SOLVENCY II BRIEFINGS

29 & 30 November

AGENDA

- Introduction
- FSA Update
- Impact on market timetable
- Capital setting process
- Summary

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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

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DELAY REQUIRES MODIFIED APPROACH

- 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

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Solvency 2 – update from the FSA

Graeme Tennyson

Manager – Lloyd's Market Supervision

FSA – Prudential Business Unit

Contents

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

Internal model issues - Validation

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**

Internal model issues - Documentation

Findings

- 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 is 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?

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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...

YES (Green rated agents)	**NO** (Amber/Red rated agents)
✔ All areas meet principles of SII requirements *and* ✔ Lloyd's & FSA material feedback addressed by 31 December *and* ✔ Work outstanding is minor/developmental only *and* ✔ Project phase finished and most elements in use *(excl Pillar III)* *and* ✔ Credible operating model and structure established *and* ✔ SCR reviews demonstrate model is credible and robust *(ie SCR methodology was appropriate and any loading was down to a difference of opinion – eg on parameters)*	✘ 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 *(over and above Pillar III)* *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

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>
<tr><th>YES
(Green rated agents)</th><th>NO
(Amber/Red rated agents)</th></tr>
<tr><td colspan="2">SCR review actions have already addressed ICAS requirements</td></tr>
<tr><td>• Support agents in enhancing and embedding processes in operational mode
• Agent Status Reports not required
• Developmental feedback provided on all timetabled submissions
• Prudential measures would not apply</td><td>• Greater level of scrutiny and oversight
• Agent Status Reports required with regular and frequent interaction
• Additional resubmissions required to address feedback on top of timetabled deliverables
• Deadlines set for completion of work (Fines will be considered for lack of response to feedback)
• Prudential measures would only be applied at year end if Lloyd’s considers gaps mean that agent poses greater risk to CF</td></tr>
</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?

	JANUARY	FEBRUARY	MARCH	APRIL	MAY	JUNE	JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER
OVERALL		~~Self Assessment Scoring update (Voluntary)~~		~~Self Assessment Scoring @ end Q1~~			~~Self Assessment Scoring @ end Q2~~					
IMSCR Internal Model SCR							DRAFT SCR		FINAL SCR			
VBS Valuation and Balance Sheet			SII BAL SHEET @ 31/12/12			LIM ASSET DATA (DRY RUN) @31/12/12			SOLVENCY II BAL SHEET @ 30/6/13		LIM ASSET DATA @30/09/13	
TPSF Technical Provisions and Standard Formula	GQD RETURN			GQD RETURN TPD @ 31/12/11	ACTUARIAL FUNCTION REPORT		GQD RETURN ~~SF SCR Re-run @ 31/12/11~~		~~TPs @ 30/06/12 (unaudited)~~	GQD RETURN		
MV Model Validation						~~Data Audit Report~~	~~CAT risk template~~			VALIDATION REPORT ~~Cat documentation~~		~~Cat documentation~~
GRMU Governance Risk Management and Use			ORSA SUBMISSION				MODEL CHANGE SUBMISSION					
SREP Supervisory Reporting						~~Reporting Implementation Plan~~						
DFA Documentation and Final Application										~~Final Application Status sign off~~		

KEY

- Purple box: Apply Solvency II requirement in full
- Orange box: Apply Solvency II requirement on soft basis
- Red cross: 2012 Solvency II submission - not required in 2013

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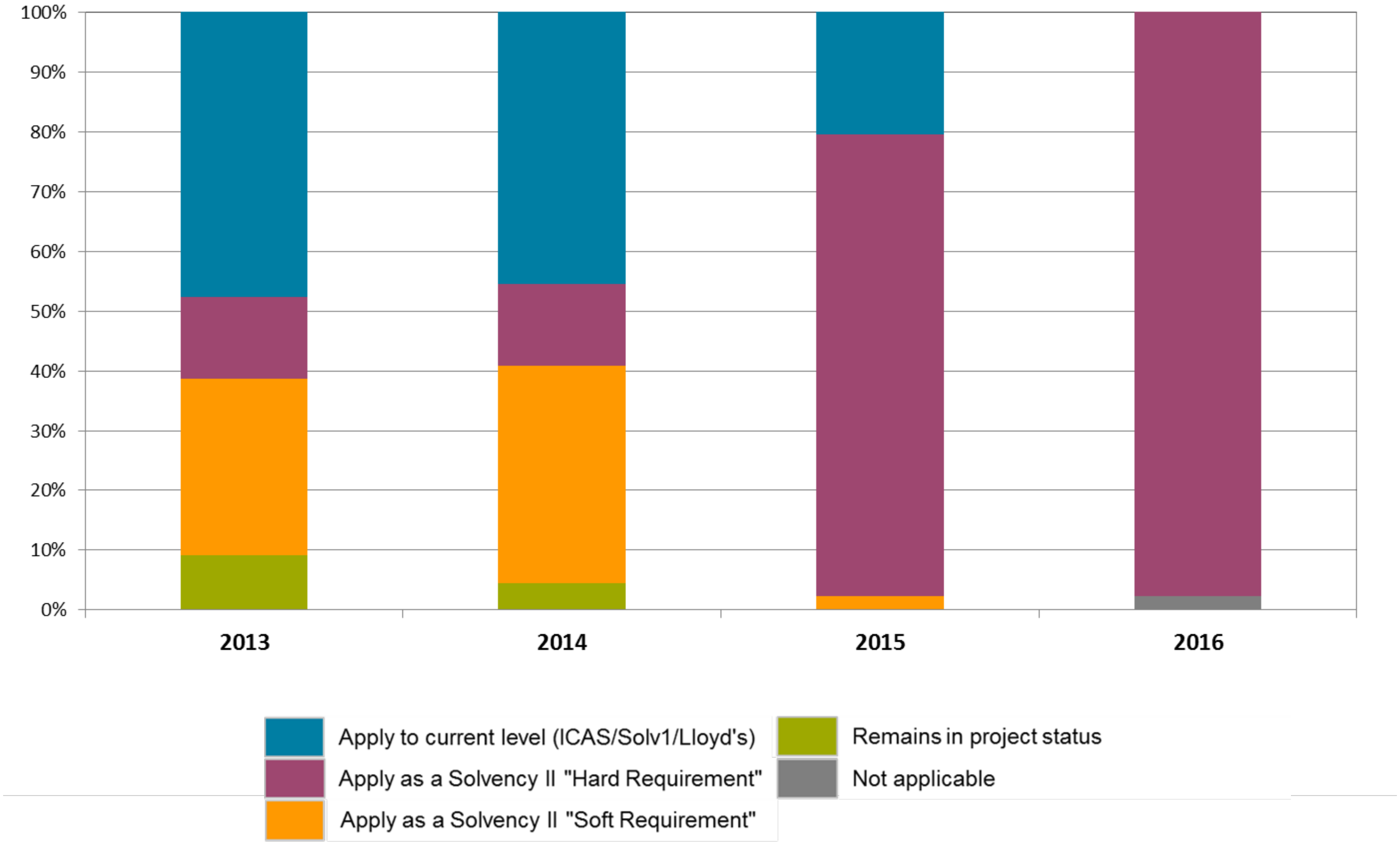
PROPOSED APPROACH TO SOLVENCY II PHASING – BY NUMBER OF DRY RUN SCORING ELEMENTS



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

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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

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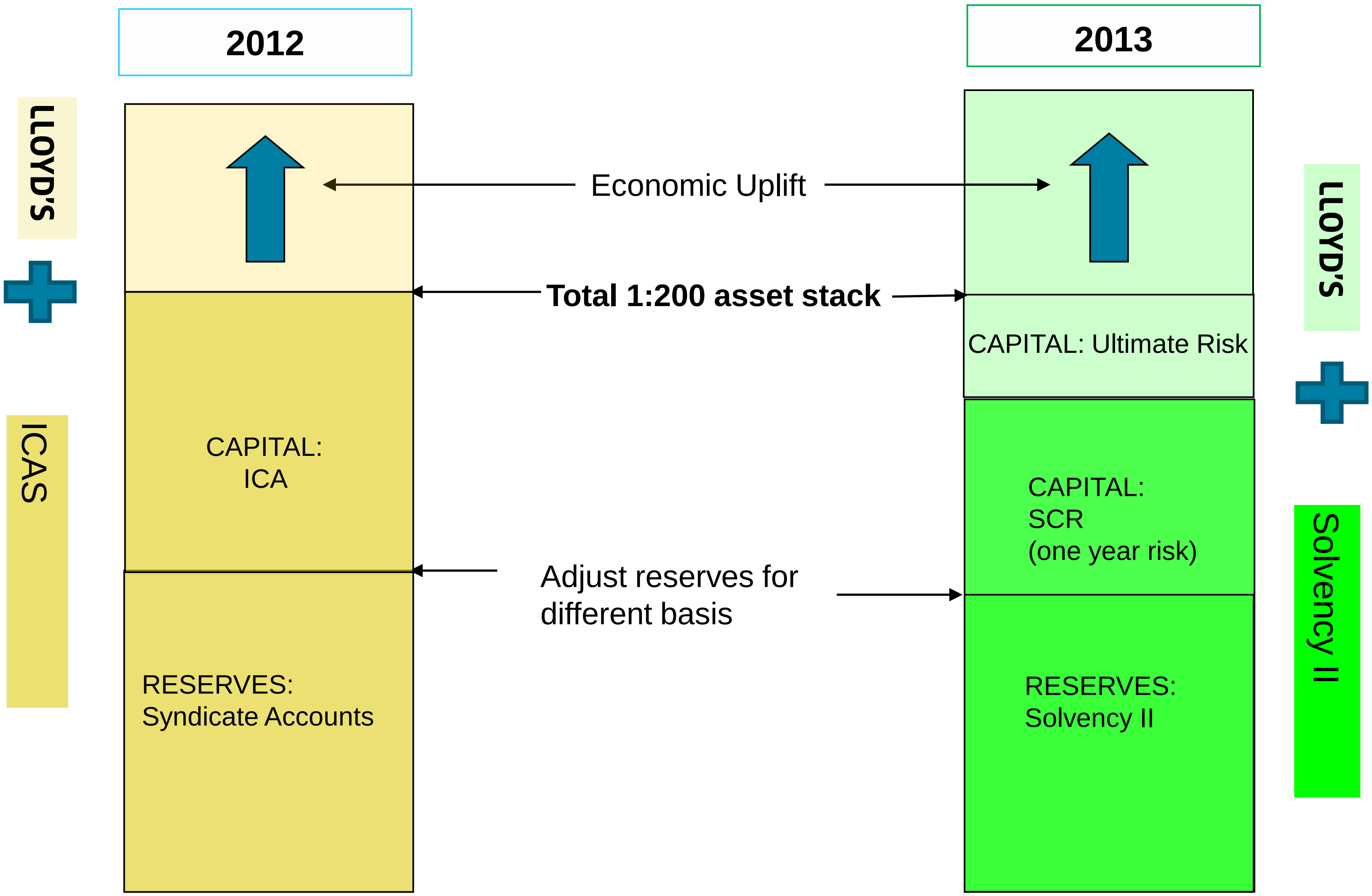
CASH FLOWS AND AGGREGATE RESOURCES ARE MATERIALLY UNCHANGED USING ULTIMATE BASIS



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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

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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

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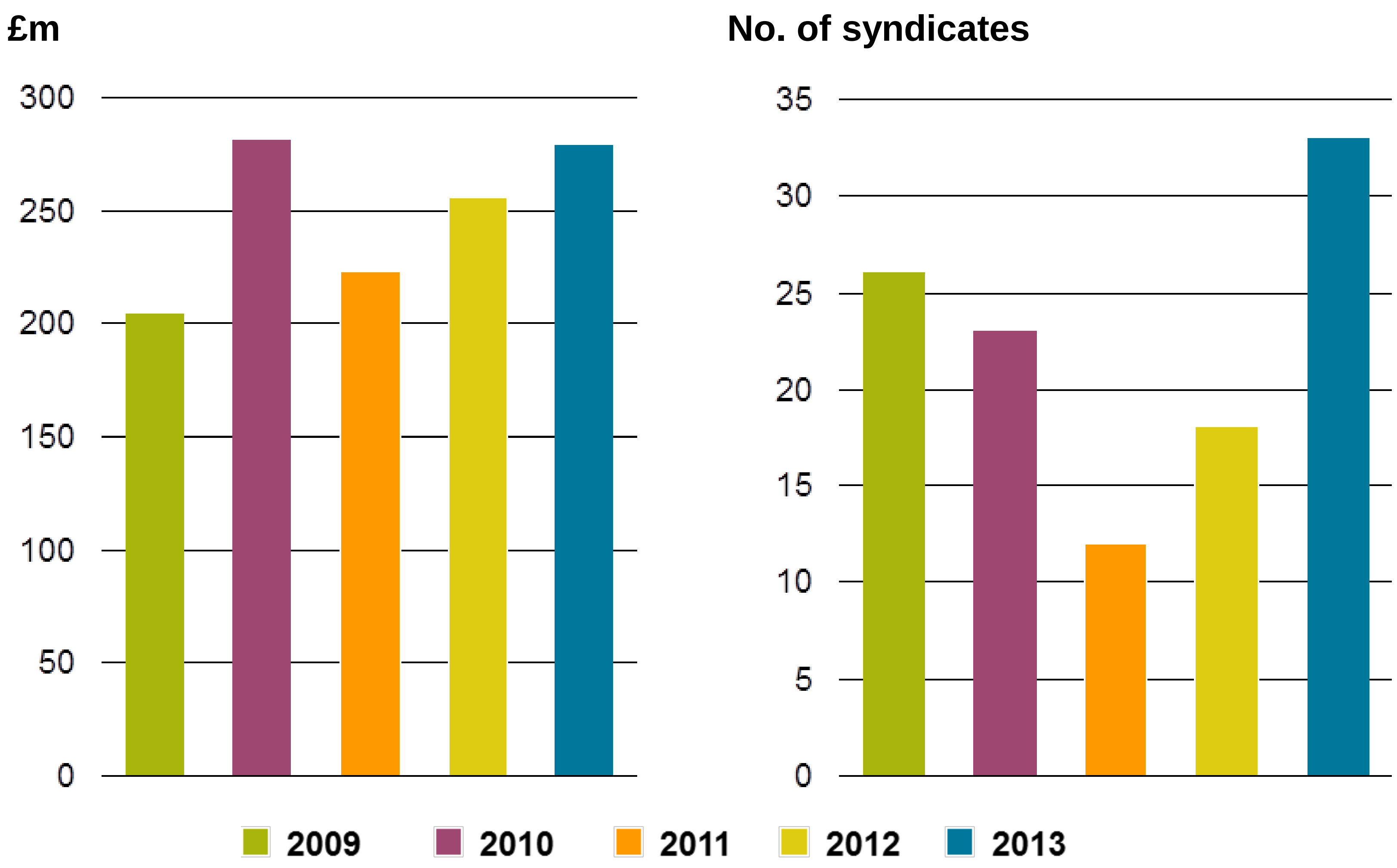
SIMILAR UPLIFTS TO RISK CAPITAL REQUIREMENTS AS PREVIOUS FULL REVIEW SEASON



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

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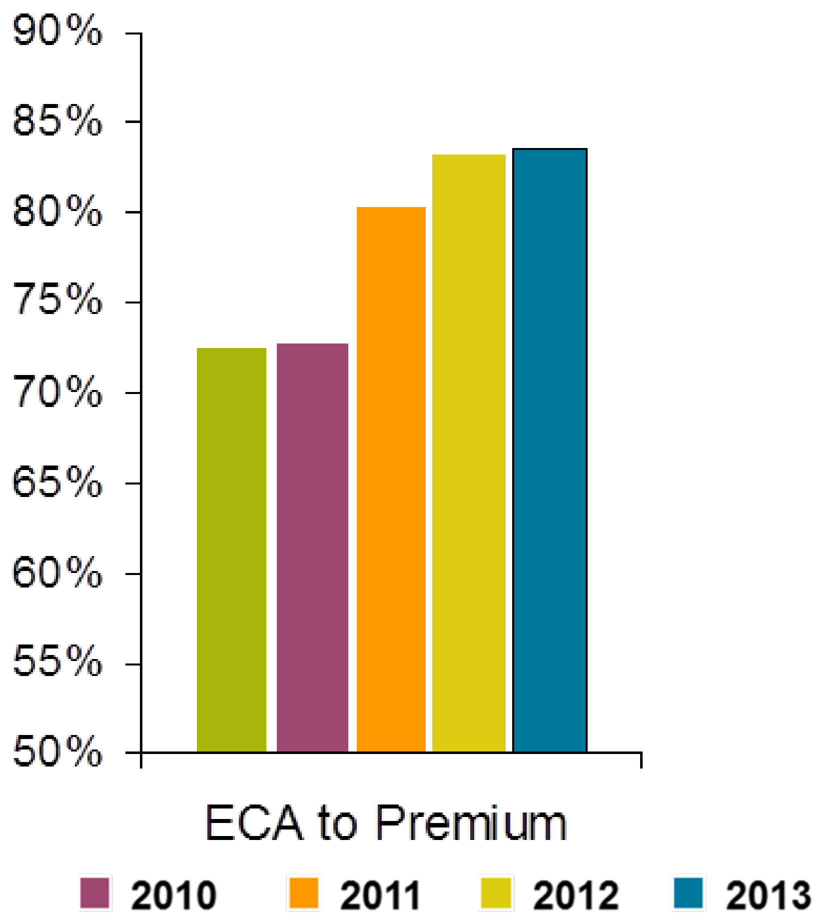
RISK CAPITAL REMAINS AT 83% OF GROSS PREMIUM

£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

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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

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