OLIVER WYMAN

SOLVENCY 2: PREPARE FOR IMPACT
KEY DEBATES

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Steven Zietsman

MARSH & McLENNAN COMPANIES

Agenda

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3. Solvency 2 key debates
   A. Liability measurement
   B. Asset allocation
   C. Timetable and process
   D. Equivalence requirements
   E. Clash of regimes

Solvency 2 is the updated set of regulatory requirements on capital adequacy and risk management for insurance firms that operate in the European Union

Solvency 2

Pillar 1 Quantitative requirements	Pillar 2 Supervisory activities	Pillar 3 Supervisory reporting and public disclosure
• **Minimum capital requirements (MCR)** determined in formula-based approach • **Solvency capital requirement (SCR)** to cover a one-year value loss at 99.5% confidence level • SCR determined using **standard approach** or **internal models**	• Identification of risks not captured by Pillar 1 • **Own Risk and Solvency Assessment (ORSA)** as key element – should cover risk identification, measurement, management and monitoring • **Supervisory review process** harmonising approach, tools and mandates of supervisory authorities in Europe	• Improve risk disclosure to the public and supervisory authorities • Transparency by allowing market participants to assess key information on the risk profile and risk management
Revaluation of insurers' balance sheet and capital requirements	**Changing behaviour and culture within organisation**	**Increased transparency and disclosure of insurers**

The impact of Solvency 2 on the insurance industry – Waiting for more certainty

Impact on insurance business models

Products and liabilities
- Gradual decline of traditional participating life
  - But spread adjustments and transition phase supports s/term
  - Volatility, low yields and low ROC bring pressure in l/term
- Increase in unit-linked and VA-type products
- Strong non-life insurers will see little impact on capital

ALM and risk management
- Hedging (incl. interest rate risk) to remove unrewarded risk
- More dynamic ALM – greater use of derivatives to manage downside risk and duration
- More reinsurance by weak insurers
- Need to invest in technical and human resources

Assets
- Increased use of swaps/derivatives to control int rate risk
- Appetite for credit, mortgages and covered bonds – dep. on risk charges
- Increased use of equity derivatives, with little increase in equity allocation
- Matching premium may encourage investment in certain illiquid assets (e.g. CRE lending)

Corporate and capital structure
- Introduction of leverage to capture difference in legal entity and group capital requirements
- Use of internal reinsurance as a further mechanisms to access diversification benefits
- Local regulatory requirements may trap capital and reduce fungibility between geographies

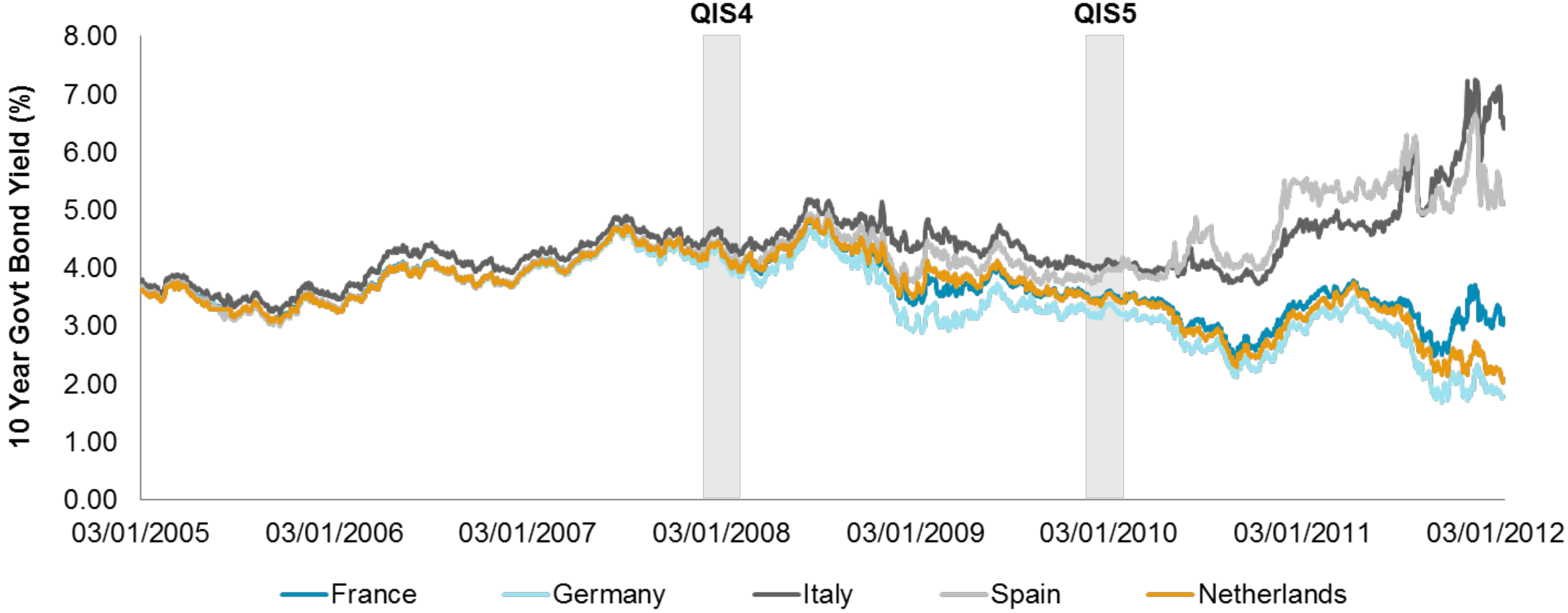
Capital markets
- Clash of regimes and market sensitive capital requirements: “Volatility squared”
- Increased cost of capital in the short term as companies adjust
- Orderly transition from existing hybrid capital instruments

M&A
- Selective increase in M&A
  - Desire to shift product mix away from traditional life
  - Drive for growth markets
  - But local regulatory capital traps limit diversification benefit

Reinsurance
- Relative winners given demand for capital from weaker players – mutuals, for example, may have limited access to other sources
- Greater recognition and use of reinsurance as a risk mitigation tool under Solvency 2

Why are the discount rates and capital requirements such a hot topic?

Yield on Government Bonds in core Solvency 2 markets
2005 to 2012



Source: Bloomberg, Morgan Stanley Research, Oliver Wyman

Lower yields in core markets and the rise of “government bond spreads” has created significant stress under current proposed framework

Liability measurement – the most crucial aspect of the S2 debate

Key debates

- Considerable uncertainty about the liability discount rate to be used under Solvency 2
- Proposed counter-cyclical premium is seen as unsuitable in its current form
- Specification of a matching premium is still uncertain
- The very low levels of bond yields are making the implementation of Solvency 2 more problematic for the industry than originally envisaged

Morgan Stanley/Oliver Wyman view

- Compromise on the discount rate – allowing the inclusion of spread adjustments and stabilisation of long-term discount rates under certain conditions
- No evidence of a desire by the politicians to create capital stress – expect there to be some element of "reverse engineering" in the ultimate calibration
- Counter-cyclical premium – expect a formulaic approach, removing its contingent nature
- Matching premium approach – expect it to be preserved or replaced with an economically similar combination of back-book grandfathering and an illiquidity premium on new business
- Use of extrapolation method for discount curves to help stabilise long-duration liabilities where fixed-income markets are not sufficiently deep and liquid

Asset allocation – still uncertain, but change is likely depending on appetite for risk

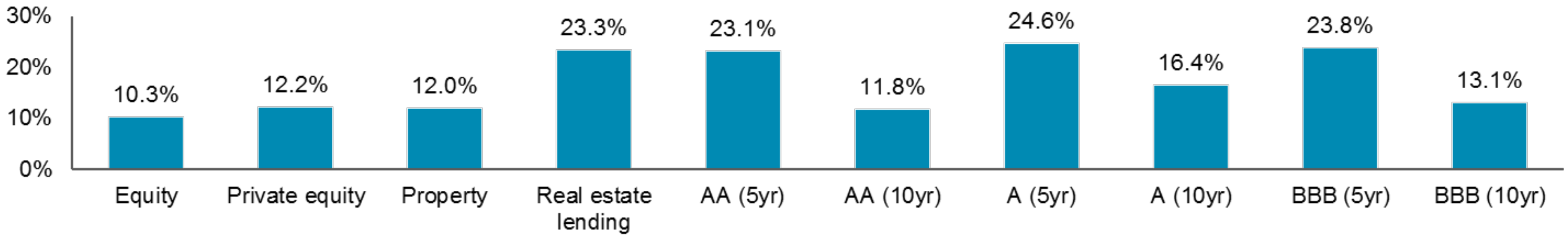
Key debates

- What impact will the increased sensitivity of insurers' balance sheets have on their strategies?
- How will insurers look to manage market risk in the new environment and what impact will this have on investments and asset allocations?
- When will insurers decide and implement their new investment strategies, and what impact will this have on markets?

Morgan Stanley/Oliver Wyman view

- Asset allocations will remain differentiated across different types of business but stronger focus on managing the volatility and optimising risk with return
- De-risking of traditional business will continue
- Annuity businesses under matching premium rules will invest further in illiquid funding to provide returns for shareholders and support annuity pricing
- Currently, short-duration, high quality credit and real estate lending look relatively attractive assets under Solvency 2, while equities and direct real estate appear less attractive

Estimate of the likely relative attractiveness of different asset classes under the current draft Solvency 2 rules



Source: Morgan Stanley Research, Oliver Wyman

Note: For credit, focus on credit spread capital. Interest rate risk and asset / liability duration mismatch capital requirements are not considered nor do we consider the effect of 'Symmetric Adjustment Mechanism' for both equities and spreads.

Timetable and process – delayed, but still happening

Key debates

- Solvency 2 has been delayed, at one point some even questioned whether it would actually come into force
- Although it is clear the original October 31, 2012 deadline is not possible, the "realistic" implementation date is not clear
- The delay has resulted in many different aspects of Solvency 2 being re-opened for debate

Morgan Stanley/Oliver Wyman view

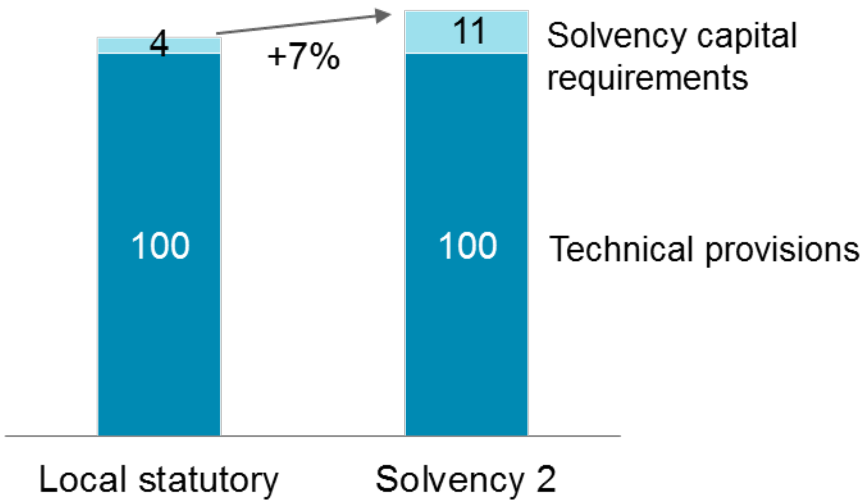
- We believe Solvency 2 will be introduced, but most likely not until January 1, 2014 or even later
- The next key date is likely to be the European Parliament plenary session vote on July 2, 2012
- Solvency 2 is likely to be less uniform than originally hoped
- We expect to see use of grandfathering and some inconsistent implementation between member states

Solvency 2 equivalence requirements could be problematic

Key debates

- Will Solvency 2 apply, for instance, to the US business of EU insurers, and place them at a competitive disadvantage in key markets?

Example: Capital requirements for US fixed annuities could more than double under Solvency 2



Source: Morgan Stanley Research, Oliver Wyman

Morgan Stanley/Oliver Wyman view

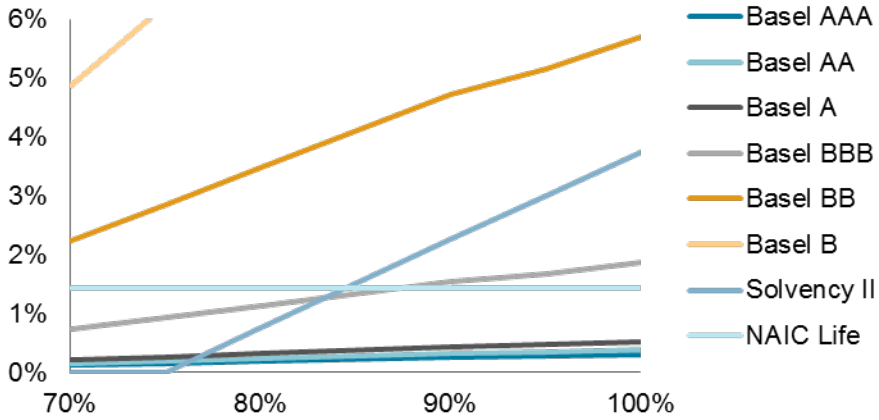
- From a political perspective it seems reasonable to assume the European Commission would have no desire to put European insurers at a competitive disadvantage relative to international peers
- The US market is problematic given the clear shortfall of the existing regime relative to an “economic” capital framework with consolidated group supervision; however, we anticipate some form of waiver or deemed equivalence – albeit on a temporary basis
- Regardless of the ultimate decision, preparing for Solvency 2 has better informed European insurers of the relative attractiveness of US product types, and we expect continued reshaping of product portfolios away from traditional spread contracts
- We note that several European insurers – Allianz, Aviva and AXA, for example – prudently assume non-equivalence for US subsidiaries in reported economic solvency ratios. Any relaxation in the rules would therefore boost existing capital metrics

Clash of regimes: Solvency 2 in a broader regulatory context

Key debates

- How does Solvency 2 interact with other regulatory and accounting developments worldwide?
- What other regulatory change should be expected to flow from the recent crises?
- Are we going to see a global Solvency 2 applied consistently someday (analogous to banking's "Basel")?

Example: Capital requirements for residential mortgages



Notes: Source: International Institute of Finance (IIF), Morgan Stanley Research, Oliver Wyman

Morgan Stanley/Oliver Wyman view

- Constant delays and rising complexity mean that the EU's Solvency 2 project is less likely to become a de facto global standard, in our view
- We expect one of the most significant clashes to be with IFRS 4 Phase 2 – which is unlikely to converge with the approach taken by Solvency 2, in particular for liability valuation
- We argue the market is under-estimating the risk that certain EU insurers become classed as "SIFIs" – however, the financial consequences of this (if any) are not yet clear
- We see inconsistencies between Solvency 2 and the new banking frameworks: for example, in terms of the capital consequences of owning certain assets; we expect this to drive regulatory capital arbitrage

Implications for Investor Relations

Insurance business models

Products and liabilities
- Change in product landscape over time
- Relative winners and losers

ALM and risk management
- Focus on risk appetite
- Increased scrutiny of risk positions
- More frequent and detailed market communication

Assets
- Increased balance sheet volatility due to assets held
- Insurer returns depending on investment markets?

Corporate and capital structure
- Local regulatory requirements may trap capital and reduce fungibility between geographies
- Changes in group structures to access diversificat6ion

Capital markets
- Market sensitive capital requirements
- Increased cost of capital in the short term

M&A
- Selective increase in M&A
- Relative positioning of company and competitors

Reinsurance
- Greater recognition and use of reinsurance
- Implications on balance sheet and result volatility

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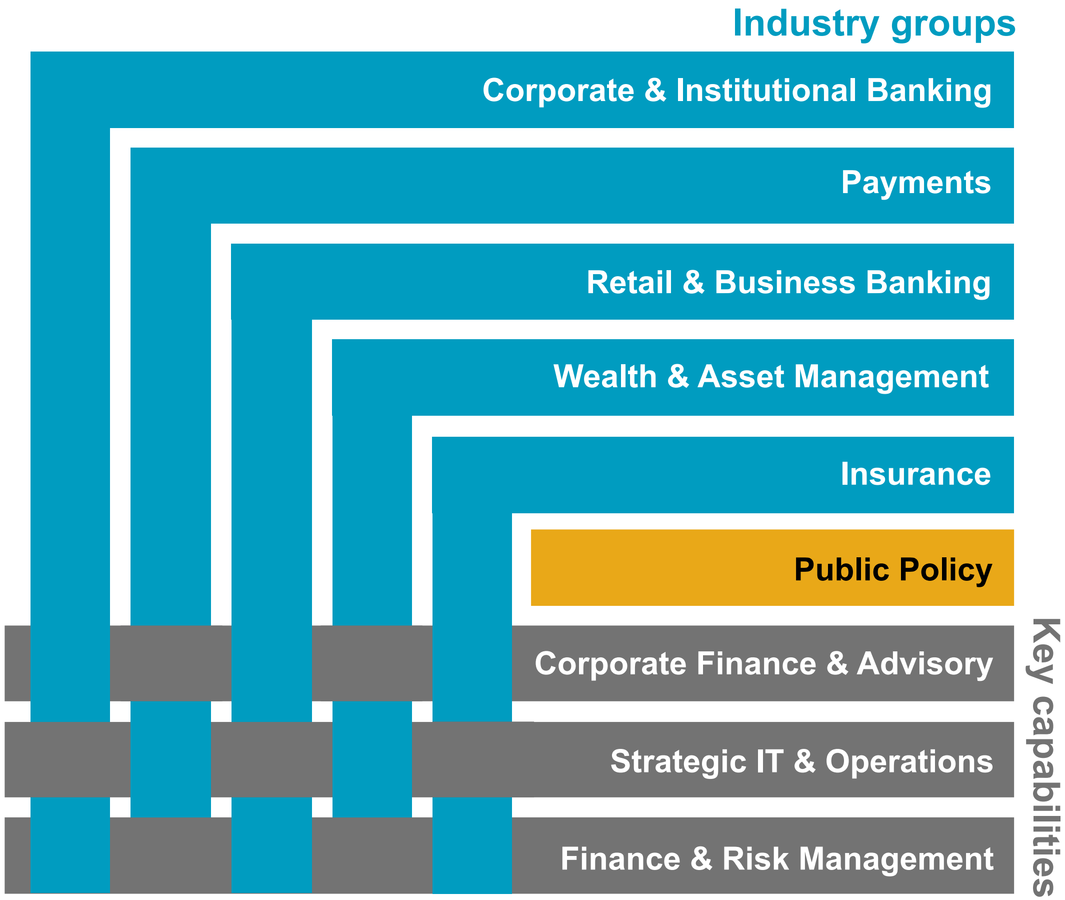

- Oliver Wyman's Financial Services unit is an international management consulting firm with over 1,100 professionals dedicated to the financial services industry in 30 offices across 20 countries
- We have an unparalleled understanding of the market structure, economics, and possible future development of all segments of the financial services industry
- Last year we executed over 1,300 projects globally
- 90% of our business is from repeat clients, who include
  - Over 75 of the top 100 global financial institutions
  - A wide range of leading banks, insurers, asset managers and payments companies across the globe
  - Regulatory and government agencies
  - Top private equity firms

QUALIFICATIONS, ASSUMPTIONS AND LIMITING CONDITIONS