SOLVENCY II BRIEFINGS

29 & 30 November
AGENDA

► Introduction
► FSA Update
► Impact on market timetable
► Capital setting process
► Summary
JANUARY 2014 IMPLEMENTATION DATE NOW “COMPLETELY UNREALISTIC”

Lloyd’s does want to

► Apply a pragmatic approach which enables cost effective completion of the programme
► Continue to use SCR models for capital setting
► Leverage the benefits of Solvency II without being held to the entirety of the Solvency II tests and standards
► Assist agents in developing and enhancing the most valuable aspects
► Complete a robust assessment and review of Lloyd’s existing minimum standards to ensure alignment with Solvency II

But we don’t want to

► Enforce full compliance an expected 3 years ahead of implementation
► Lose the good work done to date and allow it to lapse
We should assume at this stage that Solvency II rules will ultimately apply.

Lack of certainty but Lloyd’s has planned assuming a 1.1.2016 start date.

Options discussed internally as well as with the LMA and FSA.

- “Full Stop” and “Full Steam Ahead” considered and dismissed.

“Soft Landing” deemed appropriate approach to take.

Phased implementation - least painful and most efficient.

- Avoids full burden of Solvency II compliance in advance of go live.
- Does not lose good work already done.

Quantitative requirements apply immediately to support use of Solvency II models.

Qualitative requirements phased in over 2013 to 2016.
Solvency 2 – update from the FSA

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Manager – Lloyd’s Market Supervision
FSA – Prudential Business Unit
Contents

1. Introduction / Timing
2. Internal model issues – general feedback
   1. Validation
   2. Documentation
   3. Use / Pillar 2
3. Early Warning Indicators
4. ICAS +
Introduction

- Omnibus 2 out to March 2013
- Still 2014…
- FSA planning horizon moved to December 2015
- No early implementation
- Allowing the sector to benefit from work carried out to date
- Lloyd’s market considerations in timetabling
  - Use for ICAS / ICAS +
  - Challenges of applying the Directive to the market
Good Validation…

• Combines BAU validation (e.g. Three Lines of Defence) and programme related activity

• Identifies all key material assumptions underlying the internal model – appropriate scope

• Defines materiality for each component being validated

• Sets quantitative triggers for tests/standards in validation policy and states triggered actions (e.g. automatic add-on/revert to previous model iteration)

• Has a clear escalation path or feedback loop to the model change policy, should any validation tests be failed

• Clearly documents any past issues identified through validation
Several examples of incomplete or otherwise undeveloped documentation

Documentation in an large number of cases are not in line with what is happening in practise

In some cases the documentation is highly technical and contains little explanation of specific methodologies used

Some documentation appears to be produced solely for our benefit – ideally, documents could help to show good use and embedding of the model

Several firms are doing remedial work to address significant issues with documentation
Internal model issues – Pillar 2 MI

- Timely & reliable
- Clearly presented
- Not overwhelmed by detail
- Risk points drawn out clearly
- Whole firm view aggregated
- Linked to risk appetite
- “Big bets” made clear

- Inter-relationship of risks clear
- Impact on capital clear
- Assumptions clear
- Stress testing
- Multiple scenarios
- Dynamic
Early warning indicators

- PRA developing a set of Early Warning Indicators for firms with internal models
- Purpose is to give comfort that capital does not drift once the directive goes live
- Working with EIOPA on EWIs
- Immediate supervisory review if EWI breached
- Looking at MCR multiples for calibration – working with industry to refine
- Will need to think carefully about GI and London Market issues
ICAS +

- Two stage process to allow firms to benefit from the S2 work they have carried out to date
  - Reconcile differences between SCR and ICA (e.g. reserving)
  - Assessment of S2 progress from the firm
  - Assess prudence levels within the model + validation
  - Move towards use of the model and ORSA without further reconciliation
- Engagement with industry to move the proposals forwards
- Non-compulsory…!
- No promises on our final outcome – being in stage two doesn’t imply model approval
Questions…?
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LLOYD’S AND AGENT SOLVENCY II PROGRAMMES ARE WINDING DOWN

► Lloyd’s IMAP submission made in July 2012 and accepted by the FSA
  – Lloyd’s Internal Model (LIM) plus catastrophe and investment components now fully operational
  – Full LIM validation cycle run and Validation Report produced
  – Solvency II risk governance structure now well established
  – First Society ORSA approved by Franchise Board
  – Only remaining project work is on Pillar III
► Final Application sign off submissions received from all agents on 5 October
► SCR models used to set capital for 2013

► But what happens next?
A BINARY ASSESSMENT AGAINST THE TESTS & STANDARDS AS AT 31.12.12 IS STILL REQUIRED

► Lloyd’s does not consider that 100% compliance against 100% of tests and standards is required at this point

► Lloyd’s will attest that “Agent meets the principles of all tests and standards” as opposed to “meets all tests and standards”
  
  – sufficient structure, processes and policies are in place which address Solvency II requirements
  
  – full granularity of underlying SAT requirements not necessarily in place
  
  – operating model not perfected but good enough to begin running and embedding key processes
  
  – Lloyd’s interpretation and application of requirements may still be under discussion with an agent

► Formal assessment in January 2013 on work completed against Pillar 1 & 2 requirements as at 31.12.12
### WHAT WILL A YES OR NO MEAN AT 31.12.12...

<table>
<thead>
<tr>
<th>YES</th>
<th>NO</th>
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<tbody>
<tr>
<td><strong>(Green rated agents)</strong></td>
<td><strong>(Amber/Red rated agents)</strong></td>
</tr>
<tr>
<td>✓ All areas meet principles of SII requirements and ✓ Lloyd’s &amp; FSA material feedback addressed by 31 December and ✓ Work outstanding is minor/developmental only and ✓ Project phase finished and most elements in use <em>(excl Pillar III)</em> and ✓ Credible operating model and structure established and ✓ SCR reviews demonstrate model is credible and robust <em>(ie SCR methodology was appropriate and any loading was down to a difference of opinion – eg on parameters)</em></td>
<td>✓ At least one area does not meet principles of SII requirements and/or ✓ Material feedback remains unaddressed at 31 December and/or ✓ Work outstanding will require significant resource and/or time to address and/or ✓ Significant project work remaining to be completed <em>(over and above Pillar III)</em> and/or ✓ Agent has not set out a credible operating model at this stage and/or ✓ SCR reviews raise material concerns over model and output</td>
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**NOTE:** AMBER & RED ratings defined by how many of the areas above an agent is failing to meet and the degree of work remaining
### AND WHAT IS THE IMPACT FOR AGENTS?

<table>
<thead>
<tr>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(Green rated agents)</strong></td>
<td><strong>(Amber/Red rated agents)</strong></td>
</tr>
<tr>
<td><strong>SCR review actions have already addressed ICAS requirements</strong></td>
<td></td>
</tr>
<tr>
<td>• Support agents in enhancing and embedding processes in operational mode</td>
<td>• Greater level of scrutiny and oversight</td>
</tr>
<tr>
<td>• Agent Status Reports not required</td>
<td>• Agent Status Reports required with regular and frequent interaction</td>
</tr>
<tr>
<td>• Developmental feedback provided on all timetabled submissions</td>
<td>• Additional resubmissions required to address feedback on top of timetabled deliverables</td>
</tr>
<tr>
<td>• Prudential measures would not apply</td>
<td>• Deadlines set for completion of work <em>(Fines will be considered for lack of response to feedback)</em></td>
</tr>
<tr>
<td></td>
<td>• Prudential measures would only be applied at year end if Lloyd’s considers gaps mean that agent poses greater risk to CF</td>
</tr>
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</table>
WHAT DOES SOFT LANDING APPROACH MEAN ...

► The principles of Solvency II reflect good risk management and business practice and are largely aligned with ICAS principles

► Qualitative requirements would be applied to current ICAS, Solvency 1 or Lloyd’s Standards level as a minimum

► Key valuable Solvency II processes run on a “soft test” basis in 2013 & 2014
  – Validation
  – Model Change
  – ORSA
  – Use

► Timetable on some areas can be extended – eg Profit & Loss Attribution, Data Directory and Pillar III

► Solvency II core documentation should continue to be maintained and updated
... AND HOW DOES TIMETABLE LOOK FOR 2013?
PROPOSED APPROACH TO SOLVENCY II PHASING – BY NUMBER OF DRY RUN SCORING ELEMENTS

- Apply to current level (ICAS/Solv1/Lloyd’s)
- Apply as a Solvency II "Hard Requirement"
- Apply as a Solvency II "Soft Requirement"
- Remains in project status
- Not applicable
What does a soft test requirement mean?

• Agents should run processes according to the policies they have in place
  – per operating models submitted to Lloyd’s in October 2012

• Lloyd’s will require submissions from agents to review
  – timetable and frequency to be agreed for individual areas
  – developmental feedback loop but do expect agents to action

• Further support provided from Lloyd’s via workshops, guidance and thematic review work

Example – Model Change Policy

• Scope and frequency of model change assessment should continue as per the agent’s model change policy
• Model is not yet locked down and “approved” so no formal approval required from Lloyd’s on major changes
• Lloyd’s will require submissions from agents but lower frequency than BAU (*ie not quarterly at this stage*)
• Lloyd’s will review basis of application of policy and provide developmental feedback to agents
• Lloyd’s will continue to provide market guidance and develop its own BAU processes
INDEPENDENT ASSURANCE ON STATUS SHOULD BE MAINTAINED

► Lloyd’s need to work from 31.12.12 assessment point and maintain an on-going view on status of each agent
  – RAG ratings will continue and feedback followed up
► No full quarterly attestation required via QMA in 2013 & 2104
  – Capital adequacy confirmation only as under ICAS
► However, important for agents to maintain assurance processes established and be able to demonstrate this to Lloyd’s
  – Annual summary of position likely to be required
  – we will consult via LMA Solvency II committee
  – reliance on existing processes where possible – eg validation
IN THE MEANTIME WE WILL CONTINUE TO TRANSITION TO BAU

► Work of Solvency II syndicate facing team will move to a broader risk oversight role in business as usual
  – change of reporting lines with effect from 1 January 2013
  – move to Risk Management

► Maintain responsibility for Solvency II tests and standards work

► Co-ordination and view of agent status across all Lloyd’s standards

► Review of Lloyd’s existing minimum standards and 3 tier approach
  1. Set out minimum regulatory requirements
  2. Be clear on any Lloyd’s specific requirements over and above
  3. Guidance/best practice - clarity on what is a “nice to have” rather than a requirement
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LLOYD’S WILL CONTINUE TO USE SCR MODELS TO MEET ICAS REQUIREMENTS

► Quantitative requirements would apply immediately to support use of Solvency II models

► One year ultimate SCR number required via Lloyd’s Capital Return (LCR) as for 2012

► Supported by Solvency II balance sheet and Technical Provisions to provide equivalent protection
  – one year regulatory number required on a soft test basis to assist with LIM calibration and SCR review process
  – no standard formula calculation required by Lloyd’s in 2013

► Actuarial Function report required on soft test basis to support TPs
  – No opinion required on underwriting or reinsurance for 2013 and 2014
CASH FLOWS AND AGGREGATE RESOURCES ARE MATERIALLY UNCHANGED USING ULTIMATE BASIS
REVIEW CONCLUSIONS MEET ICAS STANDARDS AND FEED INTO SOLVENCY II IMPLEMENTATION

- ICAS – capital “add-ons” address marginal shortfall in 1:200 risk
- In depth review of new models and one year SCRs
  - Parameters / plan assumptions to be on-going focus
  - One year calibration requires further work
- Models well built
  - now have improved sight of assessment by each risk type and their dependency
CAPITAL REQUIREMENT INCREASED BY £600M DURING REVIEW

- Reserve margins restricted to independent SAO view
- Business plan assumptions
- Parameters understated
  - Diversification between insurance risk and other risks
  - Diversification between classes of business
  - Market risk
  - Catastrophe risk; LCM peak perils and worldwide
- In summary, methodology reasonable, marginal understatement of risk in parameters
- Feedback and consultation planned on key themes
SIMILAR UPLIFTS TO RISK CAPITAL REQUIREMENTS AS PREVIOUS FULL REVIEW SEASON

Increases to final submitted ICA / uSCR following Lloyd’s review

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<th>Year</th>
<th>£m</th>
<th>No. of syndicates</th>
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<td>2009</td>
<td>200</td>
<td>25</td>
</tr>
<tr>
<td>2010</td>
<td>265</td>
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<tr>
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<td>270</td>
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<tr>
<td>2012</td>
<td>320</td>
<td>35</td>
</tr>
<tr>
<td>2013</td>
<td>330</td>
<td>35</td>
</tr>
</tbody>
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RISK CAPITAL REMAINS AT 83% OF GROSS PREMIUM

£bn

(1) Excludes reserve margin credit
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SUMMARY

► Solvency II implementation delayed - but it’s a “when” rather than an “if”
► Delay should not translate to “time to do more” but does give more time to complete what was already planned
► The principles of Solvency II reflect good risk management and business practice
► Phased transition to BAU beginning with those elements which add most value to Lloyd’s and agents
► No reversal – SCR models have worked for 2013 so we should continue to use going forward and impact on capital is minimal
► Year end attestation will apply so we have clear fixed point
► Consequences softened for those not meeting but feedback must be addressed to avoid penalties
► 2013 focus for Lloyd’s on development of standards and broader risk oversight
NEXT STEPS

► Slides will be made available on lloyds.com after both briefings
  – Webcast to follow
► Further detail will be issued on timetable and 2013 requirements in December
  – Agent feedback welcome ahead of finalisation in January
► Further sessions will be held in January
  – 16th – briefing on outcome of 2013 capital setting
  – 22nd & 25th – workshops on 2013 plan and development of standards