

GIRO Convention

Emerging Market Practice for ICAs

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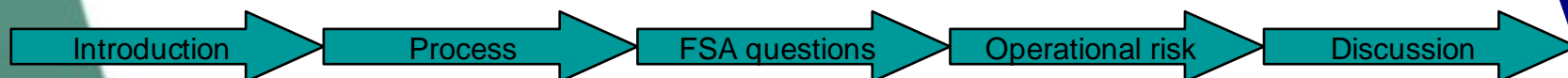
Wednesday 13 October 2004





Agenda

- Introduction
- The process
- Typical FSA questions
- Operational risk
- Discussion





Agenda

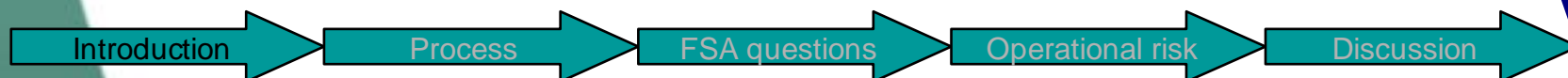
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Introduction

- The FSA pilot
- Future timetable
 - Companies
 - Lloyd's
- The FSA really mean it!
 - Asking difficult questions
 - Putting on pressure
 - Limited reinsurance on motor





Introduction

Are the new FSA rules a business critical issue?

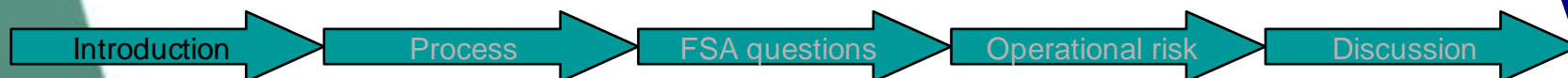
- Given the free assets of UK companies:
 - 15% fail ECR
 - 30% fail ICA/ICG
 - 40% will need to alter their business strategy
- Extra £2½ billion capital required by market
- Business strategies may change
- European super-equivalence





Introduction

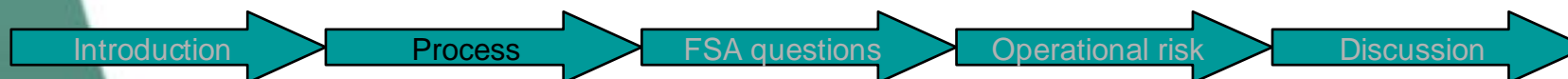
- Are insurers still behind banks?
- Banking Pillar 1 more sophisticated
- Insurer Pillar 2 more sophisticated
- Insurers now taken the lead?





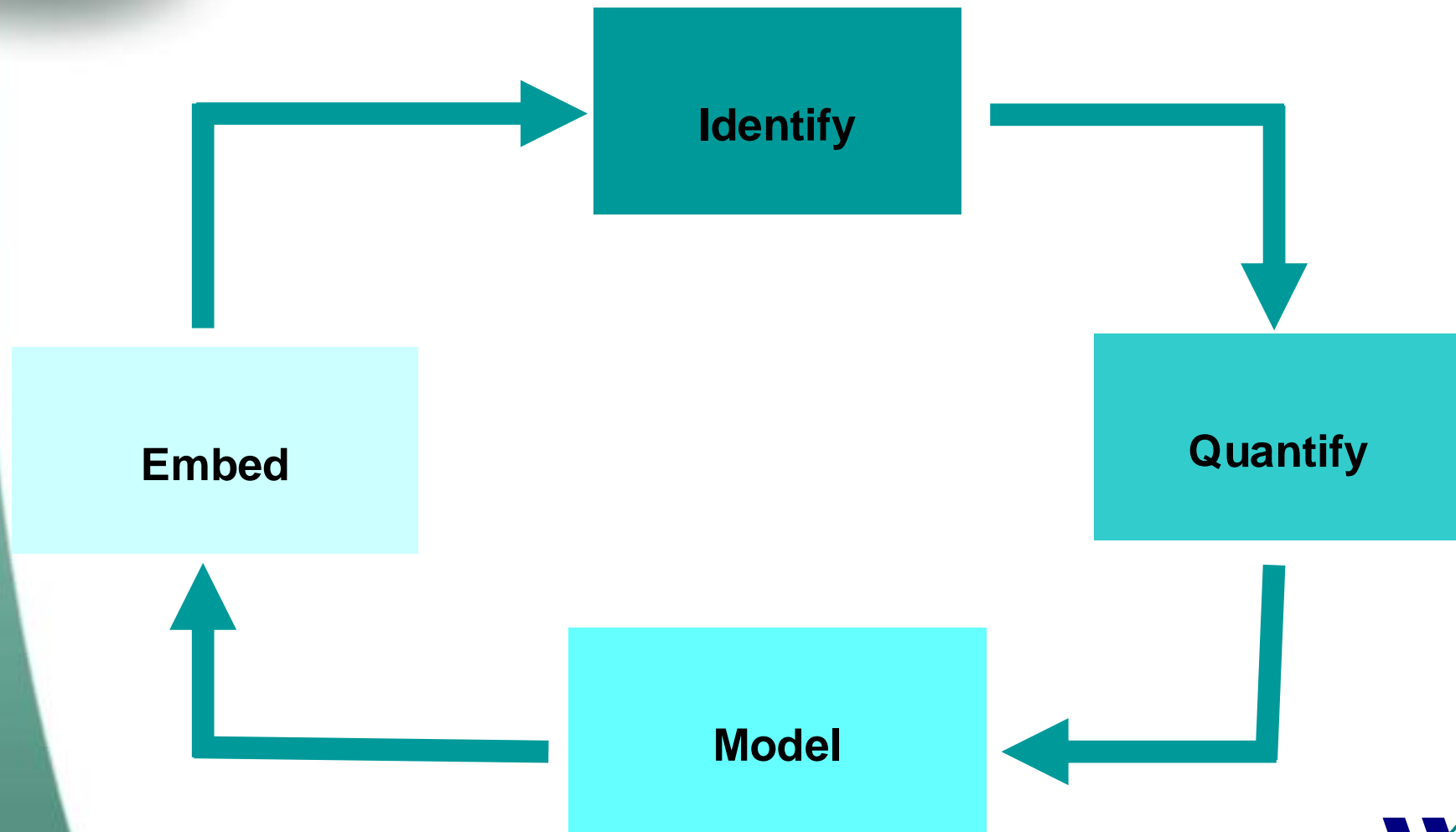
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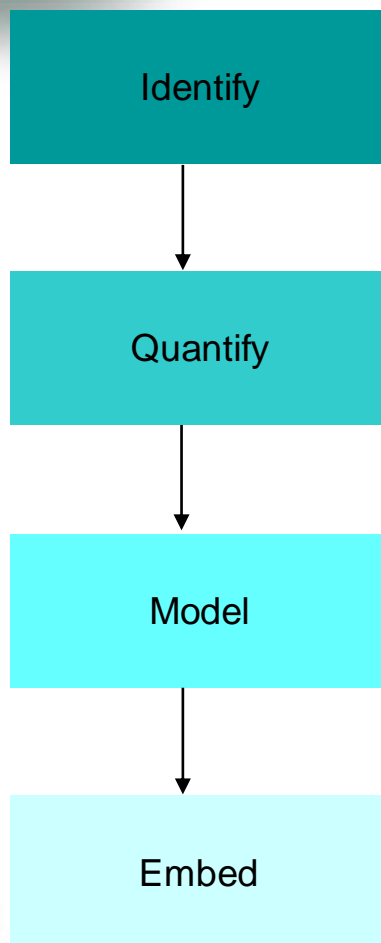




ICA Process



ICA Process



Task	Sub task	Timescale
Risk register	Risk identification	September-October
	Risk ownership	September-October
	Risk mitigation	September-October
	Risk quantification	September-October
Modelling	Customising model	September-October
	Parameterisation	September-November
Embed in culture		September-December
ICA report	Producing report	November-December
	Board sign-off	December





Risk Register

- Process principally to identify risk
- but other related uses in addition
- Design risk register with its ultimate use in mind:
 - Allocate responsibility
 - Reduce risks – systems and controls
 - Quantify risk
 - Model risk





Risk Register Headings

Risk details

- Risk name / identifier / category
- Risk owner
- Description

Systems and controls

- Outline of key controls
- Mitigation and relevant policy

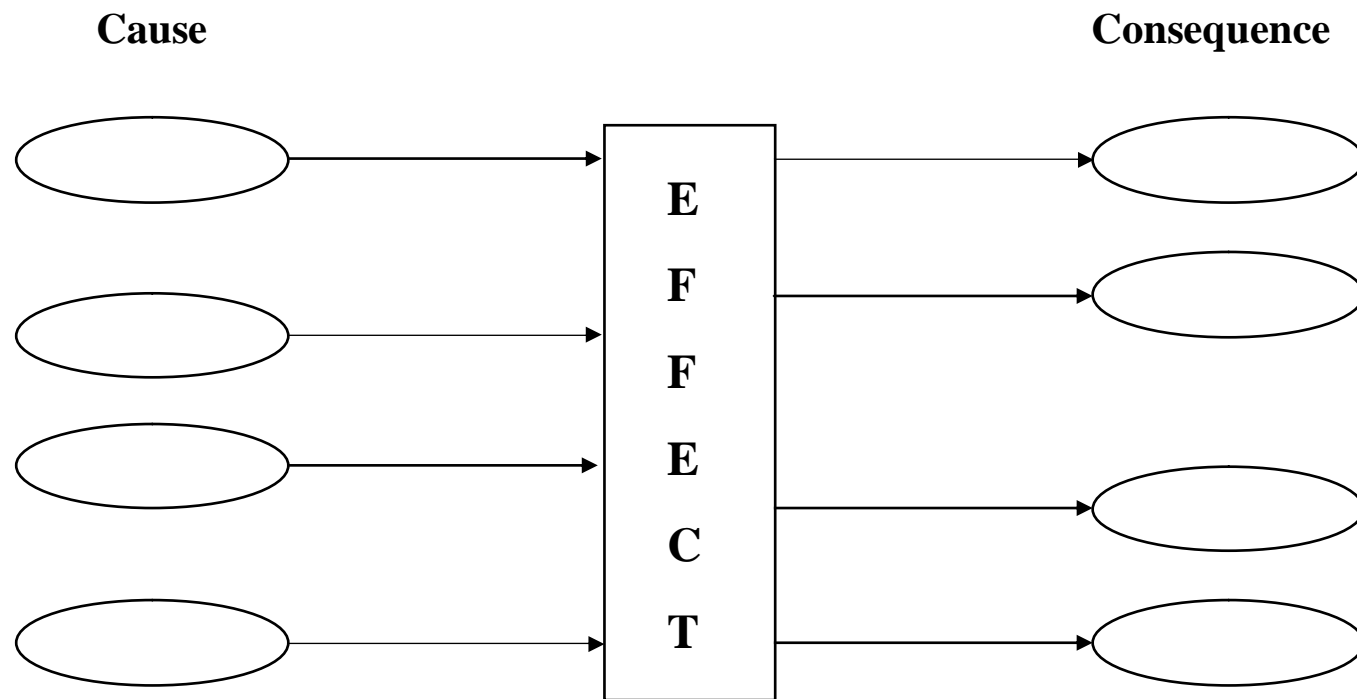
Quantification

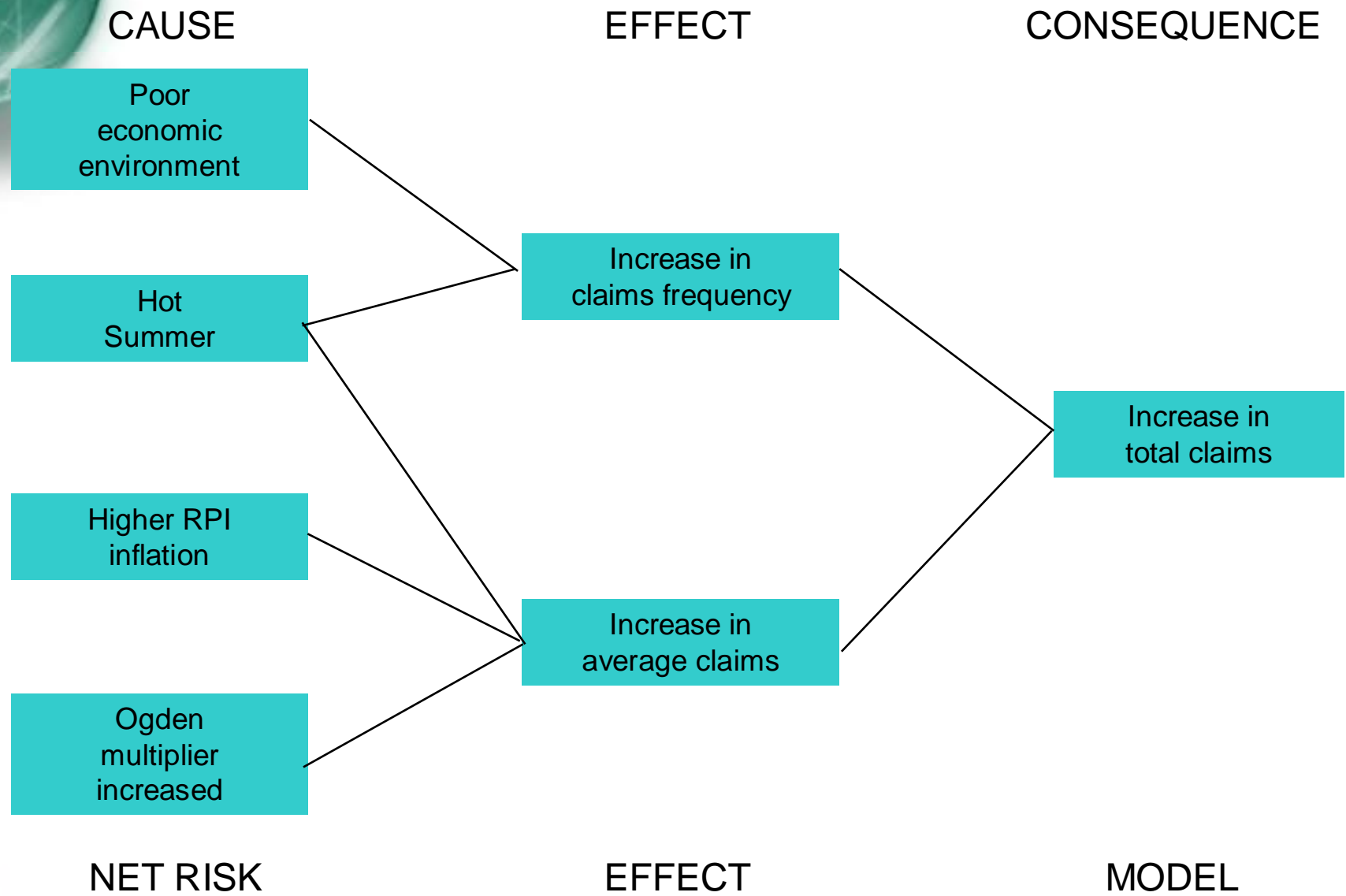
- Probability of occurrence
- Impact
- Statistical distribution

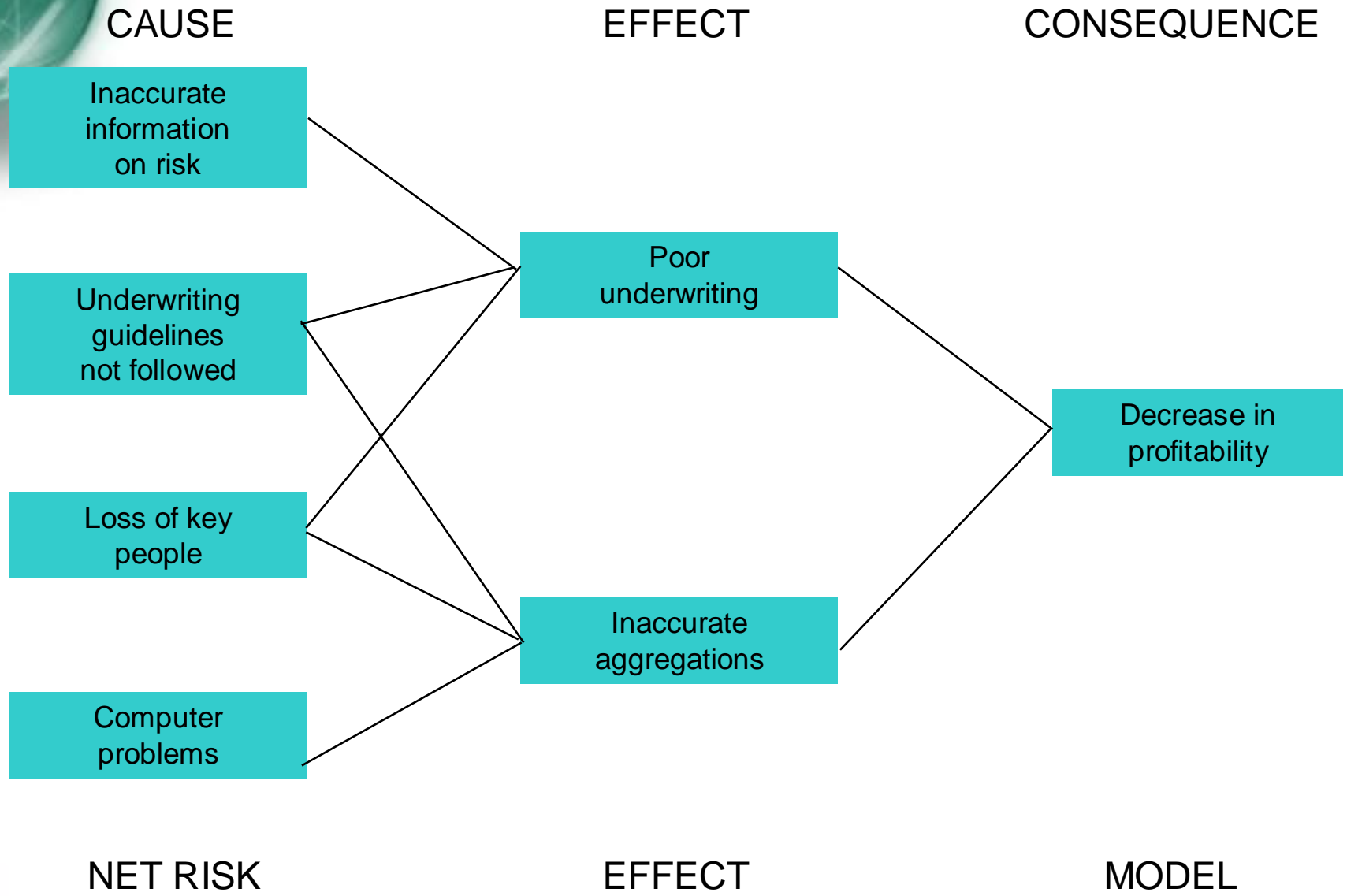
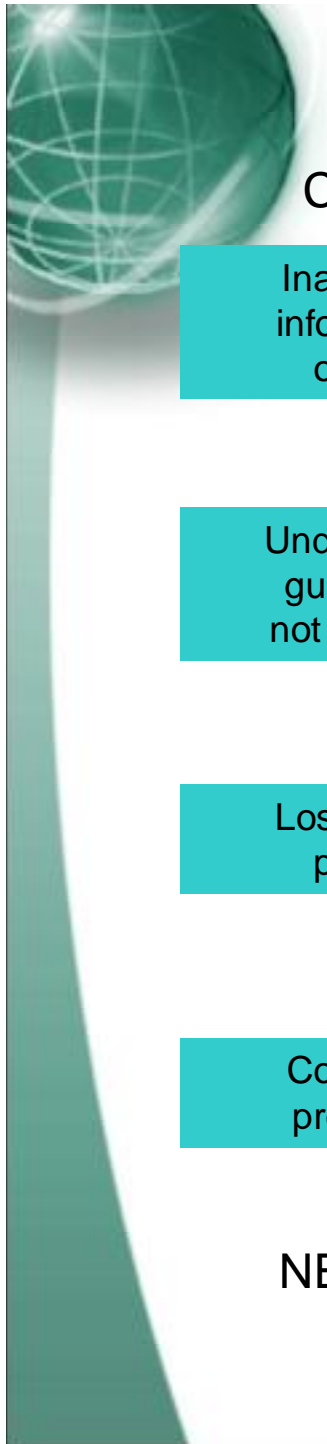




Cause, effect or consequence



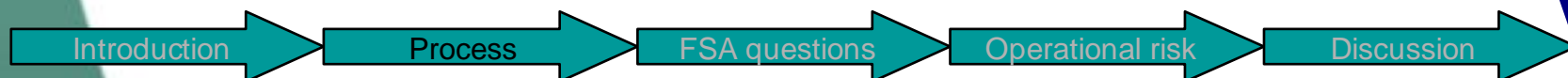


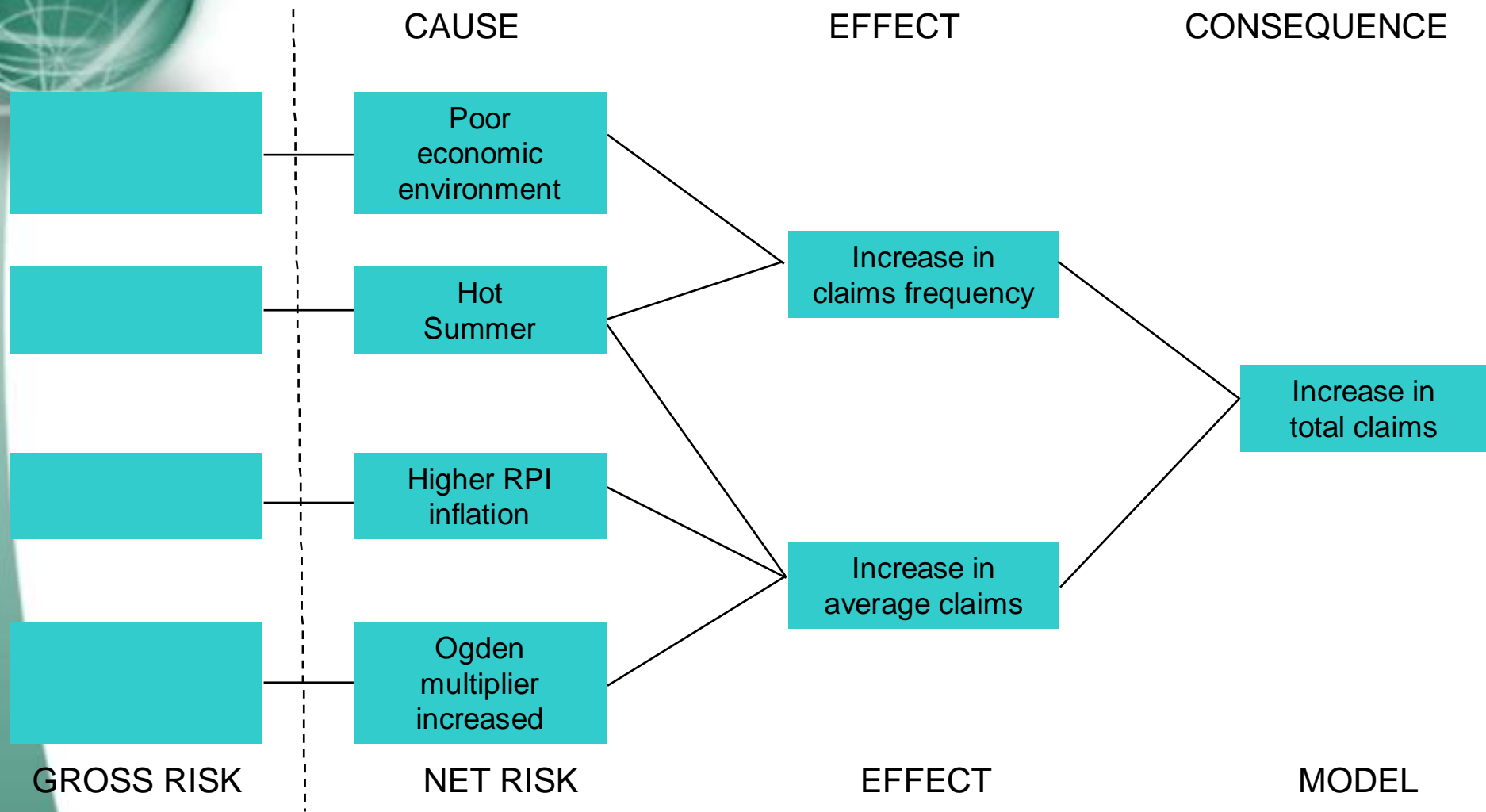




Gross risk and net risk

- Gross risk is the risk before systems and controls
- Quantification of gross risk is not particularly helpful
- But it is helpful to consider the gross risks to ensure suitable systems and control are put in place
- Quantification of net risks is required





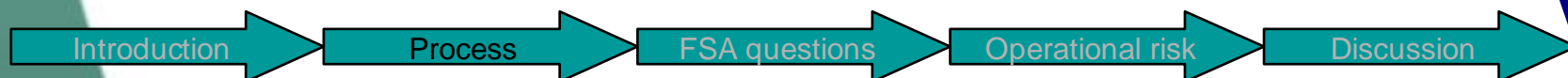
SYSTEMS
AND
CONTROLS





Modelling

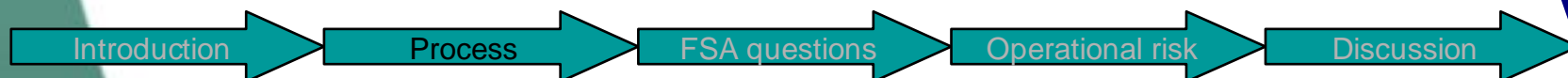
- Model consequences
- But ensure all risks have been considered
- Classify risks for modelling purposes as:
 - Too small or normal cost of doing business – do not model explicitly
 - Meaningful, but subject to substantive systems and controls – do not model explicitly
 - Too big - assess/understand and use stress tests – do not model explicitly
 - Meaningful - model explicitly





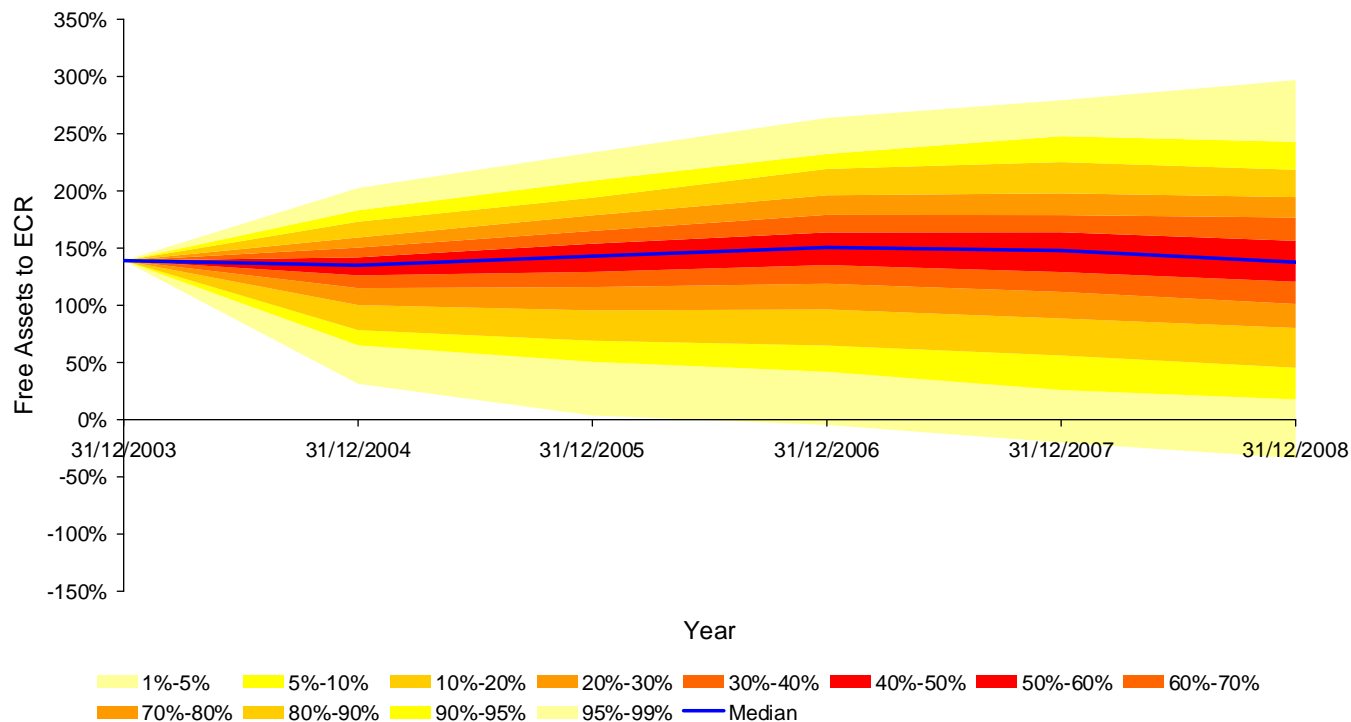
Modelling

- Stochastic model or stress/scenario testing?
- Companies
- Lloyd's
- Size



Capital underlying ICA

- Less than actual capital (- you hope!)
- Which assets do you exclude from the calculation?
- For highly capitalised companies, $ECR > ICA$





FSA documentation

- ICA output for FSA:
 - Risk Register
 - Financial Model
 - ICA Report
- Internal documents





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Typical FSA questions

Risk register:

- Allocation of responsibility
- Definition of operational risk
- Operational risk database
- Mapping risks to the model

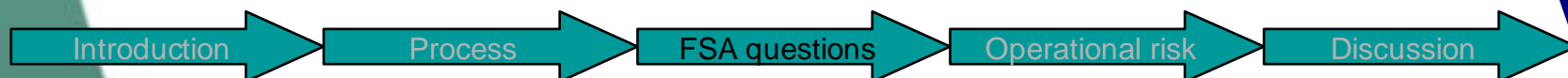




Typical FSA questions

Modelling:

- Time period
- Rating cycle
- Reserving risk
- Correlations
- Operational risk capital (as % of premium income)
- Management decision rules
- Embedded in culture
- Allowance for major events
- Parental guarantee





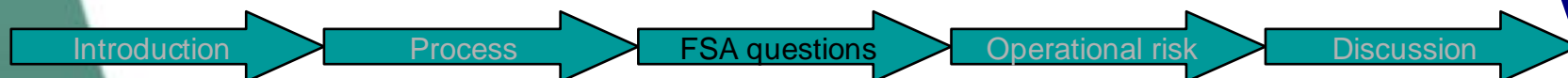
Typical FSA questions

FSA not hung up on detail

.... but they want thoughtful analysis

.... and top-level buy-in

.... and systems & controls





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- **Operational risk**
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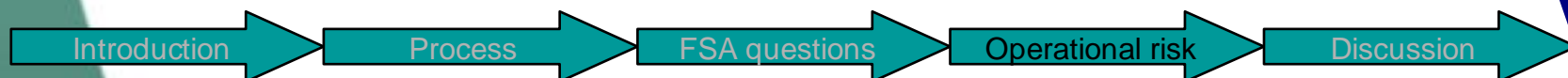




Operational risk

Basic approach

- Basic approach
 - Included in past
 - Projected in to future
 - But allow for specific items eg computer developments
- Allows for “normal” attritional risks and costs of doing business (except in investments)
- But does not allow for catastrophe operational risks eg damage to reputation



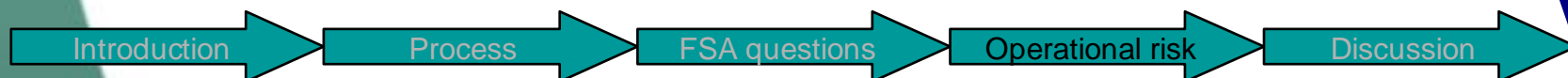


Operational risk

More sophisticated approach

- Basic approach as previously
- Consider two or three largest operational risks
 - Very rough quantification
 - Determine capital requirement
- Assume independence from other risks (reasonable assumption in practice?)

- $\sqrt{100^2 + 5^2} = 100.1$





Operational risk

Future approach

- Michael Tripp's paper
- Collect data
- Take past operational risks out of data
- Project operational risks separately

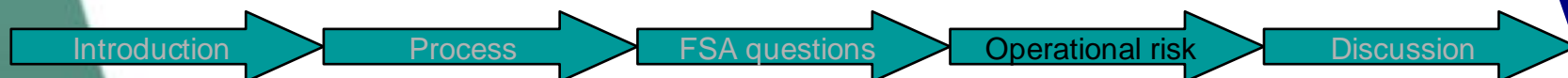




Operational risk

Comparison with Banks

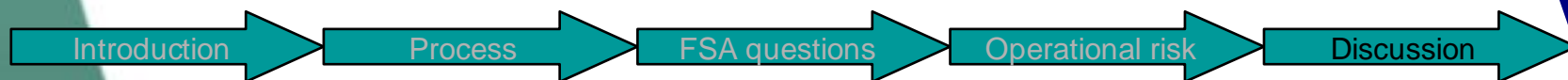
- Banks use theoretical models for all risks
- No allowance for operational risk
- Operational risk capital requirement:
 - Basic indicator is 15% of gross interest income
 - Standardised approach
 - Advanced measurement approach
- Perhaps 15% - 20% loading on capital for operational risk
- Applicability to insurance companies?





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