



The Actuarial Profession

making financial sense of the future

Challenging Times

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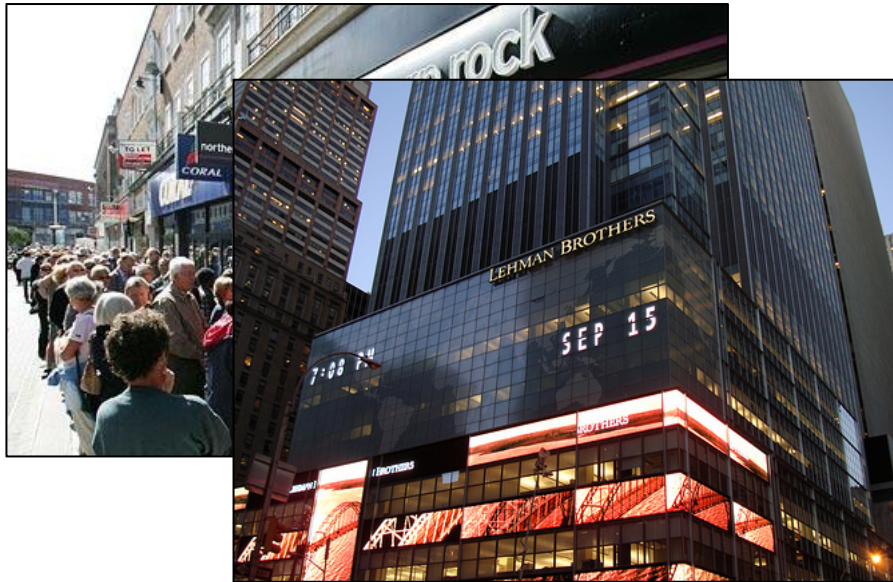
Overview

- The Global Financial Crisis
- The Turner Review
- Future of the ICAS regime
- Towards Solvency II

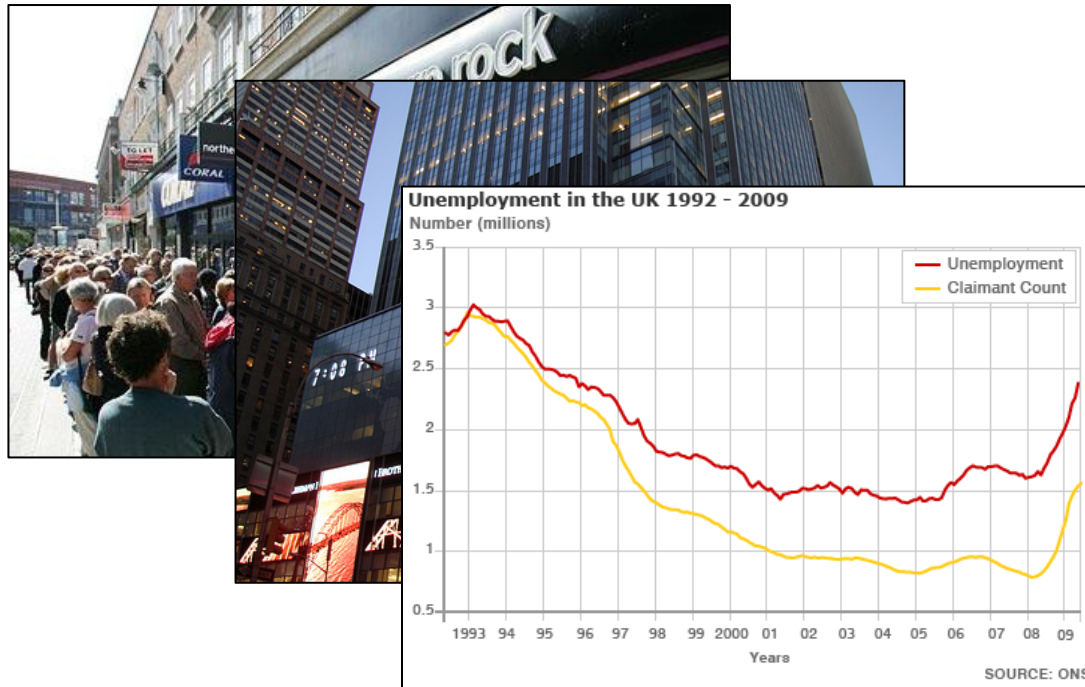
The Global Financial Crisis



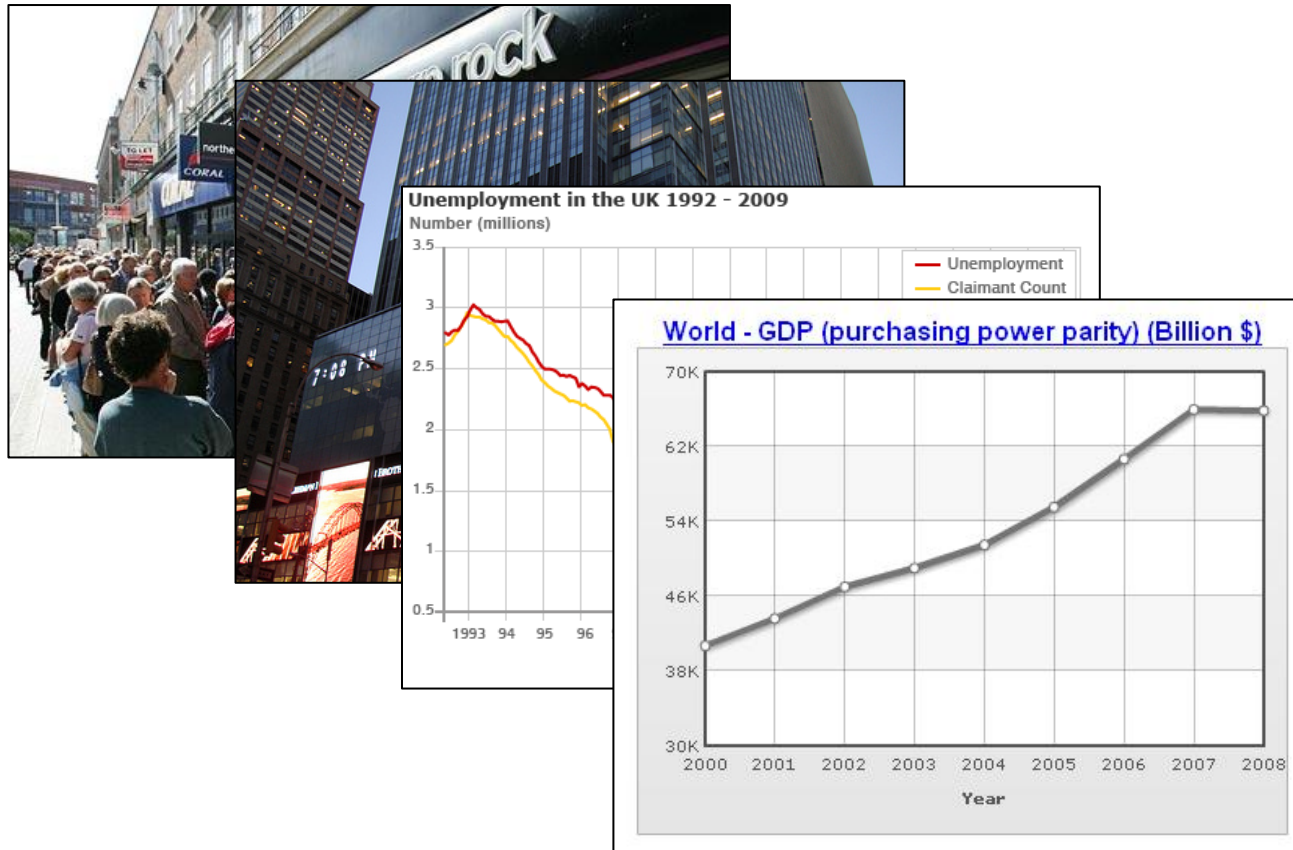
The Global Financial Crisis



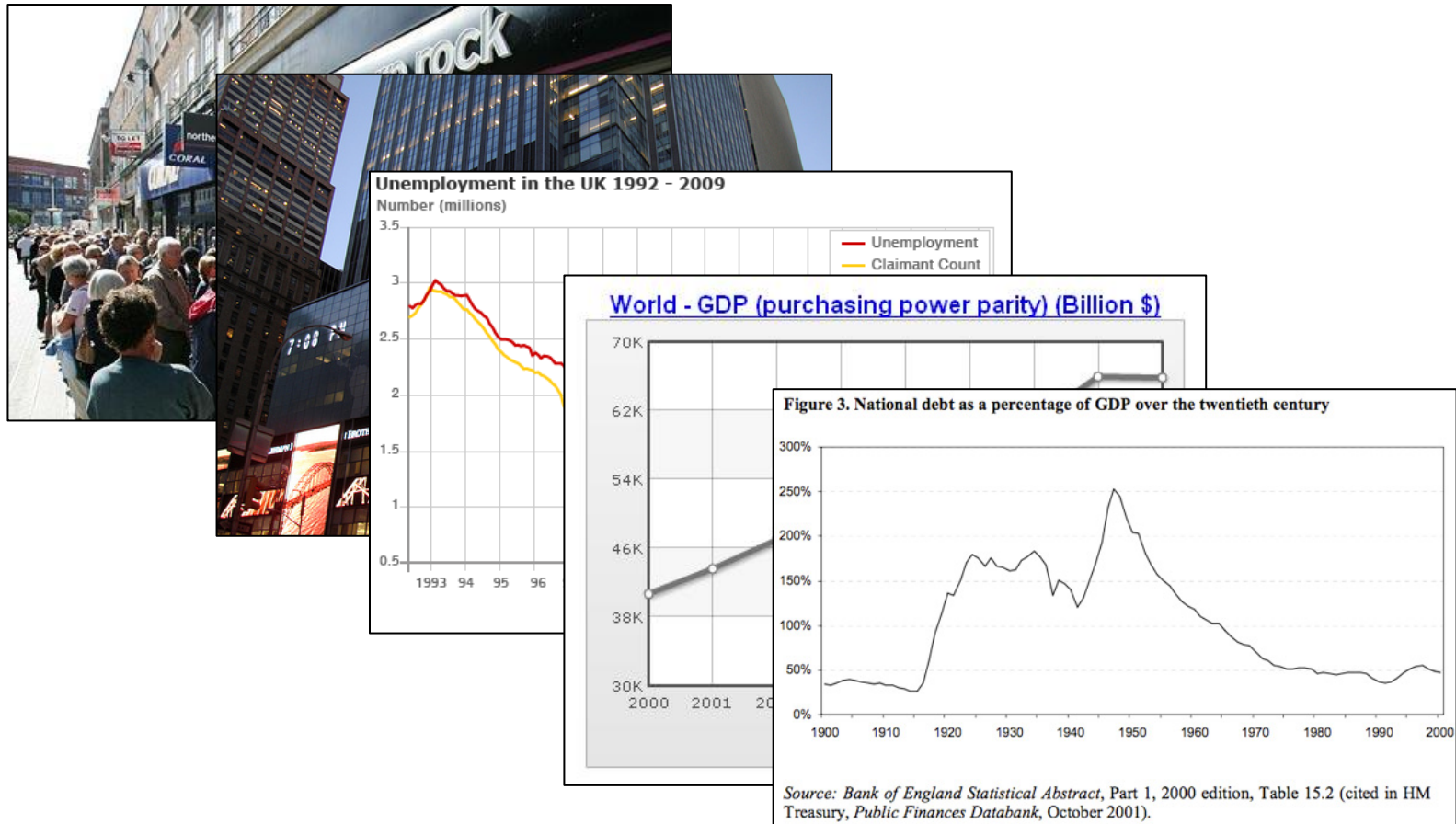
The Global Financial Crisis

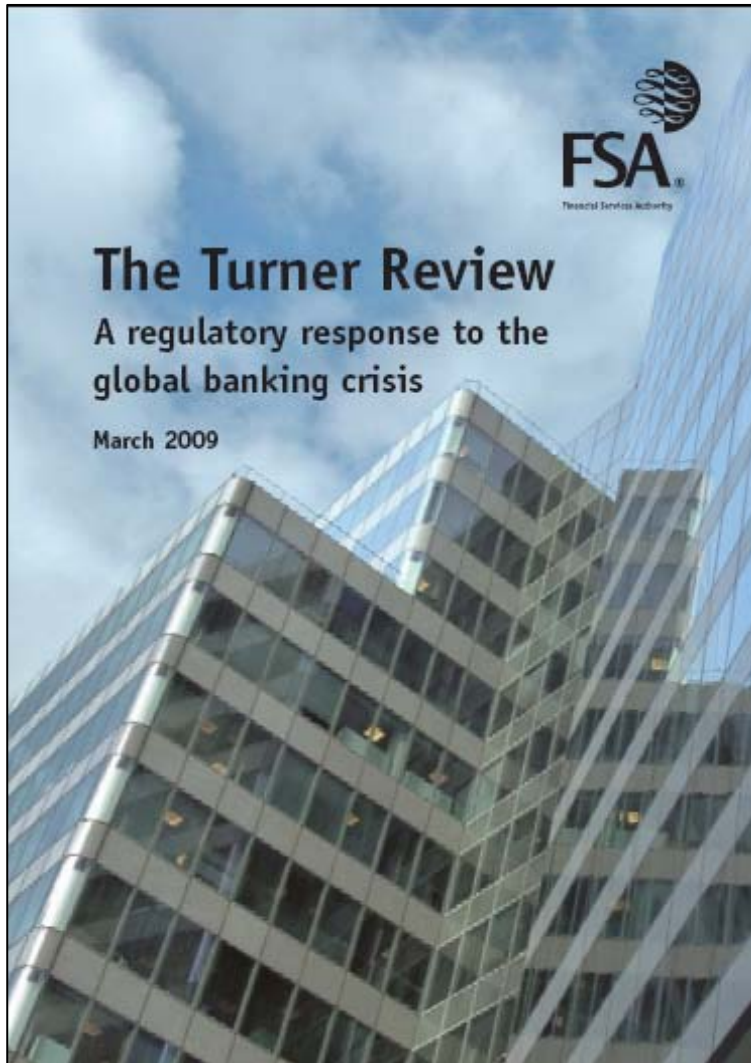


The Global Financial Crisis



The Global Financial Crisis







Key Drivers of the Crisis



- Mutation of the securitised credit model
 - Massive growth and increased complexity
 - Risk retained on banking balance sheets
- Increased leverage in multiple forms
- Increased maturity transformation, by banks and shadow banks, in new forms: reliance on “liquidity through marketability”
- Misplaced reliance on apparently sophisticated maths
- Hard-wired pro-cyclicality, ratings triggers, margin calls
- Lack of adequate/ counter-cyclical capital buffers

Exhibit 2.9: The conventional wisdom – 2006



“There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient.

The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks may be less vulnerable today to credit or economic shocks”

IMF Global Financial Stability Report, April 2006

Exhibit 1.5: The growth of securitised credit

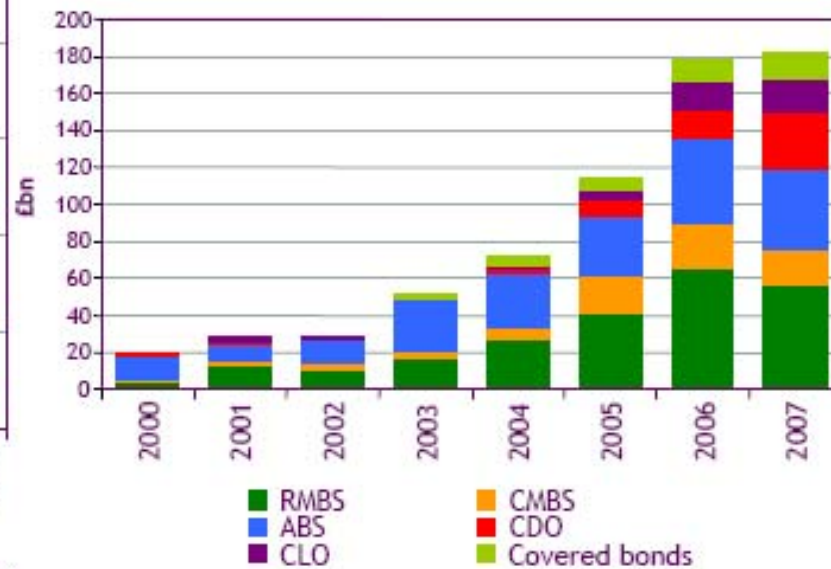


ABS – volumes outstanding, US



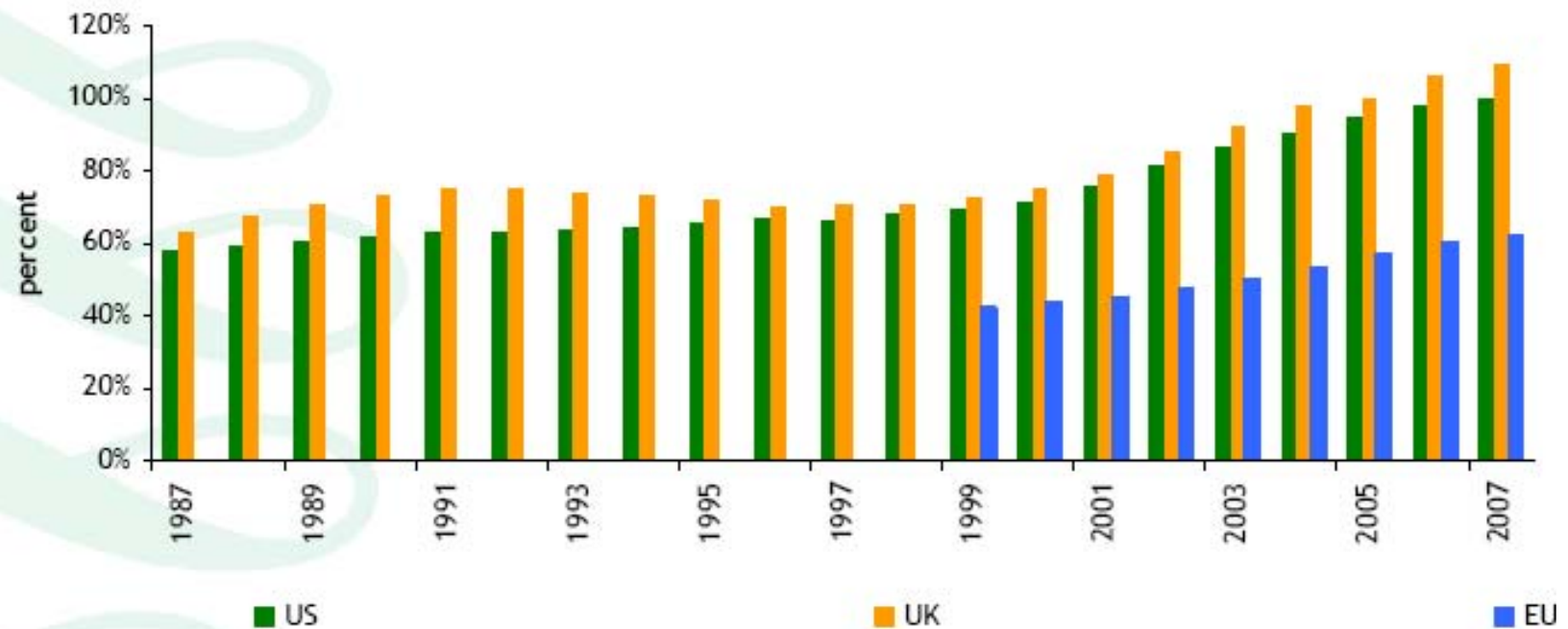
Source: SIFMA

Securitisation issuance trends in the UK



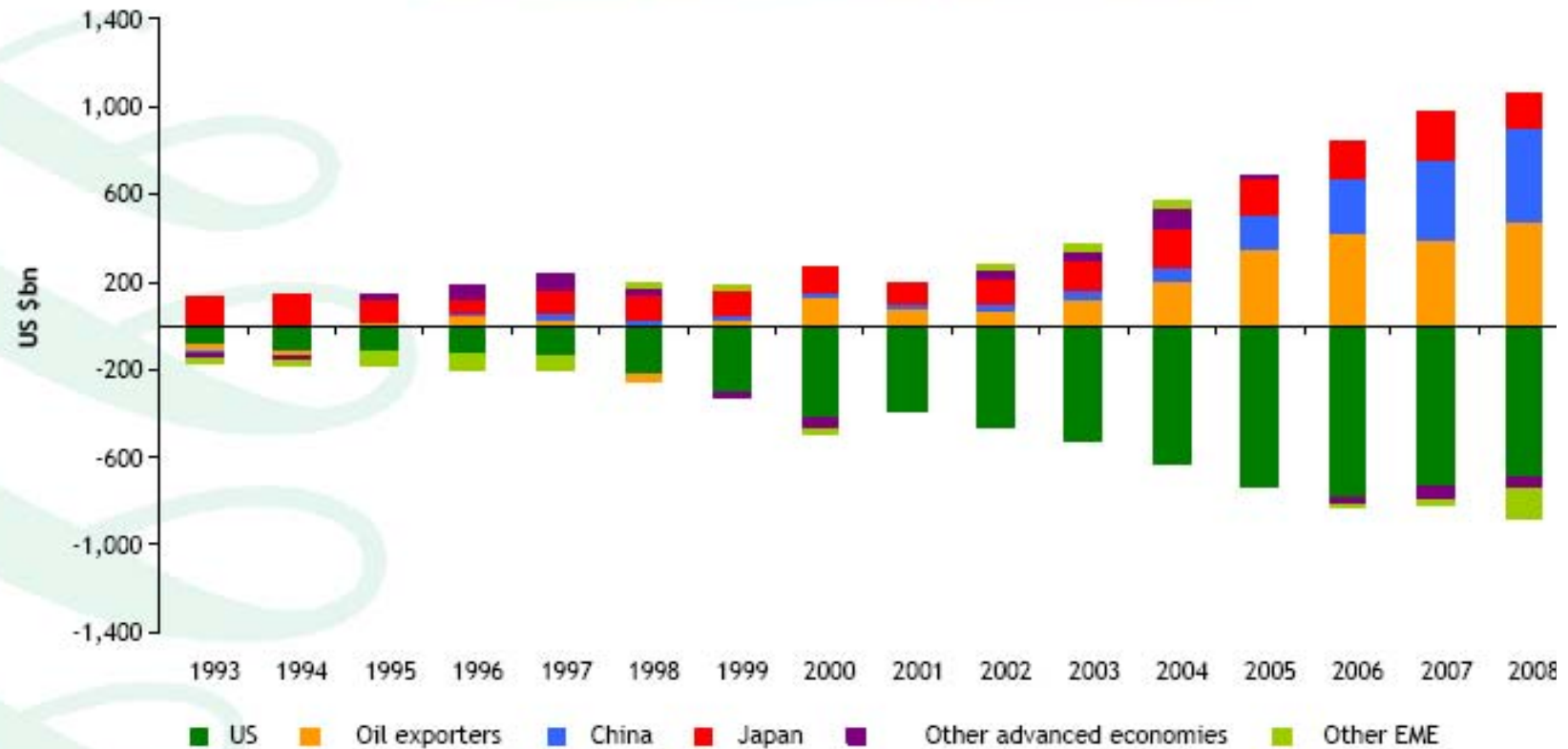
Source: Oliver Wyman

Exhibit 1.4: Household debt as proportion of the GDP



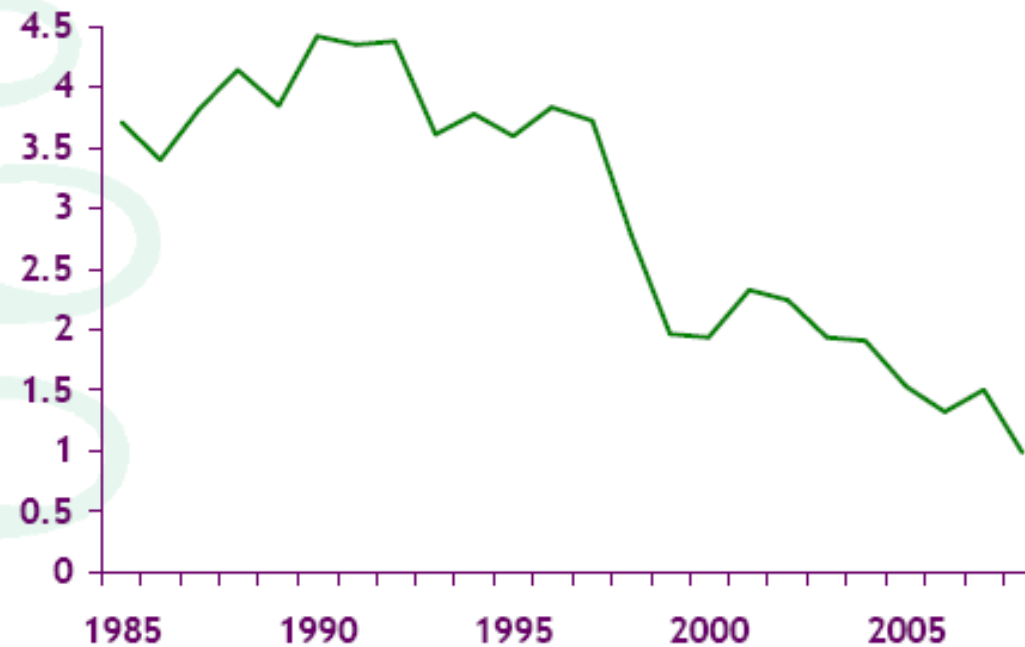
Source: ONS, Federal Reserve, Eurodata, Bureau of Economic Analysis, FSA calculations

Exhibit 1.1: Global current account balances



Source: IMF, FSA calculations

Exhibit 1.3: UK real interest rates
(20 year bonds, yield at May 25th or nearest week day)



Note: For the years 1985, 86, 89, 90 & 91 no 20 year yield is precisely available; the longest available yield (in range 16-19 years) is shown

Source: Bank of England Real Yield curve calculations

Exhibit 1.8: Estimates of mark to market losses on US credit securities: at April 2008



Source: IMF Global Financial Stability Report, October 2008

UK special factors

- Home country of leading banks involved in trading activity
- Rapid growth of mortgage debt; rising property prices
- Credit growth financed from overseas through securities sales and bank lending
- Rapid and risky growth of mortgage banks

Exhibit 1.25: Major UK banks' customer funding gap and foreign interbank deposits



Source: Bank of England, Dealogic, ONS, published accounts and Bank of England calculations

The customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors.

Five fundamental theoretical issues



1. Are financial markets rational or subject to herd/momentum effects?
2. Is the securitised credit model inherently unstable?
3. Misplaced reliance on sophisticated maths: fixable deficiencies or inherent limitations?
4. Has financial innovation been socially useful?
5. Does market discipline work?

Recommendations



1. **Fundamental changes in capital, liquidity and published accounts**
2. **Institutional and geographic coverage: economic substance not legal form**
3. **Other important changes: credit ratings, remuneration and counterparty risks**
4. **Macro-prudential analysis and the need for intellectual challenge**
5. **A new FSA approach to supervision: more intrusive and more systemic**
6. **Governance and risk management: firm responsibilities and structures**
7. **“Narrow banking” versus “investment banking”: major constraints but not complete separation?**
8. **Cross-border banks: more international cooperation and more national powers**

Macro-prudential regulation

- Financial stability
- Impacts
 - Reinsurers
 - Direct insurers
- Socially useful scale
 - Tobin tax
- Remuneration policy

The future of the ICAS regime

Increased focus on two key themes



Risk-based regulation

- Principles based, outcome focused philosophy
- Targeted and proportional
- Adequate resources, including capital
- Supervisory Enhancement Programme (SEP)
- Alignment of ARROW and ICAS
- Firms better able to monitor and manage their risks

Governance

- Structure and quality of decision-making
- Significant Influencing Functions and SIF Interviews
- Importance of challenge and (I)NEDs

Should you be afraid? Very afraid?

- More **intrusive** and more **systemic** supervision
- **Close and continuous interaction** with high impact firms but does not mean smaller firms will escape spotlight
- Regulatory oversight will mean **more overseeing** and **less overlooking**
- **Credible deterrence** through visible **enforcement action**



Source: Guardian



Issues from recent ICA reviews



- **Documentation**, documentation, documentation!
- Weak stress and **scenario testing**
- Unsubstantiated **diversification** credit
- Aspirational **business plans**
- Limited consideration of **foreign exchange** risk
- **Credit risk** on reinsurance

Towards Solvency II

In principle, well-run, well-capitalised companies will have little to fear...

- Not just a regime change
- ICAS regime is good preparation for Solvency
- Internal model regime – a worthwhile challenge
- ICAS framework good preparation for Solvency II
- Gap analysis – a key consideration, particularly if aiming for model approval
- Model validation and use will be two of the hardest hurdles
- QIS 5 – speak now or forever hold your peace!
- ORSA is not “someone else’s problem”
- Specific role for the “actuarial function” for all firms



...but in practice, and in the detail, all firms have a lot to do

Personal reflections

- Relatively recent joiner to the FSA
- Desire for and openness towards change is clear
- Shift to working more with non-actuaries
- Rigour of internal ICA review process
- Keenness to foster good relationships and work together with regulated firms
- Huge recruitment and training drive
- Diversity of team
- Visible impact of the work FSA does everyday



Questions?

