Solvency 2- transitioning from implementation to optimization

16 October 2015

David O'Brien Group Head of Financial Solutions and Longevity
Renato Di Iorio Head Financial Solutions - EMEA

SCOR

Content

1	European Solvency II observations
2	Options to manage capital in a Solvency 2 world
3	Reinsurance – a strategic capital management tool
4	Criteria for success and timeline

Industry outlook quickly moving negative in face of Solvency II headwinds

- A few insurers in the UK, France and one in The Netherlands are **well advanced in implementing SII** and have projects underway to improve their SII ratios but **these are the exception not the rule**.

- Many insurers are still working hard to be compliant with the Solvency II requirements from 1/1/16 **they have not begun** to seriously look at **how to improve their ratios**.

- Solvency II rules negatively impacting net asset value
  - **Contract boundaries** (common for much of the unit-linked business) preventing future margins to be shown as an asset
  - **Future profits in subsidiaries located outside of the EEA** many not be recognised by the group because they cannot be easily and quickly transferred out
  - **Deferred tax asset** is Tier 3 capital
  - Other - restrictions on **minority interest**; more conservative criteria on **hybrid assets**; **no goodwill asset**; **intangible assets** subject to 80% capital charge; there are **restricted reserves** and **ring-fenced funds**

Industry outlook quickly moving negative in face of Solvency II headwinds

- Solvency II requires a great deal of risk capital
  - **Lapse risk** as the standard formula mass lapse is too conservative – this also causes the risk margin to be too high
  - **Insufficient diversification** (risk, geography)
  - **Deferred tax asset** being disqualified under stress scenario because future profits are not expected to emerge under stressed scenario
  - **Market and credit risk** – including issues arising from long-term guarantees
- Some stronger insurers have stated that they will **use their solvency ratio as a marketing tool** (they believe strongly that they will have a high ratio). We have informally heard of insurers who will publish their solvency ratio excluding transitional measurers to further emphasise their strength.

Size of capital buffer will fluctuate due to the inherent nature of the SII volatility

- Viewing SII as a Best Estimate balance sheet and capital projection (i.e. excluding matching & volatility adjustment, transitional measure and ultimate forward rate) **the industry will find that the own funds & SCR are volatile**.

- **Explaining the fluctuations /movements to stakeholders will be difficult**

- Insurance regulators are copper-plating required capital standards from anecdotal discussions
  - applying capital add-ons to the Standard Formula as a short term measure
  - applying capital add-ons to internal model insurers to bring them up to Standard Formula or ORSA if higher

- Furthermore, insurers will experience **additional capital volatility** associated with model calibration, dynamic updates of technical provisions, regulators developing interpretation of the rules and their perception of the industry strength.

- The consequence of lower solvency ratio or higher volatility, whether from the market, model or regulator, is a **decrease in share value**

Scarcity of new capital may lead to a rationalisation of the market

- In answering the following questions, life insurers will better understand the changes they may wish to make to achieve their ambitions.

Financial objectives

- What are the key financial performance metrics you are measured by?
- How well is your business performing against these metrics, viewed both internally and externally?
- Are these the correct metrics?

Generating competitive advantage

- What do you consider to be your current competitive strengths?
- What key market developments are likely to impact your business? How well are you positioned relative to short term and long term market trends?
- In which areas are your competitors innovating? How will the basis of competition change?
- What new capabilities are required? Should you develop or buy them?

Growth ambitions

- Do you have defined growth targets? Are you confident that these are right?
- Where is the growth going to come from?
- Do you have a balanced portfolio? How will what you're planning impact this?
- What level of investment is the business willing to make to achieve its goals?
- Have you got the right approach to build your business case?

Emerging constraints

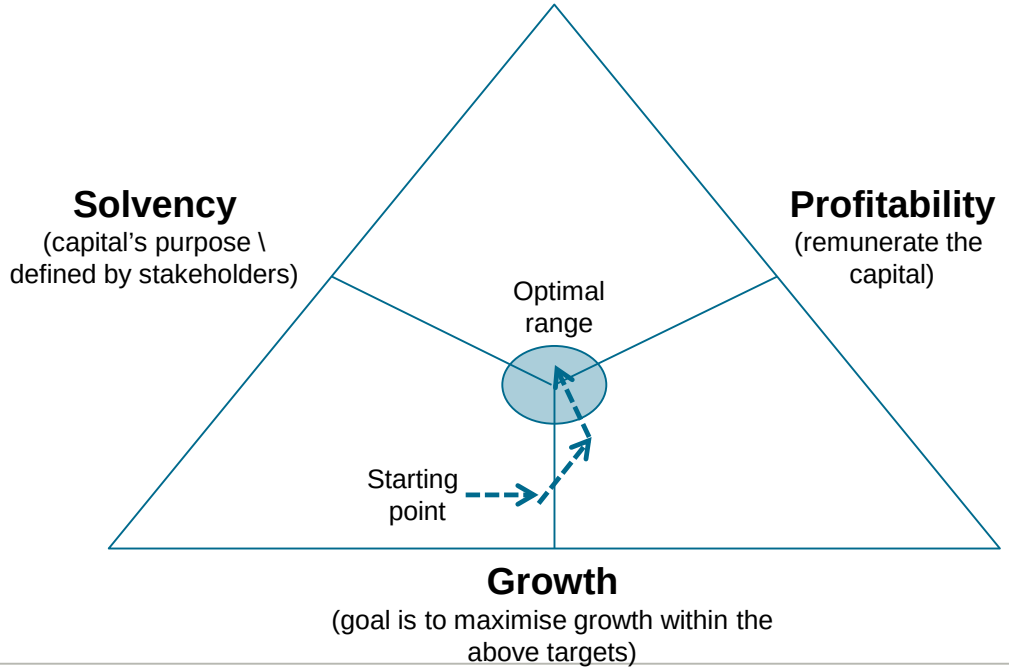
- What regulatory developments are likely to impact your business or market in the short term, medium term and long term?
- Are you better positioned than your competitors to respond to regulatory change?
- What will market changes mean for your policyholders? Your distribution network?

The notion of capital is more complex than it seems

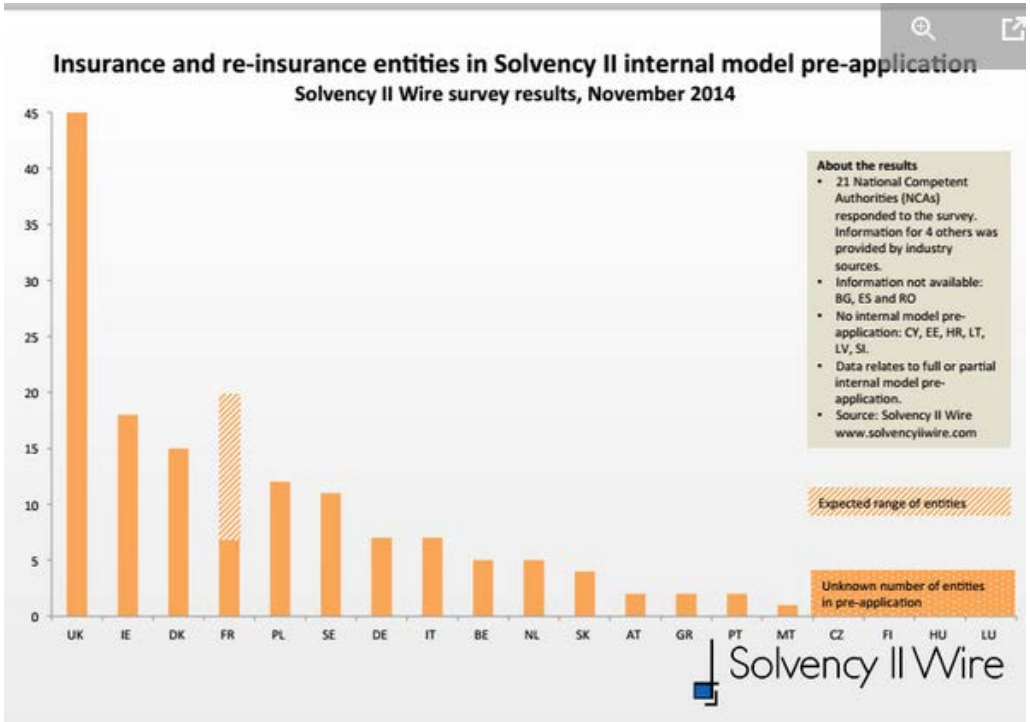
- Capital stakeholders include regulators, rating agencies, capital markets / shareholders, distribution channels/agents, policyholders and employees – each has its own views on the purpose of capital and the amount required

- A key question for insurers: How to optimise and manage capital under all the stakeholder's constraints while keeping the key principle "there is no return without risk" in mind?

- Insurers will soon be forced to take decisions that move their organisation along the three dimensions



The process – no magic bullet in following the Internal model route



Internal model should not become a capital optimisation tool, says EIOPA

The European Insurance and Occupational Pensions Authority (EIOPA) has warned against the use of internal models to reduce capital requirements under Solvency II.

8 JUNE 2015 | BY CINTIA CHEONG

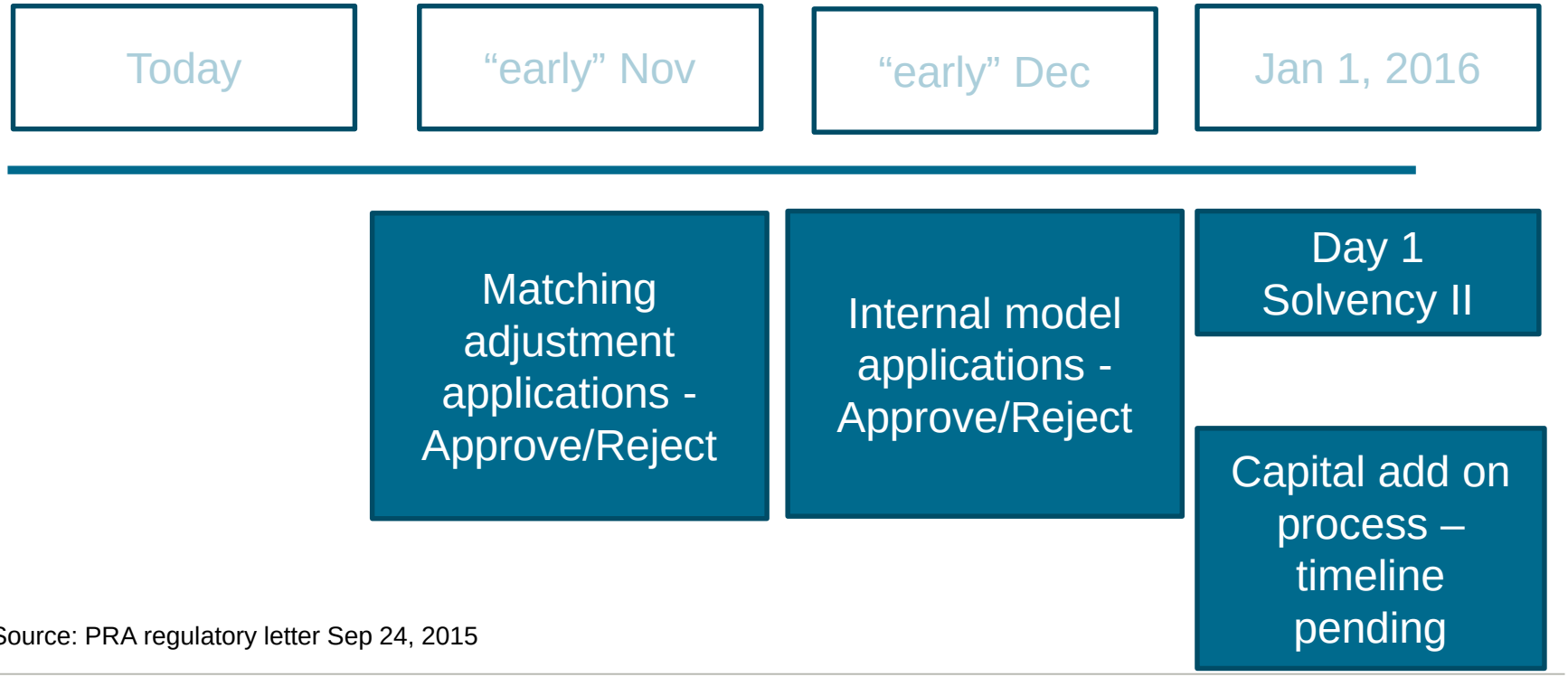
- Strong interest in 2014 in applying for internal models across Europe
- The burden of proof and high volume of documentation means much fewer applications filed
- UK – 45 pre applications now down to “around 20” Day 1 pending applications

Source: The Actuary

The process – soft landing is not guaranteed

For example, UK PRA decision making timeline and message:

“firms should have in place robust contingency plans in the event their….applications are not approved.”



Source: PRA regulatory letter Sep 24, 2015

The process – surprises on Solvency 2 capital positions have big impacts

Crunch time for insurers on capital rules

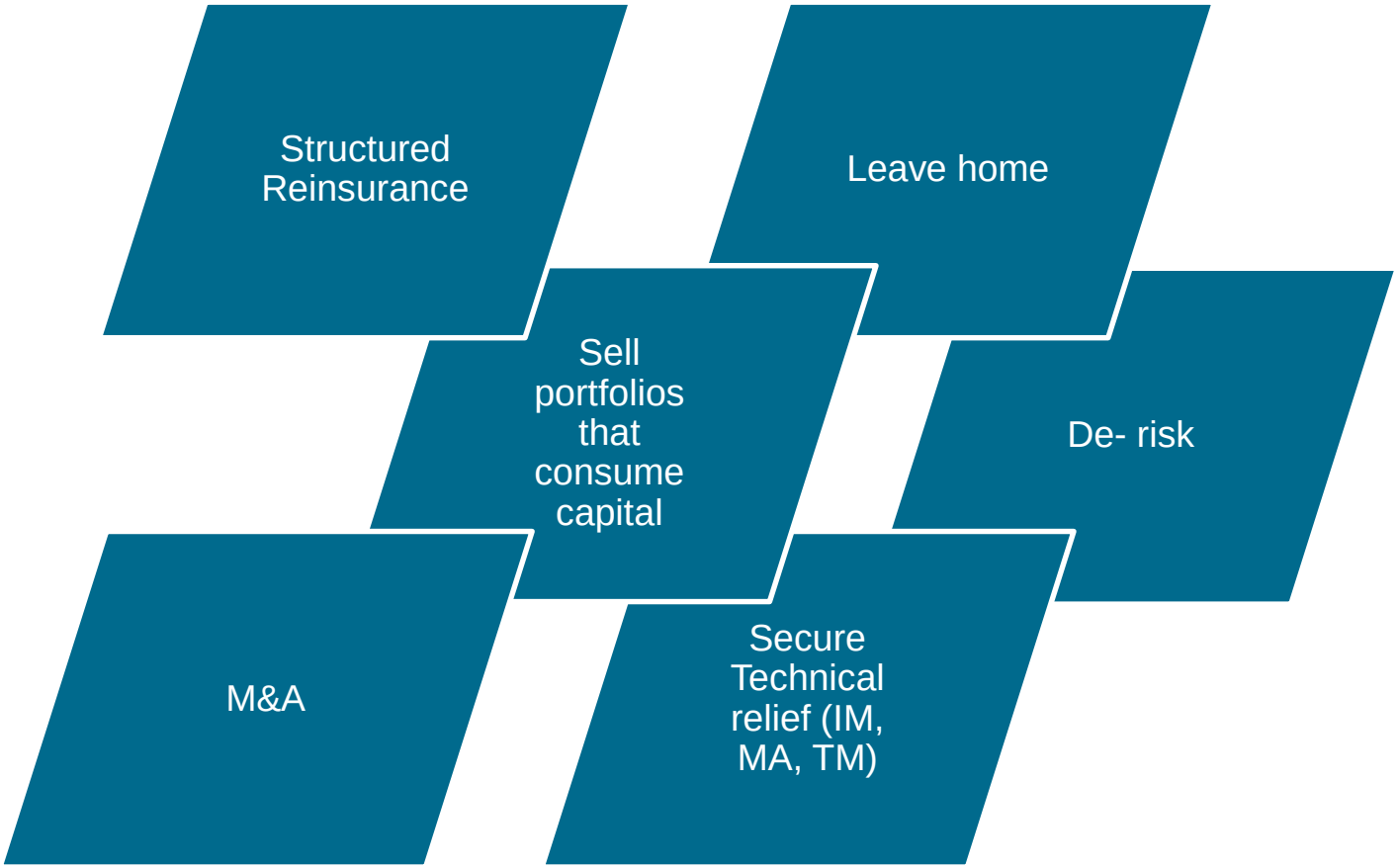
Alistair Gray, Insurance Correspondent

Source: FT, August 31, 2015

Content

1	European Solvency II observations
2	Options to manage capital in a Solvency 2 world
3	Reinsurance – a strategic capital management tool
4	Criteria for success and timeline

Options available to optimise capital within a Solvency 2 world



Options available – Leaving home?

Prudential mulls UK exit as regulation bites - reports

Firm worried about Solvency II rules

British insurer Prudential is believed to be considering exiting the UK and moving its headquarters to Asia, prompted by upcoming stricter regulation.

Source: Investment Week Oct 5, 2015

Options available – Sell portfolios that consume capital

New rules drive life insurers to hedge pension risk outside Europe

LONDON | BY CAROLYN COHN

Life insurers selling higher-risk products like annuities are moving to reinsure or hedge this business outside Europe to soften the impact of new capital rules which could add hundreds of millions of pounds to their costs.

The new European rules, known as Solvency II, which come into force in January, will require European insurers to set aside more capital against annuities, which give pensioners a fixed income for life and are considered higher risk because they are long-term products and people are living longer.

But insurers can cut the amount of capital they are required to hold against annuities by reinsuring or hedging the risk. Some companies, such as Legal & General, have already done such reinsurance deals and more are expected.

This is expected to benefit insurers in the United States and other countries outside Europe that sell the reinsurance. But it is likely to hit European insurers, given the cost of the reinsurance and, also, when life insurers offload risk via reinsurance this can dent their share of any profits.

Source: Reuters Oct 8, 2015

Options available – M&A set to thrive?

- Buy side interest likely to continue to grow in 2016 for European insurers
  - More regulatory clarity emerges, with some prospect of additional capital strain for some insurers
  - Expense burden of compliance with expanded regulatory reporting and low growth in near term increases pressure on insurers to find synergies through consolidation
  - Low interest rates outlook maintains pressure on insurers' earnings from "back book" savings business with high guarantees
  - Overhang on earnings/balance sheet quality from transitional relief measures can be cured faster by a restructure of enterprise

- Emergence of Japanese, Chinese and other investors interested in expanding outside home markets and with deep pockets to fund acquisitions.

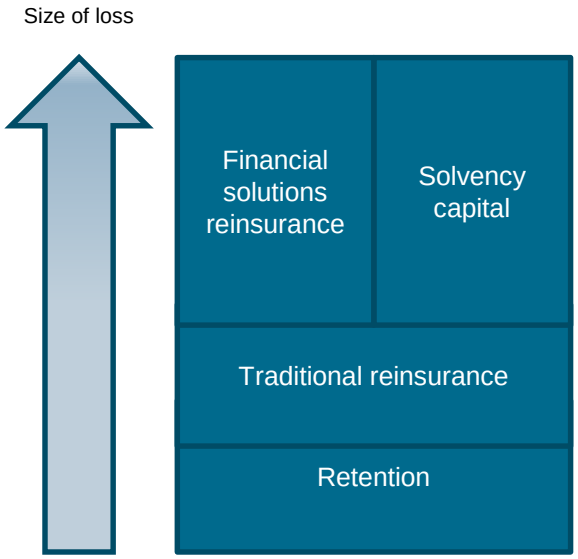
- Global trend shows high upswing in Life insurer M&A activity (USD 9.8Bn in 2014 v USD 1.5Bn in 2013 – Source Deloitte)

Content

1	European Solvency II observations
2	Options to manage capital in a Solvency 2 world
3	Reinsurance – a strategic capital management tool
4	Criteria for success and timeline

Financial solutions reinsurance is an important element of the capital structure for many insurance companies

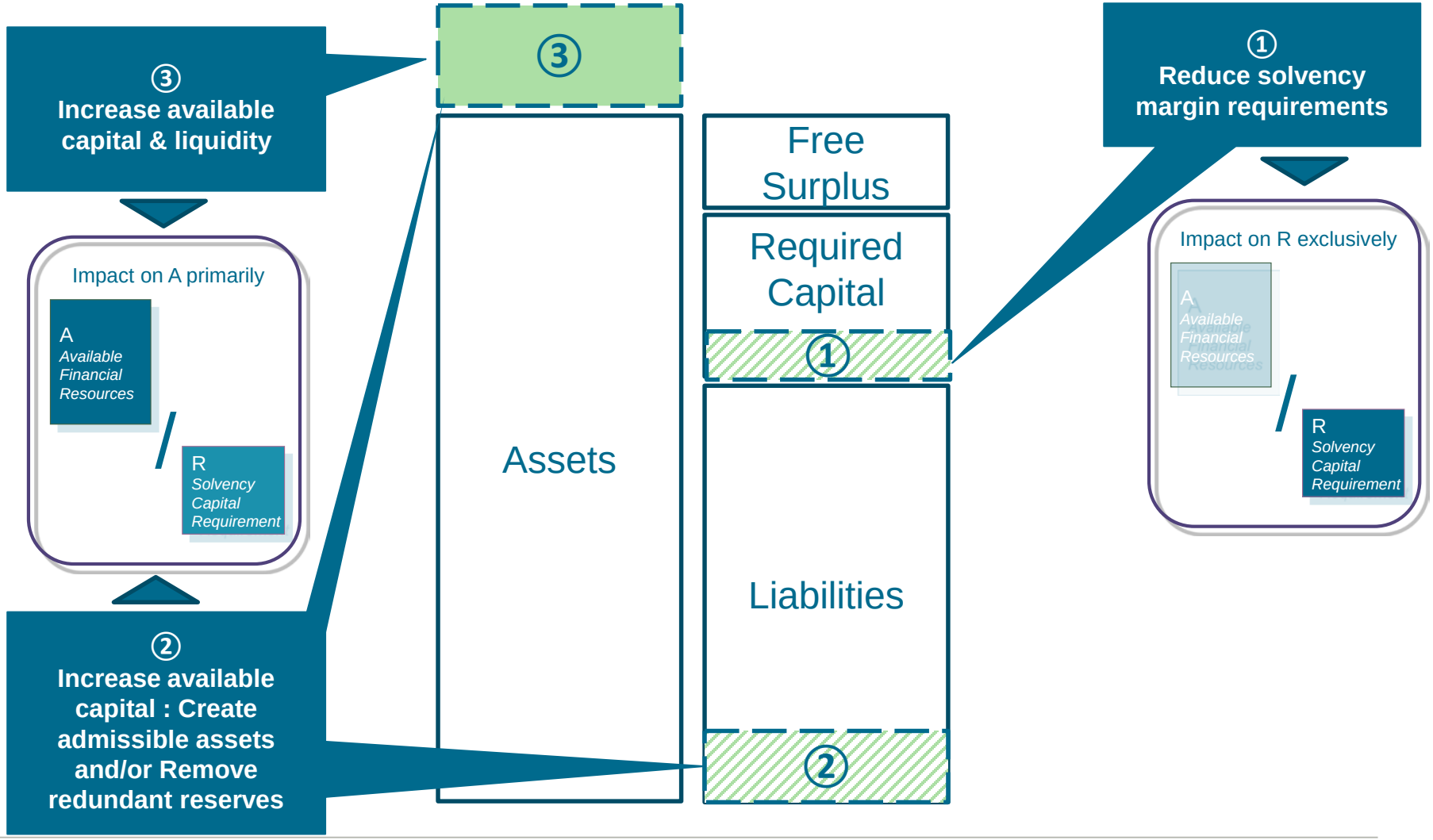
- Debt and equity are common forms of capital available to public insurers
- Reinsurance is a form of capital available only to insurance companies - reinsurance can add to an insurers assets or reduce its risks.



Considerations in valuing financial reinsurance in a capital management context

- Capital benefit as an increase in Net Asset Value and/or decrease in Solvency Capital Required
- Tenor of capital benefit
- Cost or impact on earnings
- Risk absorption as a beneficial impact on cost of equity
- Financial flexibility in transaction
- Funding or impact on liquidity considerations
- Visibility and perception of financial reinsurance as compared to alternative sources of capital

Financial Solutions reinsurance are an efficient steering tool for the solvency ratio

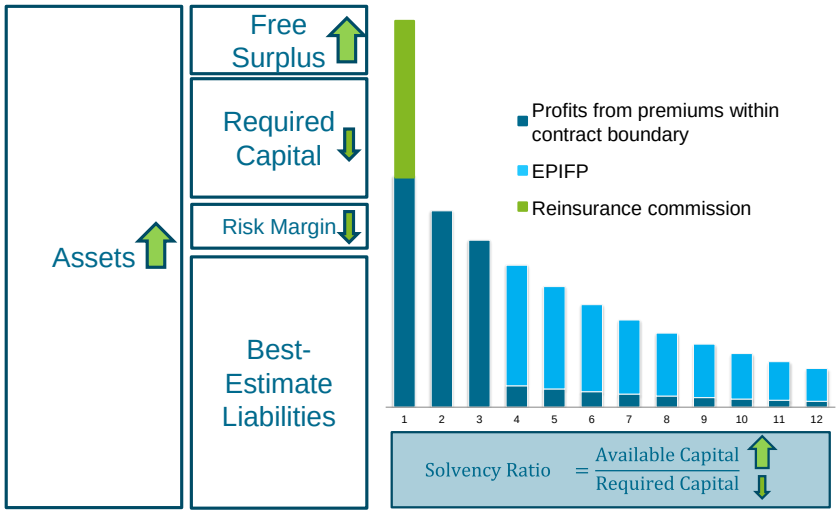


Financial solution reinsurance structures

Impact	Type
1. Reduce Solvency margin	Traditional reinsurance which decreases underwriting risk thus decreasing risk capital and risk margin
	Contingent reinsurance triggered by specific 1/200 year events
2. Increase Assets or Reduce Reserves	Lapse reinsurance (payment on mass lapse or on or other lapse stress) decreases risk capital and corresponding risk margin
	Risk margin reinsurance solution similar to VIF receivable but tied to risk margin
	Time deferred stop loss reinsurance (TDSL) financed from release of risk margins or margins not on the balance sheet
	Quota-share inforce business removing the market risk
3. Increase Available Capital	VIF monetisation reinsurance
	VIF receivable reinsurance to make eligible future profits beyond contract boundaries
	VIF receivable reinsurance in subsidiaries located outside EEA allowing them to dividend up to Group
	Front end profits to use up Deferred Tax asset

"VIF extension"
Recognition of VIF beyond Solvency II contract boundaries

Impact illustration



- Reinsurance commission increases assets
  - *There is also a slight decrease due to cession of profits within contract boundaries*
- Required capital and risk margin slightly decrease as arrangement offers protection against adverse deviations within contract boundaries
  - *There is also a slight increase in required capital due to counterparty risk introduced by reinsurance contract*

Transaction details

Solvency II stipulates that *"where the **(re)insurance undertaking** has a **unilateral right** to **cancel the contract, reject the premium or an unlimited ability to amend** the premium or the benefits so that they reflect the risk at some point in the future, any obligations beyond that point are not part of the contract"*.

Consequently, **Expected Profits in Future Premiums (EPIFP) cannot be recognized** in Solvency II balance-sheet.

Structure

"VIF extension" is a long-term **quota-share arrangement** whereby reinsurer pays a **commission** corresponding to **part of the VIF beyond contract boundaries**.

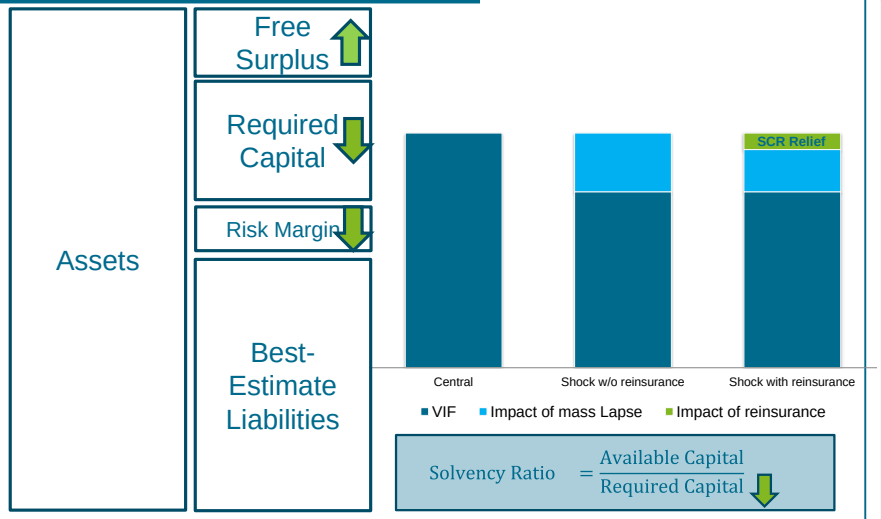
Reinsurance arrangement follows underlying contract's boundaries in the cedant balance-sheet.

Comments

- Suitable for any product that incurs contract boundary e.g. unit-linked, renewable term, certain morbidity products
- A non-cash reinsurance receivable of the initial commission makes the transaction more cost efficient

“Mass-Lapse Stop-Loss”
Protection against mass lapse risk

Impact illustration



- No material impact on assets
  - *Some marginal negative impact from reinsurance costs*
- Required capital decrease as the structure aims to capture SII shock
- Risk margin slightly decrease. Impact will depend on the duration of the coverage.

Transaction details

SCR Life for Lapse risk is the maximum of 3 scenarios:

- Lapse Up: Permanent increase of lapse rates by 50%
- Lapse Down: Permanent decrease of lapse rates by 50%
- Mass Lapse: 40% of the portfolio lapse in the current year

➢ **Mass lapse is usually the worst scenario**

The standard formula is deemed very conservative especially for UL products

Structure

A “mass-lapse stop loss” covers the cedant from **losses in VIF** due to **lapses (only)** in excess of a given threshold (eg. 30%) and up to a limit (eg. 10%).

Coverage is offered for a **limited period of time** (1-3 years)

Comments

- Suitable for any product where mass lapse risk capital does not properly reflect the turn nature of the product for example if tax penalties would entice policyholder to retain their products
- Sold in combination with more traditional reinsurance

Content

1	European Solvency II observations
2	Options to manage capital in a Solvency 2 world
3	Reinsurance – a strategic capital management tool
4	Criteria for success and timeline

Financial Solutions provides an expert team

Capital adequacy constraints → **Capital Management = Optimization under Constraints** → **Financial Solutions reinsurance**

Accounting	• IFRS • Local GAAP
Economic net worth	• Internal model view • Economic Balance shet view
Regulatory	• SII • Comframe • SIFIs • Other
Rating agencies	• AM Best • Fitch • Moody's • S&P
Clients	• Claims payment
Shareholders	• Risk adjusted return
Financing	• Cash flow and capital

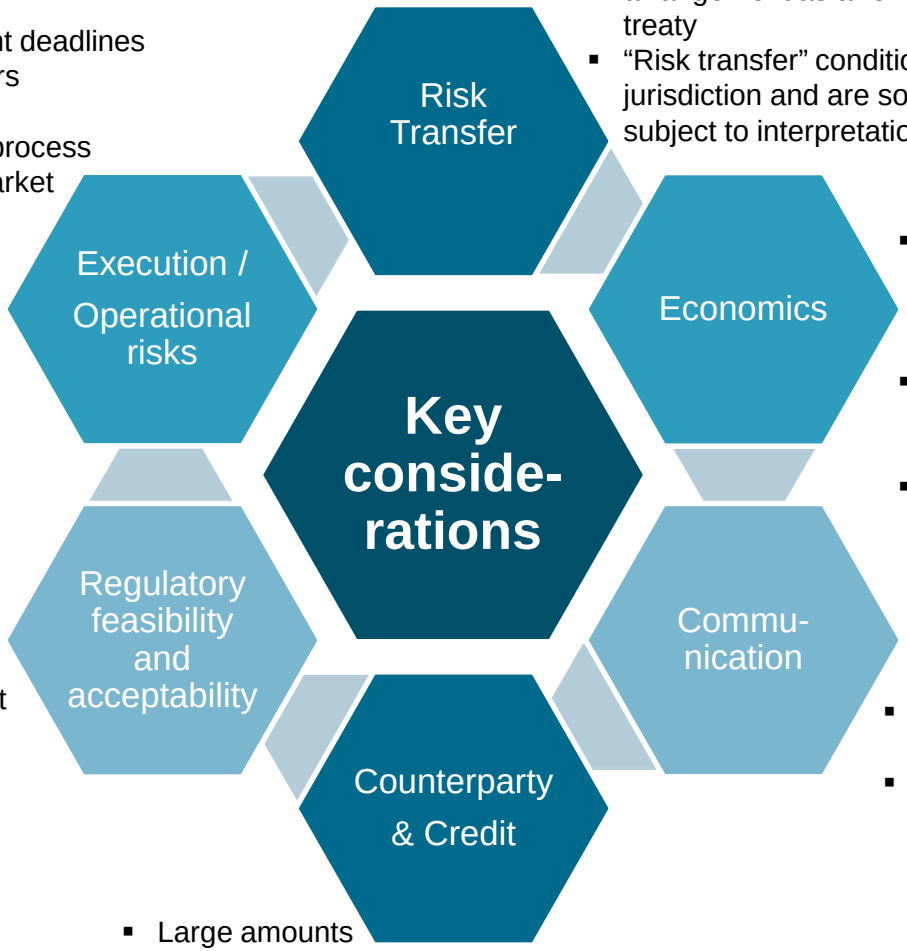
Implementing state-of-the-art capital management techniques

In normal operating conditions	In times of structural changes	In crisis/stressed conditions

- Define risk appetite and risk tolerances √
- Optimize (but preserve a strong) capital position √
- Maximize transferability √
- Maximize financial flexibility √
- Optimize shareholders' remuneration √

SCOR's Financial Solutions reinsurance provides an internal centre of expertise to develop and implement capital management Reinsurance solutions for our life insurance clients

Considerations to keep in mind when deciding to transact



Risk Transfer

- Required criterion to qualify the arrangement as a reinsurance treaty
- "Risk transfer" conditions vary by jurisdiction and are sometimes subject to interpretation

Execution / Operational risks

- Long process
- Management of tight deadlines
- Various stakeholders
- Governance
- Closing/signature process
- Reactions in the market
- Reputation risk

Economics

- Each deal requires a 360° review (risk management, financial, tax, regulatory, legal etc) by both parties
- Objectives, constraints, trade-offs have to be clearly stated and understood
- Costs / risks are to be weigh against benefits / rewards

Regulatory feasibility and acceptability

- Regulatory feasibility
- Regulation sometimes silent or unclear as to the qualification, accounting / solvency treatment
- Assets admissibility
- Regulator's approval sometimes required
- Regulations evolve
- Reputation risk

Commu-nication

- Transparency between parties is key
- Communication to the regulator, Board, auditors and to the market (investors, rating agencies etc) is to be properly managed

Counterparty & Credit

- Large amounts
- Long term arrangement
- Risk of default

Criteria for success when structuring a reinsurance transaction

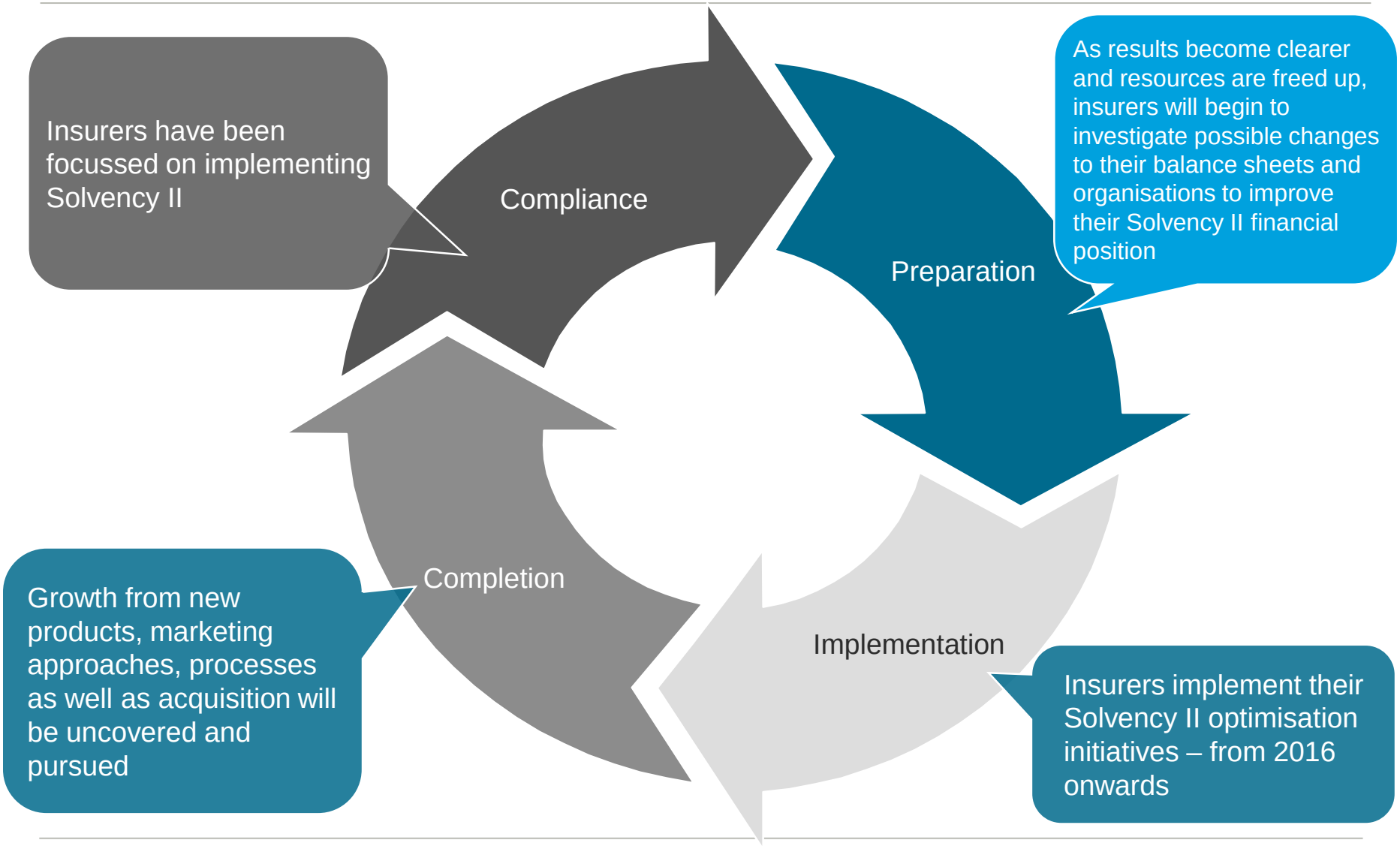
- Precise definition of objectives, constraints and trade-offs
- Feasibility assessment
- Effective project management and governance
- Appropriate skillsets and sufficient resources
- Internal and external effective coordination and communication
- Selection of the appropriate underlying block of business
  - Usually stable and predictable blocks with limited number of benefits are well suited for Financial Solutions
- Alignment of interest / win-win transaction
- Correct assessment and mitigation of identified risks
- Simplicity of structure to reduce execution risk
- Right choice of reinsurance partner
- Long-term perspective

We at SCOR have an experienced dedicated team, appropriate risk appetite and full commitment from Executive Management to transact in a professional efficient manner

Normally transactions can take between 3 and 6 months

	Step 1	Step 2	Step 3	Step 4	Step 5
Indicative timeline	1-2 weeks	2 weeks	4-8 weeks	5-10 weeks	1-2 weeks
	Diagnosis and design of the solution	**Formal launch**	**Non-binding offer**	**Binding offer**	**Execution**
	▪ Client objectives setting ▪ Preliminary feasibility assessment ▪ Outline of possible structures	▪ NDA signature ▪ Data exchange and analysis	▪ Portfolio review and structuring by SCOR ▪ Share analysis and non-binding offer with cedant ▪ Cedant's review ▪ Refinement of analysis and structure by SCOR ▪ Cedant's review	▪ Both parties agree to move forward ▪ Additional data exchange with due diligence ▪ Cedant and SCOR's internal review process and authorization ▪ Draft treaty wording: review, change and finalize ▪ Final round for cedant and SCOR's internal and external approval process ▪ Cedant's review	▪ Final negotiation (if necessary) ▪ Signature of legal documents ▪ Execution of the transaction

Summary - transitioning from implementation to optimization



Disclaimer

This presentation and none of the information contained is intended to be legally binding or enforceable. The presentation is not exhaustive and shall not give rise to legal rights or obligations.

The information provided in this presentation does in no way whatsoever constitute legal, accounting, tax or other professional advice. While SCOR Global Life SE has endeavored to include in this presentation information it believes to be reliable, complete and up-to-date, the company does not make any representation or warranty, express or implied, as to the accuracy, completeness or updated status of such information. Therefore, in no case whatsoever will SCOR Global Life SE and its affiliated companies be liable to anyone for any decision made or action taken in conjunction with the information in this presentation or for any related damages.