SAM focus

Understanding the developments in QIS2 for Life Insurers

The recently issued second Quantitative Impact Study ("QIS 2") represents an important step towards the development of SAM Pillar 1

Life insurers have the opportunity to provide quantitative and qualitative input on some topical issues which have surfaced in previous QIS exercises in both South Africa and Europe.

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Alternatives tested

1. Many of the changes to the technical specification employed by QIS 2 represent testing of alternative approaches to the QIS 1 specifications. Insurers should take care not to assume that all of the proposals in QIS 2 would in all cases be the next step in the development of technical specifications. In a number of instances, the methodology would be tested to ensure that the preferred approach is sufficiently rigorous. The debate around which approach is preferred is captured in discussion documents and position papers and insurers should use the opportunity to comment on these as they become available.

Contract Boundaries

2. A significant change from QIS 1 is the treatment of contract boundaries for insurance contracts.
3. The approach tested will in general result in longer contract boundaries, with the greatest impact expected for investment contracts.
4. The impact will be notable in the calculation of best estimate liabilities (expected to be lower), the risk margin (expected to be higher) as well as the SCR (expect to be higher). It would be important for insurers to understand the relative impacts on eligible own funds and the components of the capital requirements. Strategies aimed at reducing the capital requirement will be impacted by changes to contract boundaries.
5. Particular care is required when making assumptions about the ability to re-price products and reinsurance contracts.

Loss absorbing capacity

6. QIS 2 still uses the modular approach to aggregate the SCR modules and sub-modules.
7. While this still introduces possible double-counting of loss-absorbing capacity as losses are absorbed in multiple modules, the approach of calculating risk charges gross of the loss-absorbing capacity of technical provisions has been done away with. An adjustment to prevent double counting has therefore been introduced in the market risk module.
8. Insurers now have the option to allow the risk margin to fluctuate when shocks are performed to the extent that the risk margin is impacted. This may have a material impact on results and it would be worthwhile to assess a number of approaches to the calculation of the risk margin in both the base case and stressed scenarios.
9. The loss absorbing capacity of deferred taxes now uses simplified assumptions with the aim of introducing a more consistent treatment across insurers.

Counterparty and credit risk

10. The treatment of assets sensitive to changes in credit rating has seen the counterparty default module absorbed in the credit and counterparty risk module.
11. In addition, insurers are requested to distinguish between liquid and illiquid instruments. This change may alleviate some of the data requirements on insurers

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as the application of stress relating to illiquid assets requires fewer data items.

12. The default risk associated with risk mitigating contracts is stressed in the module on which the risk mitigating contract would have an effect.

Policyholder behaviour

13. There are a number of changes that attempt to address policyholder behaviour. The most notable of these are where lapse rates are increased following market shocks. Insurers should assess both the practicability and suitability of this approach.

Group Submissions

14. One of the new additions to the QIS is the additional submission required for insurance groups (groups).

15. In QIS 2 the scope of a group should be determined in accordance with IFRS consolidation principles as the starting point and include considering the extent of participation of one entity in another. This participation is driven by economic interest as well as the degree of influence exhibited and entities that are operationally important for the group.

16. An interesting consideration is the slightly different definition of a group adopted by the Interim Measures, which are expected to be effective in 2013. Under these measures, an Insurance Group is categorised into a number of categories, being either a Solo Plus, Pure Insurance Group or Financial Conglomerate with the latter two requiring a non-operating holding company (NOHC). The interim measurers require consolidation according to the Deduction and Aggregation method.

17. The submissions under QIS 2 test consolidation under both the Accounting Consolidation and Deduction and Aggregation methods, with additional submissions required for groups with participations outside of South Africa as well where an internal model is available.

18. The Accounting Consolidation and Deduction and Aggregation methods are polar opposites in their allowance of intra-group diversification, with the Accounting Consolidation method allowing for a favourable treatment between insurance subsidiaries. The Deduction and Aggregation method derives the consolidated Solvency Capital Requirement ("SCR") as a function of the Solo entities' SCR's, therefore deflecting any diversification benefit. Indications from Solvency II QIS 4 suggest that the intra-group diversification could create a release of up to 21% in the group SCR.

19. A noteworthy complication presented by the group submission requirement is the treatment/adjustment of intra-group transactions. The principles adopted by Solvency II and which also feature in the QIS 2 specifications are to eliminate the potential for internal creation of capital and double counting of capital charges for the same risk.

20. Internal creation of capital, or double gearing, arises as a consequence of the economic participation between two entities in the same group being counted as own funds for both entities. This would not be realistic under a shock event and therefore an adjustment is necessary to the appropriate scales. Under QIS 2, this takes the form of removing the value of the participation and any associated capital charges from the participating undertaking.

21. Double counting of capital charges captures the majority of intra-group transactions such as loans and risk mitigation agreements. These transactions must

be largely eliminated from both sides of the equation although under QIS 2 the requirement is made simpler, albeit probably temporary, by not being required to adjust for intra-group reinsurance.

Ring Fenced Funds

22. QIS 2 introduces two required alternative assessments of Ring Fenced Funds (RFFs) in addition to the base case to assess the impact of possible ring-fencing arrangements.

23. Included in the scope of these assessments are all *operationally* ring fenced structures reflecting practical and contractual, rather than purely legal, restrictions and barriers to using funds in one structure to absorb losses elsewhere. Importantly, this assessment is made on a going concern basis.

24. Insurers with discretionary participating feature contracts (DPF) are the most likely to be impacted, but insurers would need to consider other limitations which may have the effect of ring-fencing.

25. For both alternatives, own funds will be ring-fenced to only meet losses within the RFF. The rules used to aggregate eligible own funds at an entity level reflect this.

26. The first approach only allows for the diversification of capital requirements within each RFF, whereas the second approach allows for diversification between each RFF's capital requirements as well the capital requirements outside of any RFF. A limit is, however, applied to this diversification benefit.

What you need to do?

27. Consider the relationship between contract boundaries, how risk is passed on to policyholders and subsequent policyholder behaviour. The current specification, although it may not be the final SAM proposals, allows room for companies to develop their own assumptions around many of these aspects and it is important that they are implemented consistently.

28. Assess how contract boundary assumptions will impact risk management strategies, e.g. whether it would be sensible to reduce market risk on own funds, but thereby increase insurance risk.

29. Assess how the treatment of liquid and illiquid assets will impact the credit and counterparty default risk component.

30. In performing group submissions, consider the imminent Interim Measure requirements and how to avoid duplication of work.

If you wish to discuss how we can help you, please call your regular contact or alternatively:

Jac Niemand
jac.niemand@za.pwc.com
021 529 2462

Christiaan Nel
christiaan.nel@za.pwc.com
021 529 2519

Francois Kruger
francois.kruger@za.pwc.com
011 797 4717

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