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Solutions for Discontinued Insurance Business

The day after tomorrow*

Insolvency, restructuring and Solvency II in the new financial landscape

*connectedthinking

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Introduction

Agenda

Insolvency

Restructuring

Solvency II

Insolvency

Economic times “are arguably the worst they've been in 60 years, and I think it's going to be more profound and long-lasting than people thought.”

Alistair Darling, Chancellor of the Exchequer
The Guardian, 29 August 2008

13 September 2008 – The Economist

“The world economy may well muddle through, as it has so often in the past. Growth in much of the developing world is still strong. And the recent fall in commodity prices, although partly sparked by economic fears, should be a boon.”

Financial crisis

15 September 2008 – Lehmans

Complete collapse in confidence

“You only find out who is swimming
naked when the tide goes out”

Warren Buffett
Letter to shareholders, 28 February 2002

Financial crisis

Emerging lessons from Lehmans – it's not about complexity

Financial crisis

Impact on insurers

Financial collapse

- Less capital available
- Reduced investment returns
- Increased scrutiny from investors and regulators
- Flight to quality

Economic collapse

- Less to insure
- Increased claims
- Increased fraud
- Consumer risk awareness

Financial crisis

Who will be hit?

Lines of business

- D&O and E&O
- Financial guarantee

Specialists will be hit harder than diversified operations

Credit insurance

General deterioration in claims experience

Financial crisis

Losses

The domino effect

Insolvency or downgrade of a counterparty can have a domino effect

Example

- Cedant B has significant exposure to insolvent Reinsurer A.
- As a result Cedant B becomes insolvent.
- Cedant C is reinsured by Reinsurer B and now suffers loss due to B's insolvency and in turn becomes insolvent...

Financial crisis

Mitigating losses – what are the options?

Commutation

Set-off

Debt trading

Creditor driven schemes

Insolvency – is there a better alternative?

Creditor driven schemes

- Creditors concerned about solvency of reinsurer
- Rather than wait for insolvency, creditors collectively suggest a solvent scheme
- Once company agrees, it proceeds like any other solvent scheme with exception, possibly, of an advisory committee of creditors

Solvent schemes – key features

- Wholesale commutation
- Deal takes account of all stakeholder interests
- Bar date for submission of claims
- Actuarial assessment of ultimate liability
 - allocation – “we tell you”
 - submission – “you tell us”
- Commutation
- Payment arrangements

Restructuring

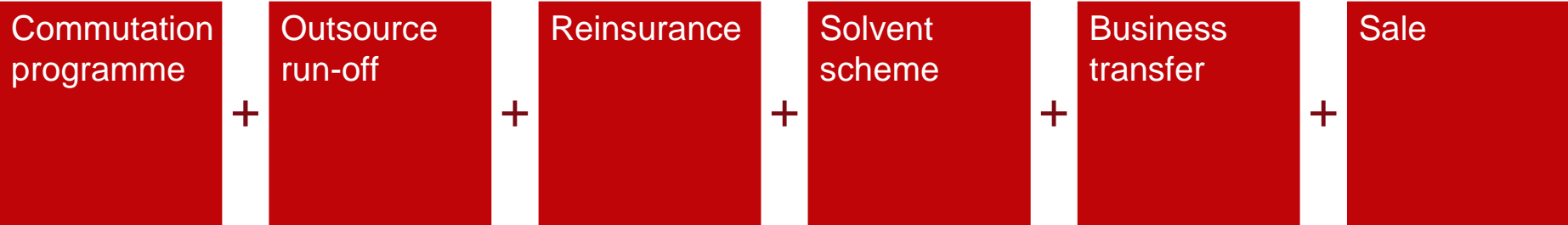
Restructuring

Run-off strategy – traditional

Commutation
programme

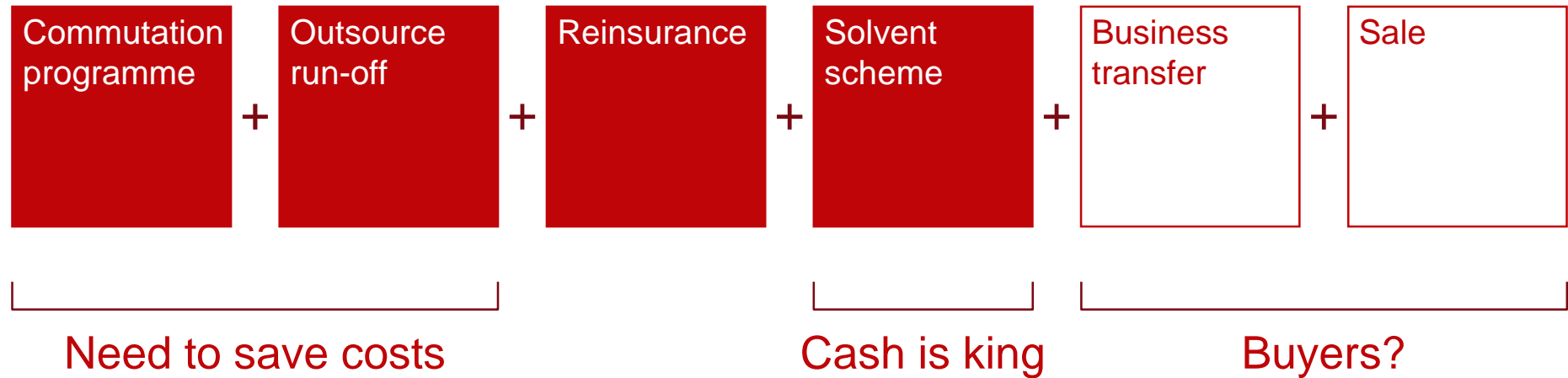
Restructuring

Run-off strategy – recent



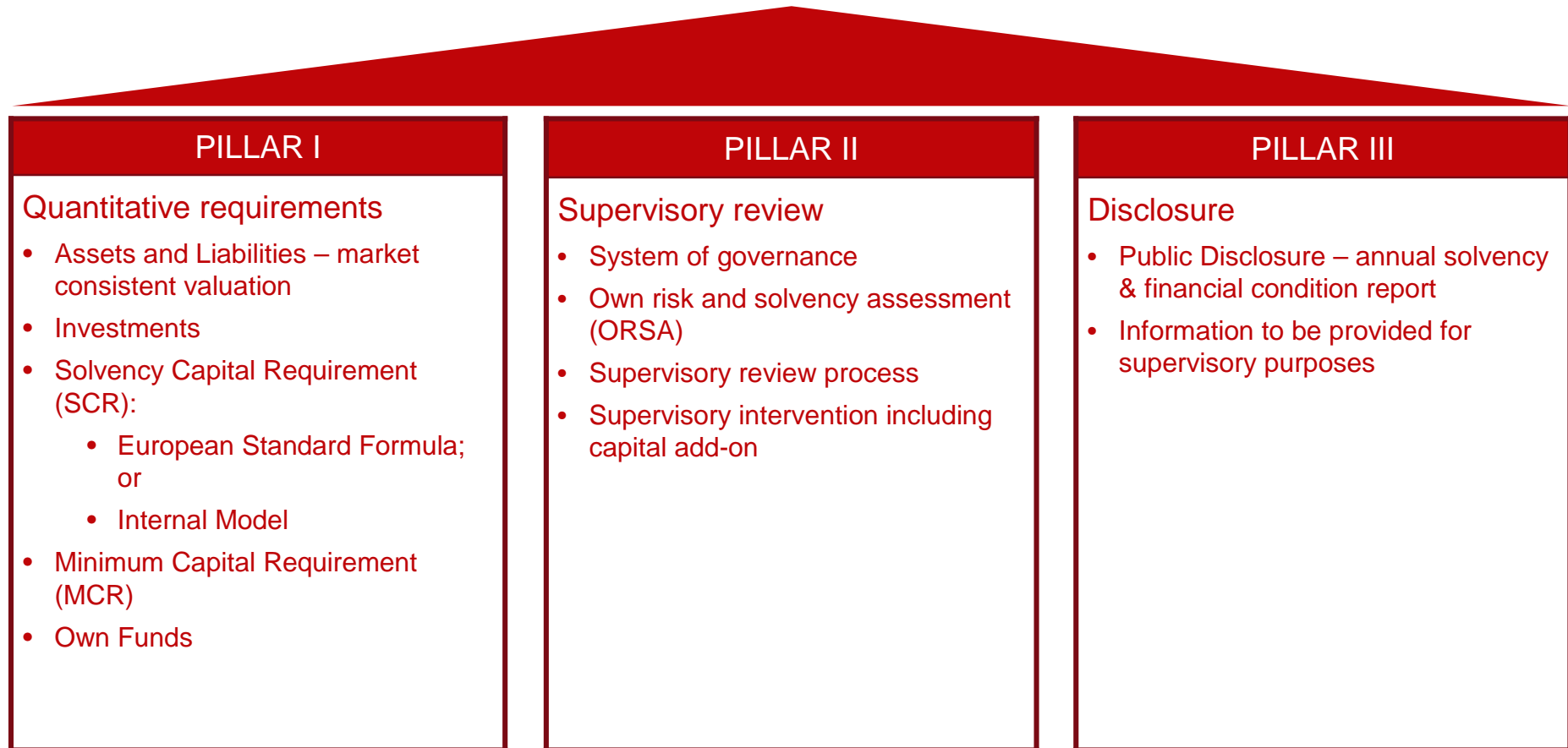
Restructuring

Run-off strategy – now?



Solvency II

The Three Pillar approach to supervision on both a solo and group basis

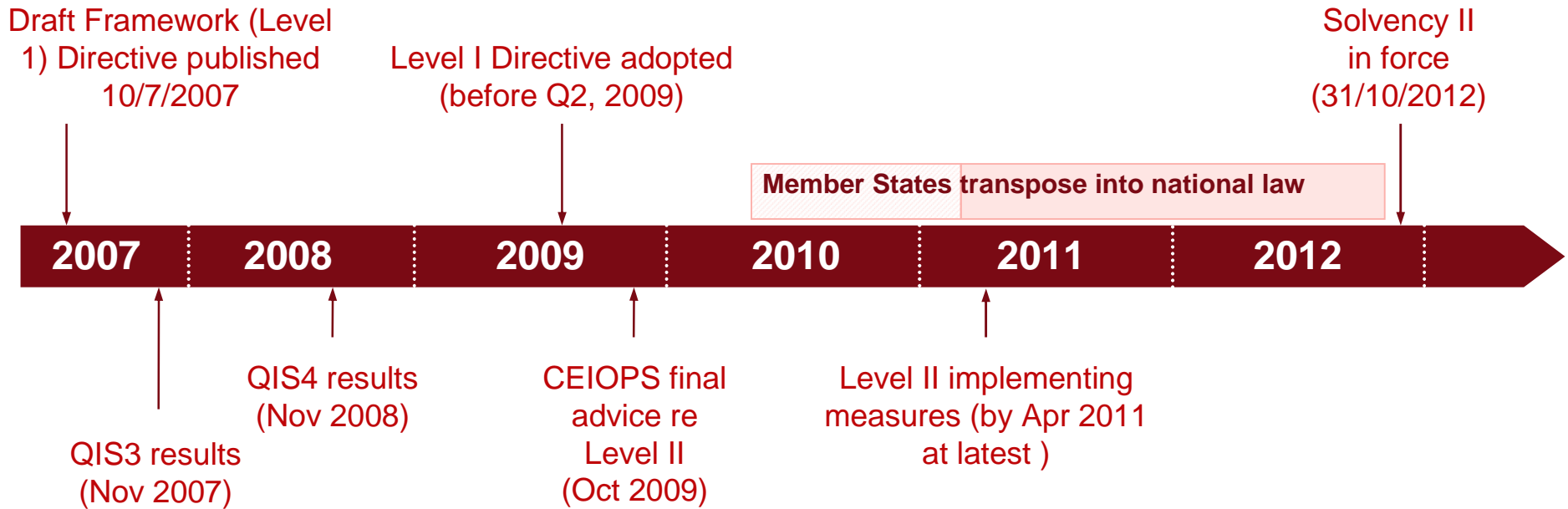


GROUP SUPERVISION – all pillars applicable to solo entities and groups

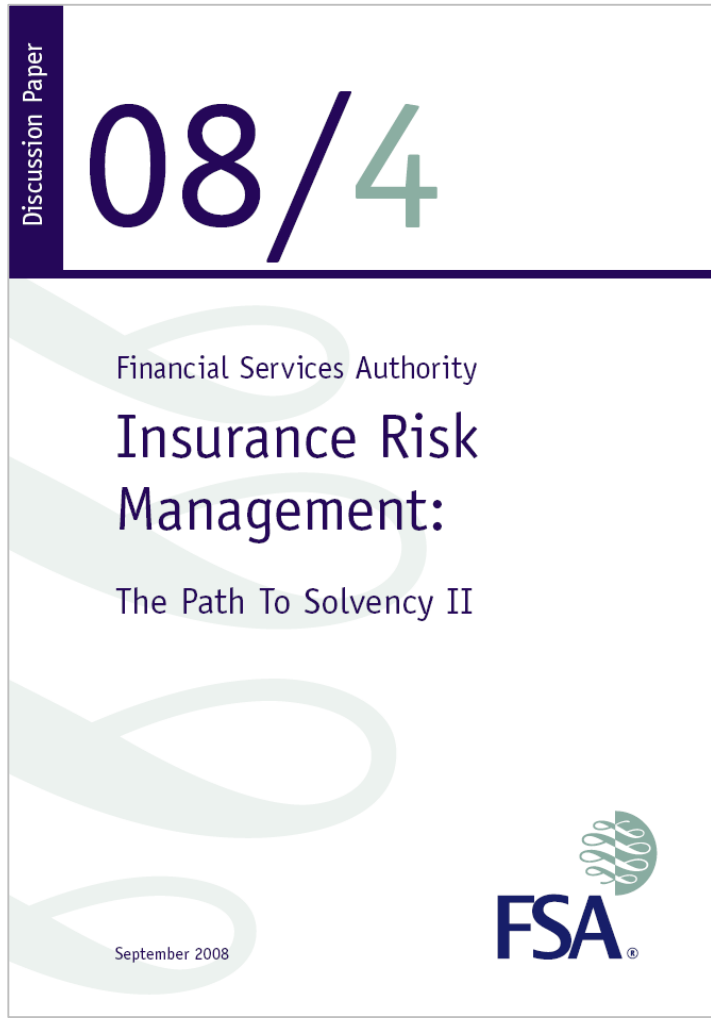
Solvency II

Timeline


Legislative schedule



FSA puts down their marker



The Path to Solvency II – the FSA’s DP 08/4



The FSA issued this paper on the 25th September to highlight and explain key elements of the Solvency II regime, with the aim of stimulating and helping UK insurers’ preparations. It identifies areas in which firms might best focus their preparations through the coming 12-18 months and provides some detail on the crucial model approval process.

At the same time firms will need to determine carefully the most appropriate model strategy: choosing between the internal model route and the standard formula approach (or potentially a hybrid of the two).

Our experience is that addressing implementation of Solvency II includes a shift in the culture and mindset of the business with important implications for strategic planning, management skills, incentives, and organisational behaviour. So the FSAs call for action is timely. This is particularly so over the approval of the use of internal capital models where a ‘dry-run’ and ‘pre-approval’ process is set out. This needs action.

Key messages

You need to act now

The key theme from the FSA is a call for action now to prepare for Solvency II. The timeframes are short given the amount of effort that will be required from firms. The FSA highlights that the risk of not acting far outweighs the effort of engaging now. The FSA will be engaging with CEOs of all UK-regulated firms asking for action in three areas:

1. Putting in place an implementation plan for the Solvency II project involving a systematic gap analysis;
2. Nominating a single individual by March 2009 who will be responsible for Solvency II delivery;
3. Assessing the potential quantitative impact of the new regime by completing a Quantitative Impact Study (QIS4 being the latest one) to inform the above.

Our experience with Basel 2 has shown that successful implementation starts with the critical first step of Board engagement. The FSA’s view is consistent with this and the paper emphasises that firms that haven’t done this already cannot afford to wait any longer.

Given the direction taken by the UK insurance industry under the ICAS regime and firms’ emphasis on Enterprise Risk Management (ERM) it is our view that the majority of UK firms will wish to assess solvency via an internal model route. The discussion paper outlines the basis for participation in ‘dry-runs’ for model approval. This presents firms with an excellent opportunity to engage with the FSA around developing their standards and achieve model approval before Solvency II implementation in October 2012.

The initial qualifying criteria for firms to participate in these dry-runs are:

- Participation in or subsequent completion of QIS4
- Substantial progress on documenting the internal model
- A fully prepared implementation plan - including meeting the Directive’s tests
- A plan to develop, iteratively, the model used to determine capital

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A Call for Action – a summary of the Discussion Paper

Action	Timetable
Gap analysis and implementation plan	Q4 2008, Q1 2009
Solvency II “Senior Individual” identified	March 2009
Confirm approval will be sought for internal model	June 2009
Confirm “dry run” entry criteria met	H1 2010
Dry run submissions	November 2010
Internal model submission (1 st batch)	October 2011
Confirmation of approval	March 2012

Documentation of model(s) is also a requirement for the “dry run” process

Key messages for Boards – the timetable has accelerated

Where has Brussels got to?

Lamfalussy procedures evolving with Solvency II:

- Work on the ‘Level 1’ framework directive, in parallel with
- CEIOPS work (including QIS4) to provide input to ‘Level 2’ implementing measures
- CEIOPS simultaneously thinking through ‘Level 3’ standards/guidelines.

Framework Directive:

- Co-decision: European Parliament/European Council (EcoFIN): intention to fast-track with one ‘reading’
- Vote on favour in EP ECON committee on 7 October 2008
- Difficult negotiations ongoing in Council:
 - Equities
 - Group provisions (currently excluded)
- Czech Presidency making progress
- EP Plenary session on 21 April 2009
- Text has to be finalised by 20 March 2009

Solvency II status – political developments

Broader ramifications: the economic and global context

Impact of current market turmoil:

- Market consistent valuation principle underpins Solvency II
- EU high-level working group on group supervision (De Larosière) due to report by March 2009

Current prospects for Solvency II?

- Move into second reading = (considerable) time delays?
- Seems unlikely that will not go ahead in some form
- If Solvency II were not to proceed
 - National supervisors might go ahead anyway:
 - Pillar 1 requirements – national interpretations?
 - Increased focus on Pillar II likely
 - Impact on industry = increased complexity and cross-border regulatory arbitrage
- FSA committed to implementing aspects not in ICAS anyway

What has QIS4 told us?

- Good level of participation but still many firms not engaged
- In the UK most non-life firms and many life firms could cover their SCR
- Most firms could cover their MCR
 - Captives and niche insurers face specific challenges
- Internal model SCR vs. standard formula SCR
 - Life: on average internal model results were higher
 - Non-life: on average internal model results were lower
- QIS5 in 2010

Who is exempt from Solvency II?

Reinsurers in run-off before 10 December 2007 – exempt in full

Insurers and reinsurers may be exempt from Solvency II if:

- Annual premium does not exceed EUR5 million
- Total technical provisions, gross of reinsurance and SPV recoveries, does not exceed EUR25 million
- Total **group** technical provisions, gross of reinsurance and SPV recoveries, does not exceed EUR25 million
- Business does not include insurance or reinsurance of liability, credit and suretyship
- Reinsurance does not exceed EUR0.5 million or 10% of gross premiums or 10% of total technical provisions

Solvency II

Impact of Solvency II for run-off companies is unclear

Reinsurance run-off subsidiaries

- Exemption a side effect from re casting Reinsurance Directive

Direct insurance run-off subsidiaries

Branches in run-off

Exempt run-off subsidiaries still included in

- Overall Group solvency calculation
- Group supervisory framework

Proportionality – how will it apply?

Impact on acquisition of portfolios in run-off prior to 10 December 2007?

How should groups deal with their run off going forward?

Capital implications of Solvency II (likely to be higher than live business)

To be addressed in Level 2 implementing measures?

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