Solvency II – One year on
One step forward; two steps back

Life2017
Andrew Crean and Kamran Foroughi

21/22 June 2017
<table>
<thead>
<tr>
<th>Metric</th>
<th>Impact of Solvency II</th>
</tr>
</thead>
</table>
| Profit                   | - IFRS profit key; generally unchanged under Solvency II  
- Explanation by main drivers (investment, risk, expenses)                                                                                                                                                    |
| Distributable cash flow  | - UK change in definition to allow for Solvency II  
- Effect in other countries unclear  
- Biting constraint unclear                                                                                                                                  |
| Capital                  | - Historically regulatory and economic capital  
- Now focus on Solvency II only                                                                                                                                                                                          |
| Value                    | - Solvency II impact on EV varies significantly by firm  
- EVs under EEV/MCEV Principles have to allow for Solvency II in locked-in capital; not necessarily value                                                                                   |
Different metrics needed for different types of business

<table>
<thead>
<tr>
<th>Type of business</th>
<th>Key metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Profit</td>
</tr>
<tr>
<td>Fee (Fund management)</td>
<td>●</td>
</tr>
<tr>
<td>Risk (Protection)</td>
<td>●</td>
</tr>
<tr>
<td>Spread (Annuities)</td>
<td>●</td>
</tr>
<tr>
<td>Legacy (With-profits)</td>
<td>●</td>
</tr>
</tbody>
</table>
Summary: Key Findings of the report
Solvency II One Year On: One step forward, two steps back

Solvency II – one step forward
The primary purpose of Solvency II is to provide a clearer picture of capital adequacy for European insurers. In this it has been successful. For investors, the framing of current coverage ratios within the context of upper/lower bounds provides guidance as to when dividends may be at risk or additional capital might be returned.

Solvency II – two steps back
As a profit performance and cash generation measure current Solvency II disclosures fall short. This is a live issue given the rapidly shrinking publication of useful EV data in Europe and the fact that the reformation of IFRS (new proposals in May) is unlikely to help for many years. Two substantive issues need addressing:

- Because there is no requirement under Solvency II to produce an in-period movement analysis, nor sensitivities, investors do not have a clear picture of free capital generation;
- Solvency II has forced apart the accounting and solvency reporting, making it harder to understand the dividend paying biting constraint.

The current position
With an aggregate Solvency II coverage ratio of 187% at the end of 2016, the industry’s current capital position is comfortable. None the less the industry would do well to address the shortcomings of Solvency II before a crisis. In 2008/09 lack of transparency on cash and capital contributed to the sector’s implied cost of equity hitting 20%. The peripheral sovereign crisis (2011) and Brexit concerns (mid-2016) support the view that investor confidence in insurance is febrile. Improved transparency should help.

A way forward
In order to aid the investor community, we propose standardised templates for the insurance industry disclosing, inter alia, a movement in Solvency II free surplus, Solvency II sensitivities, and an explanation of whether Solvency II or IFRS is the biting constraint when it comes to cash remittances and dividend paying capacity.

We appreciate that insurers have faced a significant burden to date in preparing Solvency II results and have struggled to have them ready for the normal IFRS year-end reporting timetable. Insurers may consider deferring reporting dates to enable templates to be prepared.
European insurers’ relative share price performance vs. the implied cost of equity, 2006-17

Source: Bloomberg, Autonomous
European insurers: dividends, dividends, dividends, dividends

Note: the yields here include ordinary and special payments and buy-backs related to earnings.

Source: Autonomous
European Sector Solvency II Coverage Ratios through 2016

Source: Company data, Autonomous
Sector Solvency II Surplus Sensitivities, 2016

Source: Company Data, Autonomous
Global insurance industry (still) reports c. US$1 trillion of EV
Recent demise of EV reporting in Europe

Number of European insurers showing EV free surplus analysis

Source: Willis Towers Watson, Autonomous

As a method of deriving cash/free surplus analysis, in Europe too few companies are now publishing for this to be effective
Solvency II complicates investor message
Other issues arising from Solvency II

Asset Liability Management

Complexity of model
Will Solvency II SFCRs help?

SFCR disclosures had to be published for the first time this May (Solo; deadline of 30 June for Group disclosures), with prescribed tables known as Quantitative Reporting Templates or QRTs. Will this new information help investors?

<table>
<thead>
<tr>
<th>Feature</th>
<th>Benefit</th>
<th>Useful for investors?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solo focus</td>
<td>✓</td>
<td>Highlights potential blockages in divided paying capacity</td>
</tr>
<tr>
<td>Capital ratios</td>
<td>(✓)</td>
<td>Clear interest in capital positions, but additional information required to understand impact of non-shareholder sources of capital</td>
</tr>
<tr>
<td>Transitional</td>
<td>(✓)</td>
<td>For UK firms (main users of transitionals), impact needs comparing against risk margin and explanation how the two run off</td>
</tr>
<tr>
<td>Matching Adjustment/ Volatility Adjustment</td>
<td>✗</td>
<td>Impact shown against theoretical “swaps less” rate, more interesting would be comparing against full yield on assets backing liabilities</td>
</tr>
<tr>
<td>EPIFP</td>
<td>✗</td>
<td>Unclear definition and purpose in Solvency II</td>
</tr>
</tbody>
</table>
Will IFRS 17 Insurance Contracts help?

IFRS 17 may enable better investor engagement:

- In the medium term, the IFRS 17 development will increase the pressure on EIOPA/ European Commission to simplify the Solvency II balance sheet and improve alignment with the accounting more generally.
- In the longer term, the insurance industry might attract a wider generalist investor pool that struggles today to understand why there is such different accounting in different countries.

However, in the next 5-7 years we do not think IFRS 17 represents a solution as:

- The effective date is 2021;
- The new standard is complex (being a hybrid between book and market value accounting) with a new income statement, so will take time for users to understand;
- Where existing IFRS remains a good proxy for cash available to meet dividends, the onset of IFRS 17 will likely break this link, creating further communication challenges.

In principle, we believe a going concern forward-looking accounting measure can underpin both accounting (IFRS 17) and regulatory (Solvency II) approaches, with all the differences lying in a separate Contractual Service Margin and Solvency Capital Requirement respectively.
Disclosures: a proposed way forward for normal year-end reporting

Intended to stimulate a wider debate with the insurance industry

- Standardised templates for disclosing Own Funds, the SCR and reconciliations
- Disclosure of Solvency II Free Surplus Generation
- Standardised sensitivity tests

Template to show subsidiary / divisional remittances and describe dividend paying biting constraint
## Disclosures: A Proposed Way Forward

Figure 8: Suggested template communicating dividend paying constraints

<table>
<thead>
<tr>
<th>IFRS segment*</th>
<th>Dividends paid</th>
<th>Main constraint on dividends**</th>
<th>IFRS profit</th>
<th>Free surplus generation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Group</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BU A</th>
<th>BU B</th>
<th>BU C</th>
<th>BU D</th>
<th>Group items</th>
<th>Generated for distribution</th>
<th>Retained</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Group costs</td>
<td>Dividend paid to shareholders</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Debt</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Capital raised</td>
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</tr>
</tbody>
</table>

Dividends paid up from BUs

Metrics should (where possible) be reported on the same level of granularity to aid users

* Business unit or legal entity, as appropriate for company taking into account where there may be material constraints on dividends

** This could be Solvency II or IFRS, company-specific restriction, or something else
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