the means necessary to introduce the appropriate systems, processes and measures or, alternatively, reduce the risks they face. Lack of resources can never be an excuse for not complying with supervisory standards. Since what is required of an undertaking has always to be proportionate to the risk it runs, these requirements should not be viewed as a supervisory burden but rather as a necessary part of good risk management.”

CEIOPS advice on Pillar I

- Pillar I
  - Criteria
  - Calculation of technical provisions
  - SCR Simplifications
- Pillar II - System of Governance
  - Organisational Structure
  - Qualification of holders of key functions
  - Risk management including capital management
  - Asset-Liability management (ALM) and Investment Policy
  - ORSA
  - Internal control – Internal audit – Actuarial function – Outsourcing
  - Supervisory Powers and Supervisory Review Process
- Pillar III
  - Supervisory Reporting
  - Public Disclosure

Conclusions

- Proportionality has an important role in the S II framework, but
- We are yet to see what it means in practice (will it only mean harder requirements for the large&complex companies?)
- Just the size and especially lack of resources give no ground to the application of the principle
- Also – will the principle be applied in a fully harmonised way across EU members?

Thank you for you attention!

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