

Solvency II – view from an executive sponsor HSBC Insurance UK



Recent headlines

- **Some non-life insurers may have to recapitalise or reshape their business in order to survive**
- **Six Danish life insurers and pension funds fail Solvency II test**
- **Insurance industry urges Commission to correct Solvency II implementing measures**
- **Insurers warn of 'dire' outcome under Solvency II**
- **'pension funds should not underestimate the threat posed by Solvency II'**
- **Insurers under pressure from SII timeline**
- **Lloyds: increasing concerns over the cost and complexity of the exercise. "We must make sure this one piece of regulation doesn't do lasting damage to our international competitiveness"**

- **European Bank Funding Threatened as Basel III Meets Solvency II**
- **Pension funds should not underestimate the threat posed by Solvency II**
- **Eiopa: Internal models beneficial under Solvency II**
- **Insurers, the biggest buyers of debt, are being dissuaded from buying long-term bonds under Solvency II**
- **Solvency II: Complex engineering task creates 'skills crunch' Financial Times**
- **Small and mid-size firms, the most vulnerable to Solvency II's heightened capital requirements, may consider diversification and divestiture**
- **Around of third of insurers believe that their own investors do not understand their risk appetite**
- **ABI warns Solvency II schedule 'on a knife edge'**

Today's discussion

- Where have we come from?
- Where are we now?
- Where are we heading?

HSBC Insurance

- Top 10 global insurer
- The Wealth industry
- HSBC Insurance UK
- Solvency II as an opportunity to lead



Where have we come from?

- *Gap analysis*
 - *Team formation*
 - *Review of regulations*

2009

- *Overview design*
 - *Planning and budget*
 - *QIS 5*

2010

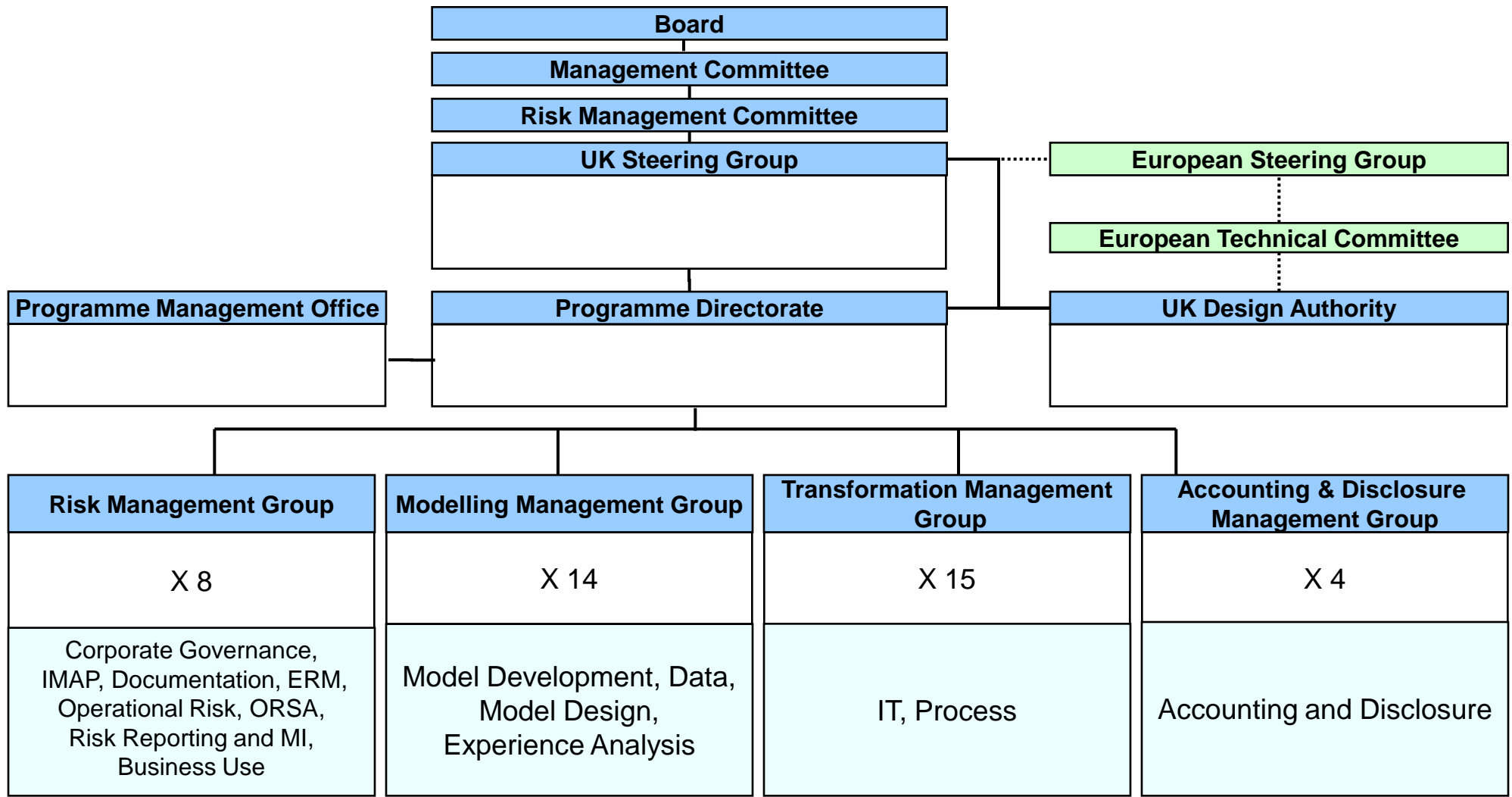
- *PAQC*
 - *FSA engagement*
- *FSA self assessment*
 - *Build*

UK perspective

2011



Programme Governance v16 – for an extremely complex project!



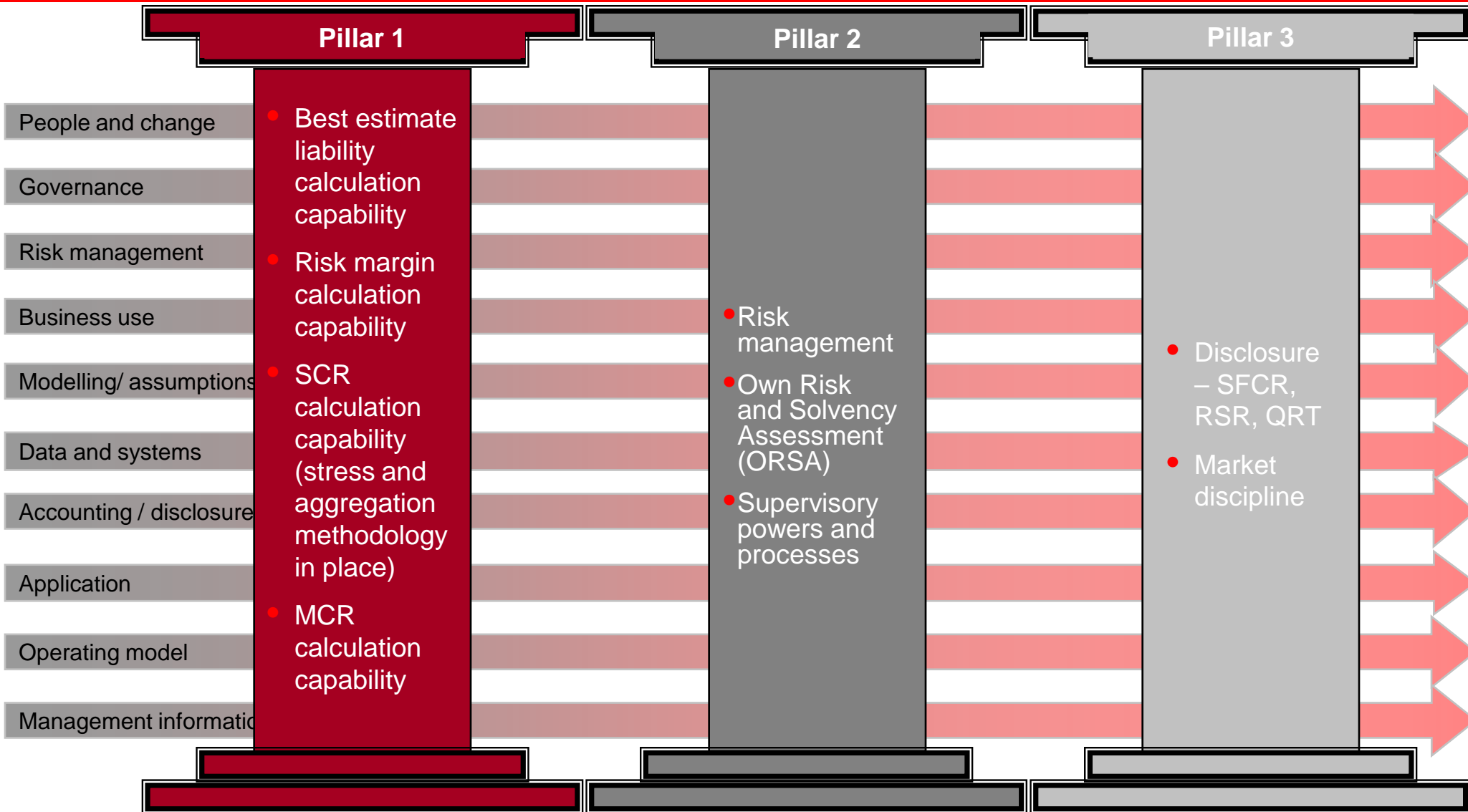
Workstreams need work packages and ownership

Work stream		Work package	Nominated owner
0	Programme management		
1	People and change	Programme communication	
		Stakeholder education	
2	Governance	ORSA	
		Governance arrangements	
		Internal control	
		Internal audit	
		Supervisory review process	
3	Risk management	Risk management framework	
		Risk appetite	
		Risk policies	
		Risk reporting	
4	Business use	Risk management	
		Scenario testing	
		Capital and solvency	
5	Management information	Risk reporting	
		Scenario testing	
		Capital and solvency reporting	
6	Modelling and assumptions	Operational risk	
		Capital and solvency standards	
		Regulatory capital and solvency	
		Capital and solvency forecasting	
		Scenario testing	
7	Data and systems	Capital and liquidity plan	
		Data quality standards	
8	Accounting and disclosure	QRT	
		SFCR/RSR	
9	Operating model	Required functions	
		Governance arrangements	
10	Application		

Finance ownership

Risk ownership

Solvency II framework



Pillar 1 governance



Risk ownership

Finance ownership

Technical provisions calculation

- Best estimate liabilities owned by Finance
- Risk margin owned by Finance

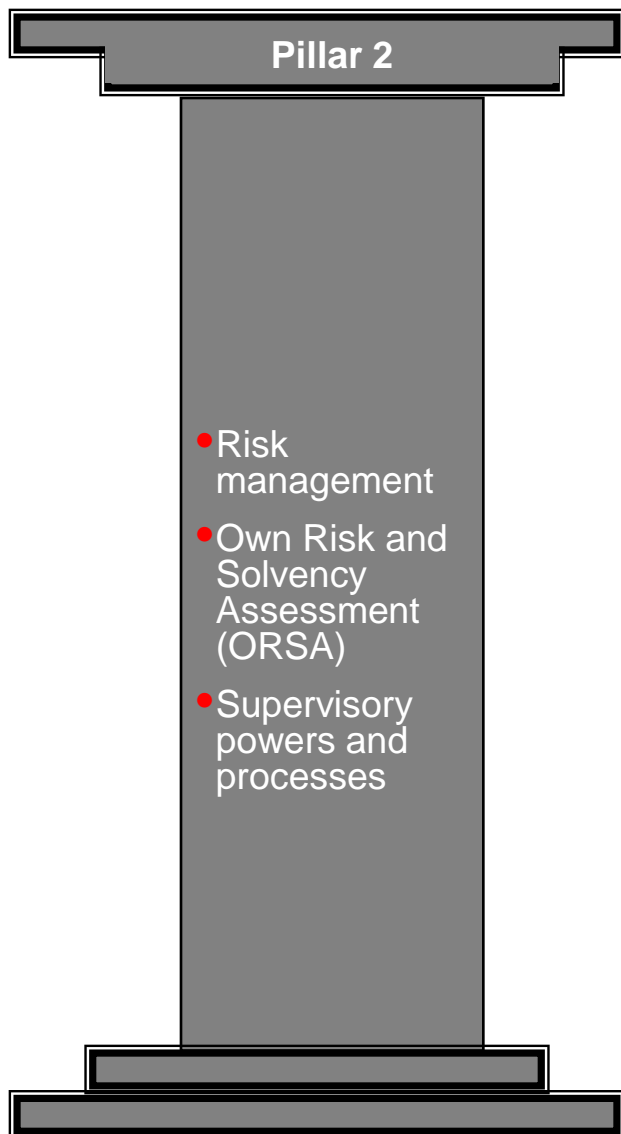
SCR calculation

- Market risk SCR owned by Finance
- Operational risk SCR owned by Risk
- Insurance risk SCR owned by Finance
- Counterparty risk SCR owned by Finance

Internal model tests

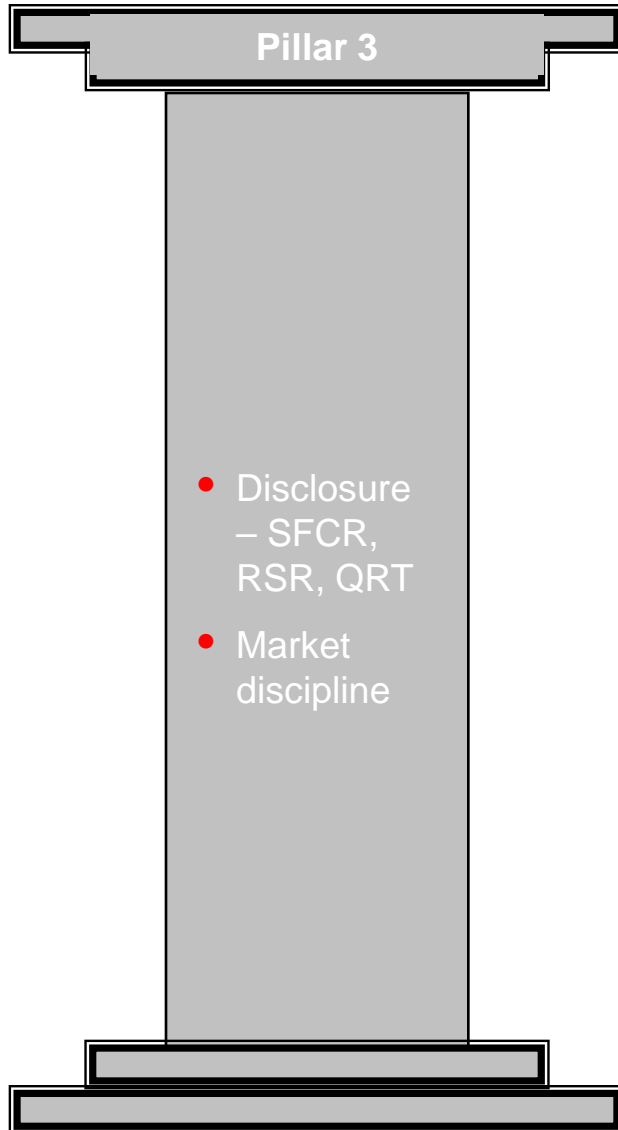
- Use test owned by Risk
- Statistical Quality standards owned by Finance
- Calibration standards owned by Finance
- Validation standards owned by Finance
- Documentation standards owned by Risk and Finance
- Profit & Loss Attribution standards owned by Finance

Pillar 2 governance



	Risk ownership	Finance ownership
Risk Management Review	ORSA process	Business Context
The executive summary and an overview of how the firm's risk and capital management activities are fully integrated into the management process and operations	This sets the scene for the ORSA document, giving the reader an understanding of the process and controls for the ORSA document	An overview of what the company offers customers, the risks it faces and how it is structured corporately
Governance	Risk Management Framework	Risk Management Process
A description of the corporate system of governance	A description of the risk management framework, including the risk appetite, and the risk identification, assessment, reporting and monitoring process.	This sets out the results of the risk management framework
Capital and solvency Framework	Capital and Solvency Position	Capital and Solvency Forecast
A description of the capital and solvency framework (e.g. methodology, assumptions) and additional requirements for internal model approval (links between Pillar 1 and Pillar 2)	This sets out the results of the point in time capital and solvency calculation on an RBC and regulatory basis and provides a reconciliation between the two	This section sets out the results of the capital and solvency forecast calculation on both a RBC and regulatory basis
Scenario Tests	Capital and liquidity plan	ORSA position over the period
A description of the scenario test framework and sets out the results of the stress tests and scenarios produced	A description of the capital and liquidity plans and evidencing the link between the risk management framework, the capital and solvency framework and their use in the business	This shows how the operation of the overall risk regime is ongoing during the 'gaps' between ORSA production.

Pillar 3 governance



Risk ownership

Finance ownership

Solvency & Financial Condition Report

- Publicly disclosed narrative reporting
- Owned by Finance

Regular Supervisory Report

- Narrative reporting to the supervisor
- Owned by Finance

Quantitative Reporting Templates

- Quantitative reporting forms to the regulator
- Owned by Finance

Key Issues – 6 months ago

- How to obtain, keep and motivate Resources
- How much Planning vs Delivery?
- How to define the Internal Model?
- How do you determine a Risk Appetite?
- What will the Final Regulations be?



Where are we now?

HSBC **Insurance**

HSBC 
The world's local bank

Key Issues – now

- How to obtain resources in a tight market?
- How to obtain time from the Board?
- Dealing with FSA pressures
- Making it real – the Use Test



Solvency II Key decisions

In 2009

(Partial) Internal Model

VS.

Standard Formula

- **Lower capital requirement**
- **FSA preference**
- **IMAP achievable**
- **Improved risk management**
- **Prestige**
- **Professional pride**
- **Competitors all adopting**

- **Simplistic**
- **No real risk insight**
- **Almost as much work**
- **Inadequate for long term**


Solvency II Key decisions

In 2011


(Partial) Internal Model

VS.

Standard Formula

- 
- Same capital requirement?
 - FSA less enthusiastic
 - IMAP very demanding
 - Improved risk management
 - Prestige
 - Professional pride
 - Competitors **not** all adopting

BENEFITS DOWN

- 
- Adequate for most purposes
 - Similar risk insight
 - Fewer demands from Regulator
 - More time for implementation

ATTRACTIONS UP

People issues:

- Finding resources
- Forming a team: the mix
- Achieving delivery
- Working together
- Getting a vision
- Motivating contractors

Politics

- Managing expectations
- Obtaining budget
- Everyone has a view
- Managing crises
- Personal goals / ambitions
- Managing from a distance

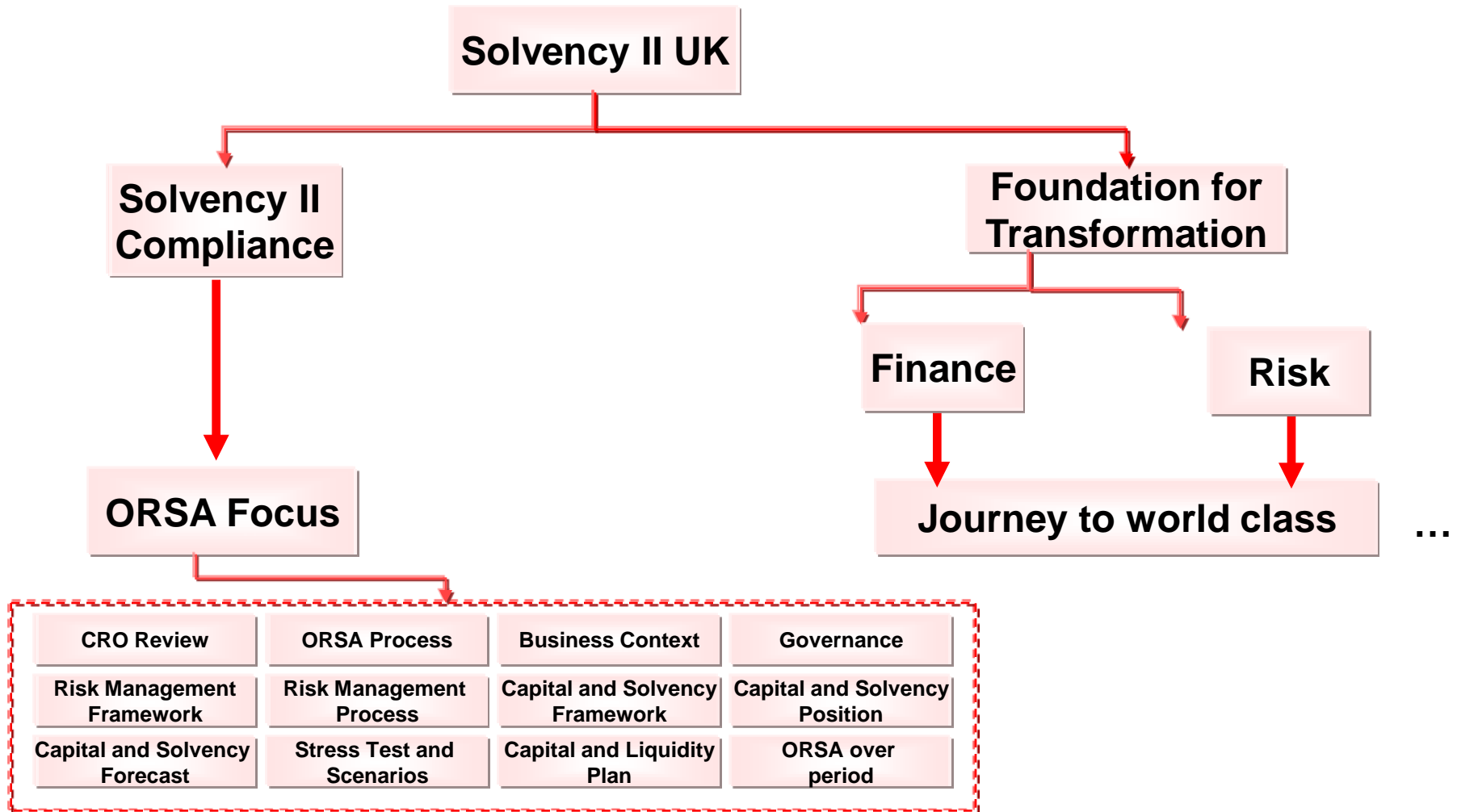
No complete answer, but leadership and communications make a difference

Vision Statement

The UK Programme will

- ▶ Securely achieve the high standards demanded by **Solvency II Compliance**, covering:
 - ▶ Demonstrating adequate financial resources (Pillar 1)
 - ▶ Risk Management Framework (Pillar 2)
 - ▶ Reporting and disclosure (Pillar 3)
- ▶ As a result, change the way the HSBC Insurance (UK) manages its business by **enhancing business decision making**, ensuring decisions are made with a better understanding of risk, capital and profitability.
- ▶ Provide a **Foundation for Transformation** of HSBC Insurance (UK) acting as a catalyst for the journey towards a world-class Risk and Financial management capability.

Vision Drill down

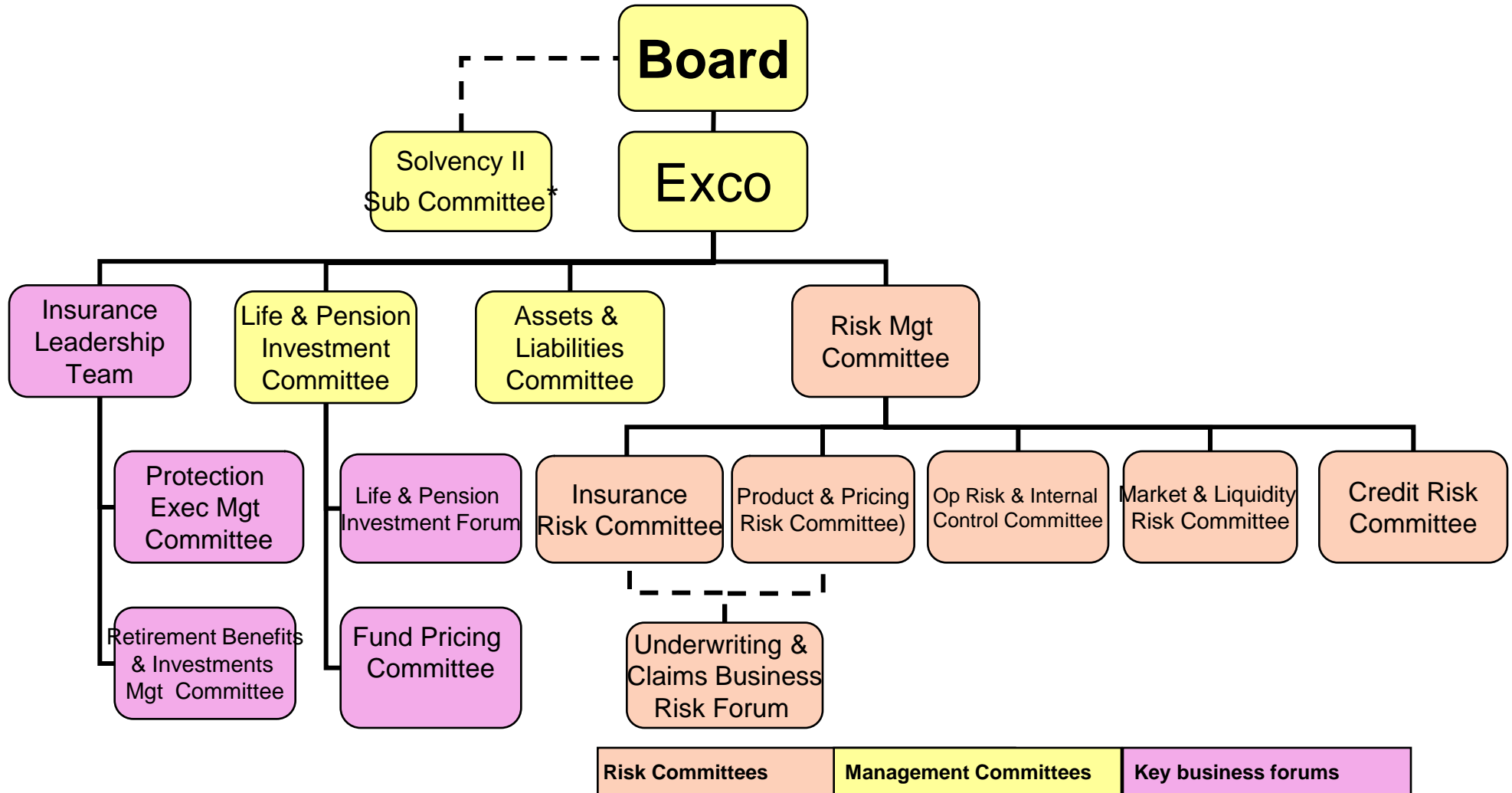


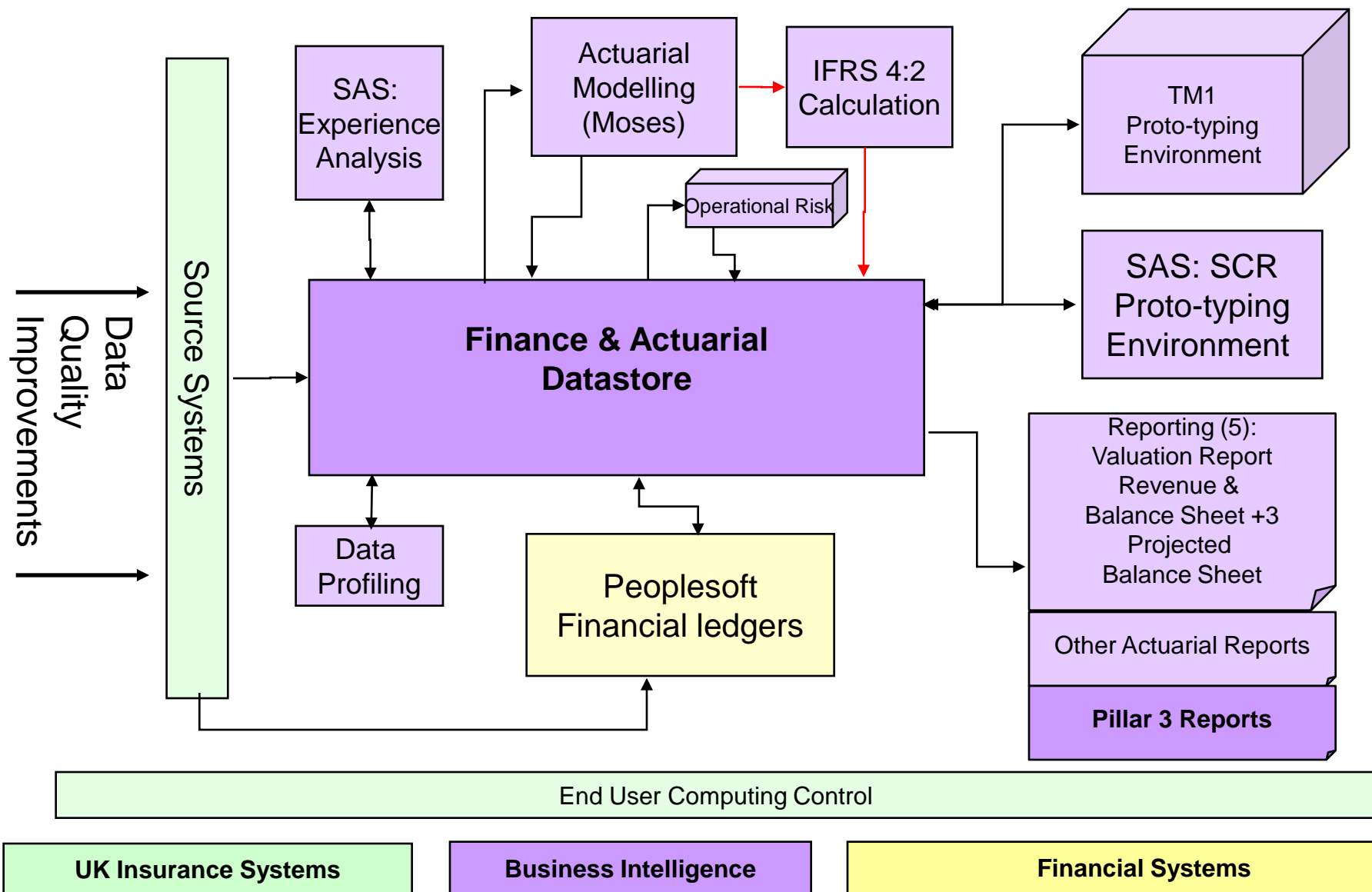
Where are we heading?

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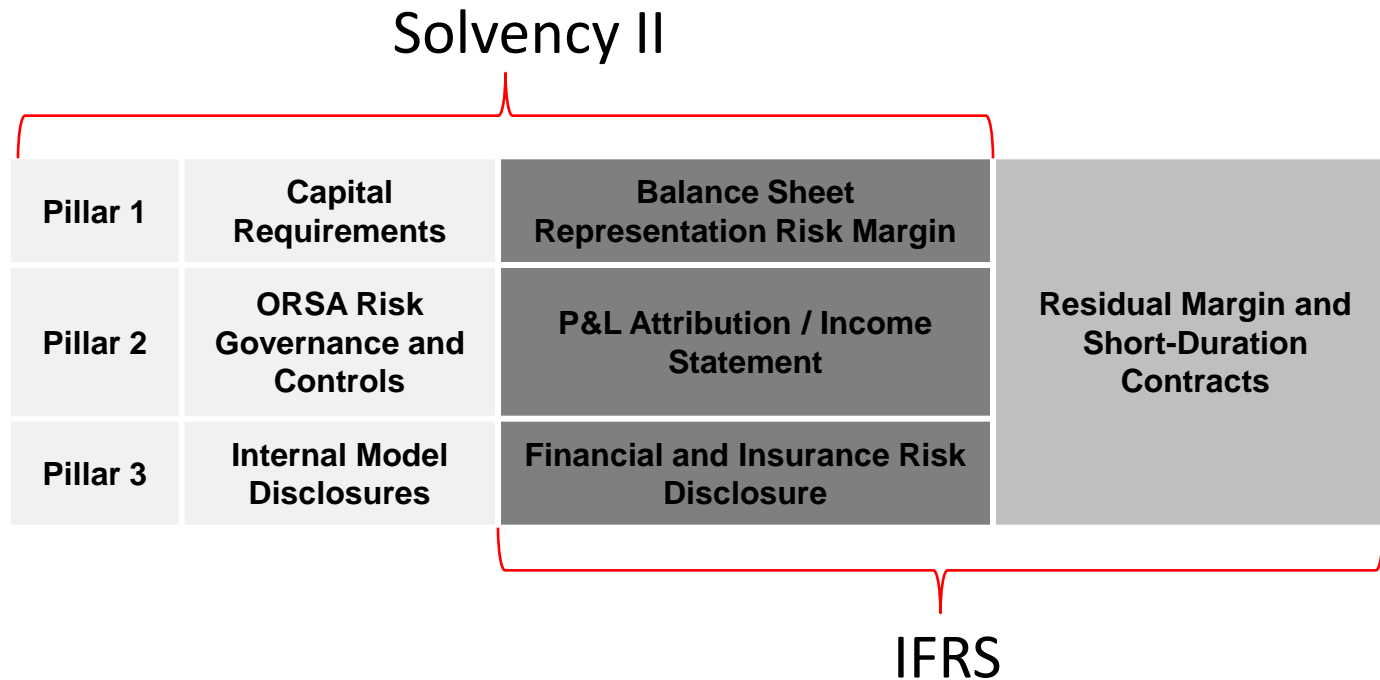
Governance Structure – more risk committees





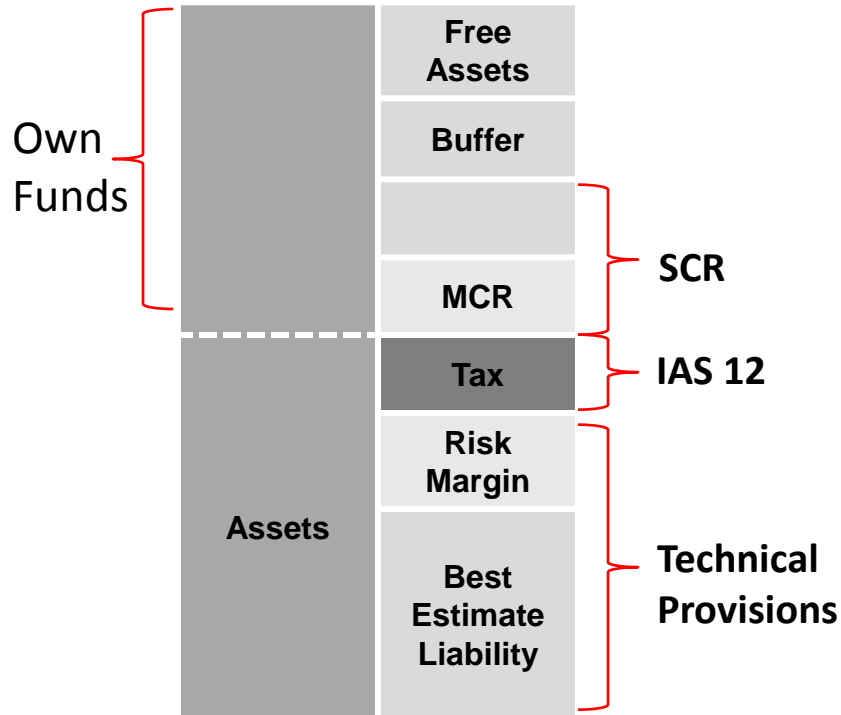
Developing for IFRS 4 Phase II with Solvency II

Solvency II and IFRS similarities and differences

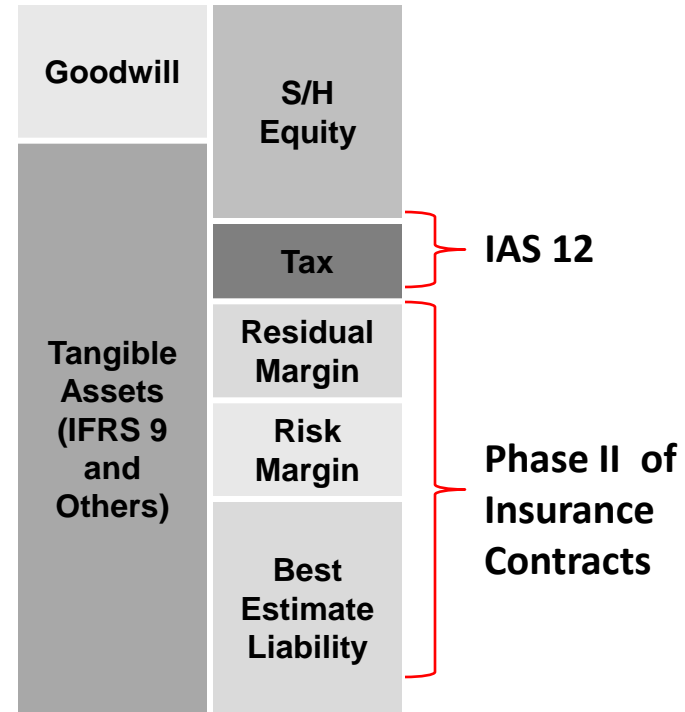


Solvency II and IFRS outputs needed

Solvency II Balance Sheet



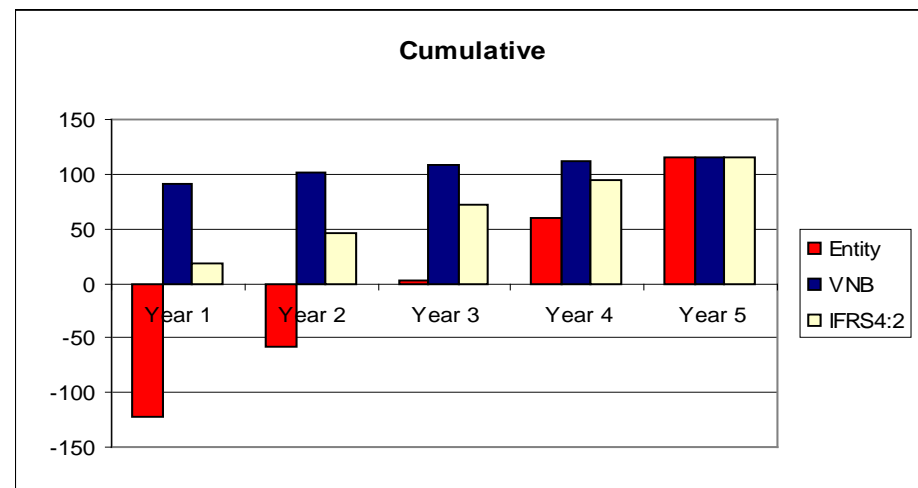
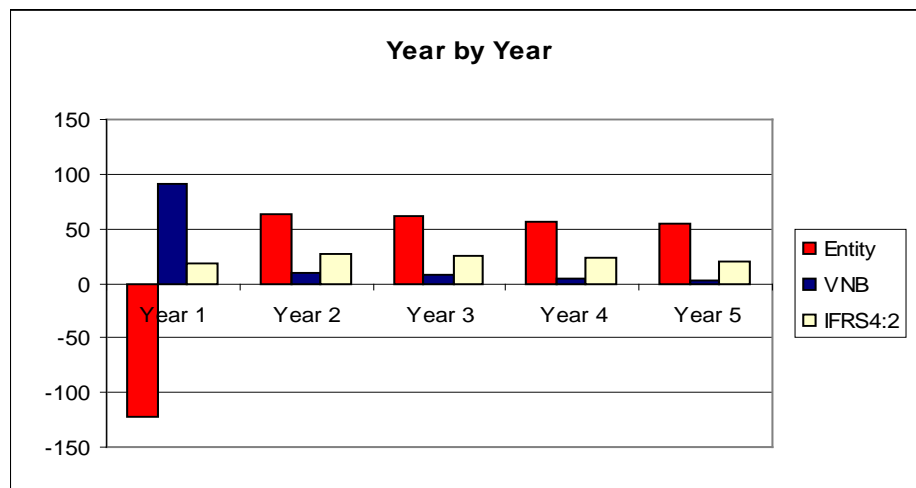
IFRS Balance Sheet



Solvency II includes Investment contracts; IFRS 4.2 includes Residual Margin

EV vs. IFRS 4.2 - Example of Financials

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Premium Income	70	65	60	55	50	300
Claims		-19	-17	-16	-14	-66
Acquisition Expense	-100					-100
Maintenance Expense	-12	-11	-10	-9	-8	-50
Reserve Creation	-100					-100
Reserve Release	20	20	20	20	20	100
Investment Return		9	8	7	7	31
Total Profit	-122	64	61	57	55	115



QIS 5 learning points

- Results favourable compared with QIS 4
- Contract boundaries are an issue
- Highlights gaps in capability / data / models
- EPIFP also a significant issue
- Operational risk models need development



FSA review priorities

We have started review meetings with the FSA on these topics:

**Risk Management, Governance
And Use Test**

Model Scope and Architecture

Data

Documentation plans

External models

ORSA



Keep close to Regulator: link to Arrow activity

Challenge processes / 2nd line of defense

Data flows, assumptions, validation

'Likely to be considerable work to do to meet the requirements'

Guidance: 500- 1000 pages on Int. Model

Processes around key models are unlikely to change

Will be a focus once CEIOPS advice is published

'Explanations and Evidence'

FSA – 10 principles of Business Use

- Senior management and the supervisory Board shall be able to demonstrate *understanding of the internal model*
- Requires the outputs from the internal model to be *tailored to the business* needs and to fit the business model
- The internal model shall be *used* to support and verify decision-making in the undertaking
- The internal model shall cover *sufficient risks* to make it useful for risk management and decision-making
- Undertakings should design the internal model in such a way that it *facilitates analysis* of business decisions
- The internal model shall be widely *integrated* with the risk management system
- The internal model shall be *used to improve* the undertaking's risk management system
- The integration into the risk management system shall be on a *consistent* basis for all uses
- The SCR shall be *calculated* at least annually from a full run of the internal model, and also when there is a significant change to the undertaking's risk profile, assumptions underlying the model, or the methodology arising from decisions or business model changes, and
- Whenever a *recalculation* is necessary to provide up-to-date information for decision-making or any other use of the model, or to fulfil supervisory reporting requirements

Developing new MI for Solvency II

Best Place to Invest

	Month	YTD	Full Year Forecast	Prior Year
Profit before tax	Green	Red	Red	Red
Return on equity %	Green	Red	Red	Red
PBT: PFS	Green	Green	Green	Green
CMB	Green	Green	Green	Green
Income (PBT + Commission)	Green	Green	Green	Green
Risk Based Value	Green	Green	Green	Green
Value on risk based capital £m	Green	Green	Green	Green
Project Harmony	Green	Green	Green	Green
Manage ARROW actions	Yellow	Red	Red	Red
Managed costs £m	Yellow	Red	Red	Red
Cost efficiency ratio %	Yellow	Red	Red	Red
Reduce Operational losses £m	Yellow	Red	Red	Red

Safe Place to Invest

	Month	YTD	Full Year Forecast	Prior Year
Regulatory Solvency ratio %	Green	Green	Yellow	Green
RBC solvency ratio %	Green	Green	Yellow	Green
Persistency - Protection	Red	Red	Yellow	Yellow
Persistency - Pensions inc PUP	Red	Red	Yellow	Yellow
Persistency - Investments	Red	Red	Yellow	Yellow
Number of Model Changes	Red	Red	Yellow	Yellow

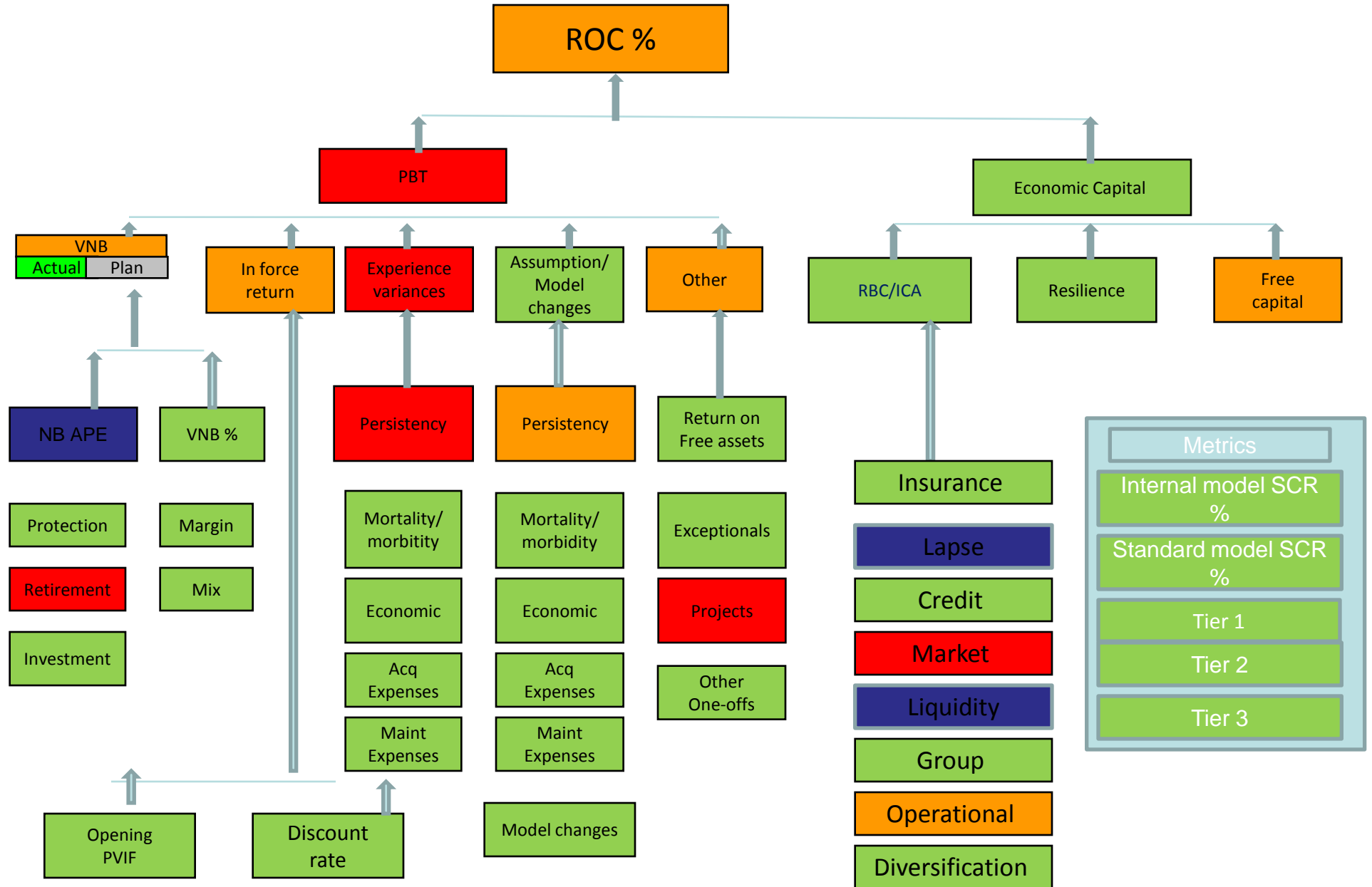
Best Place to Bank

	Target	Actual
Total APE		Red
Flywheel APE		Red
VNB + Commission – Life co		Green
Customer satisfaction index		Green
Customer recommendation index		Green
Flywheel 2011 milestones		Yellow
Direct proposition for LifeChoices/BPP		Yellow
Business dev transformation programme		Yellow
Life RDR preparation		Yellow

Best Place to Work

	Target	Actual
Leadership summary rating		Green
HSBC group values rating		Green
Growth & development rating		Green
RDR proposition		Yellow
Sustainability		Green
Community project support		Green
FTE		Green

Life Return on Capital – RBC basis



Opportunity for real benefits:



- ❖ understanding of risks and returns
- ❖ improved infrastructure / quality of MI
- ❖ achieve focus on ROE
- ❖ reinsurance assessments
- ❖ pricing for capital usage
- ❖ realistic view of capital and surplus

Any Questions ?

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Risk is...

- ***Most companies look at risk through a variety of lenses, not just in relation to economic capital. Not meeting quarterly and annual earnings, failure to meet business plans, underperformance relative to competitors, loss of ratings and financial flexibility, and lifetime product return that does not meet goals are all relevant risk concerns that might be examined over different risk horizons.***