The Actuarial Profession
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consultation response

Financial Services Authority DP 09/02:–
A Regulatory Response to the Global Banking Crisis

Comments from the Actuarial Profession

June 2009

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17 June 2009

Dear David

Discussion Paper 09/2: A Regulatory Response to the Global Banking Crisis

The Actuarial Profession welcomes the opportunity to comment on Discussion Paper 09/2. We see the regulatory response to the global banking crisis as being fundamental to the restoration of stability and confidence in financial markets. The Turner Review, and this accompanying Discussion Paper, are the result of some excellent work so far, and we look forward to working with the Treasury and the FSA more closely in developing the ideas further for practical application.

Like many organisations, the Actuarial Profession has initiated its own response to the financial crisis. The Global Financial Crisis Group was set up to co-ordinate research from different parts of the profession, to initiate new research on important issues and to disseminate the results within the profession and beyond. The Actuarial Profession has also been active in other consultations, such as that relating to Sir David Walker's Review of Corporate Governance of the UK Banking Industry

Notwithstanding this activity, we have chosen to focus our response on those areas where we believe the Actuarial Profession has most influence – quantitative risk management – and where we believe we can play a part in developing the solutions, and also on an idea to improve risk governance.

We hope that this response is helpful, and would be happy to discuss it in more detail.

Yours sincerely

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(Q1) Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

We agree with almost all points made in the discussion paper. However, it is important to recognise that no amount of capital can compensate for inadequate risk controls, or even adverse financial environments. The importance of risk controls cannot be overstated. A recognition of the need for better risk controls is included in the Actuarial Profession's response to the Walker Review, recommending that the role of Chief Risk Officer become an FSA controlled function with minimum standards of professionalism and defined risk management responsibilities. In terms of meeting a cost/benefit analysis this controlled function could be filled by an individual who also fulfils an existing function, such as the Actuarial Function Holder, in smaller insurance companies.

(Q3) Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?

We support the proposals to increase the quantity and to improve the quality of minimum eligible capital. We agree with the overarching requirement that any new definition of capital should be used to meet all types of risk, including market risk, and that therefore it must be of appropriate nature and duration for the risks to be covered.

We support the use of stress testing. The Actuarial Profession has carried out significant recent research in this area, particularly for long-term liabilities, and we would be delighted to share the results of our research.

(Q4) Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level that would be produced by a TTC ratings system?

We are, in general, supportive of micro-economic measures to reduce pro-cyclicality for institutions, or that part of their activities considered crucial to the market. However, in practice any such measures implicitly assume that cycles follow predictable patterns and that the response of institutions does not itself alter the cycle. For example material capital "smoothing" might limit growth in benign periods and effectively maintain lending beyond prudent levels in more challenging periods. Market irrationality can render this assumption of a recognisable cycle invalid, and this must be borne in mind when designing systems to deal with procyclicality.

(Q5) Are there any other key issues that the review of trading book capital should cover?

The discussion paper suggests considering alternatives to the use of Value at Risk (VaR) as a risk measure. Whilst this is sensible, it should be recognised that increased complexity is not necessarily desirable. A more complex alternative to VaR might give more apparent comfort, but not rightly so.

(Q9) Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

We agree that a range of measures is necessary. However, it is important to give sufficient weight to the issue of risk controls, as discussed in the response to Q1.

(Q15) What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?

The core funding ratio concept and other macro-prudential tools suggested in The Turner Review are possible solutions to the problems of macro-economic cycles and market irrationality. Defining and implementing such measures will require careful analysis, and we will be pleased to contribute to this. It is important that such measures are defined and applied in a transparent manner, and subject to independent review.

(Q21) Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully? If so, what are they?

The proposals for intensive supervision are commendable, but in practice will be challenging to implement and for the regulator adequately to resource. Efficient ways of applying such supervision, including use of strengthened risk management and corporate governance requirements at individual firms, will be key to successful application of such measures.

(Q22) What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

We agree that the focus should be on identifying individual firms which have systematic importance and varying the intensity of supervision at the individual firm level accordingly. There is however a risk that intensive supervision places significant power in the regulator in determining market outcomes.   Therefore the selection of systematically important firms should be transparent, and the supervisory approach should be informed by and subject to challenge from, other regulatory, government and competition bodies.

(Q23) Are there other aspects of group structures that the FSA should be taking into account?

We agree with the increased focus on the tensions between the support a group can give and the contagion risk a group brings. However, for insurance we would note that the Solvency II Directive has been finalised without the previous opportunity for group support to be recognised as capital in the solo entities. We had believed that HMT would continue to press for this to be explored at a later stage, and we believe that the lessons from the banking experience should not be applied to this area without further consideration. The risks undertaken by insurance groups can often offer significant diversification opportunities between particular risks and between the same risk in different geographies. A group that transacts internal reassurance of risks to recognise this diversification, provided its assumptions are soundly based, is acting prudently and has the potential to deliver the best price to customers.

(Q29) Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

We agree with the issues highlighted in respect of CRAs.

(Q30) Are the approaches outlined to address these issues appropriate and proportionate?

We see requirements to improve disclosure from CRAs as being helpful.

However the fundamental concern of market participants – that CRAs are funded by issuers, and therefore not independent – has not been addressed. This concern has arguably emerged over many years as credit ratings have become used for something that they were not designed for (helping price new issues). Ratings for the purpose of pricing of new issues and determining regulatory capital requirements should be based on independent analysis provided by an agent of the Basel Committee (or the regulator), funded by compulsory payment from financial institution.

(Q37) Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

The proposals for intensive supervision, and review of governance including closer working with external auditors are relevant to other sectors. We would question the reliance auditors to validate the effectiveness of the risk management function. The three-lines-of-defence model looks to internal and external audit to review such functions. It is not clear that internal audit functions have the necessary skills to perform this role. This is an issue that has already been recognised under Solvency II over the validation of internal risk and capital models. The scope and cost of external audits would also need to be broadened by management to cover such work. In insurance this recognition by management does not seem to be currently present.

On VaR models, The Turner Review states that any use such models “needs to be buttressed by the application of stress test techniques which consider the impact of extreme movements beyond those which the model suggests are at all probable”. It goes on to emphasise that deciding suitable stresses is inherently difficult and must involve judgement, not just blind application of a mathematical model.

These comments have relevance for other financial institutions, particularly insurers. It is, however, worth remembering that the Pillar II capital regime for UK insurers does take these concerns into account already in several ways:

- There is significant emphasis placed on the statistical credibility of data for modelling financial and insurance risks, and it is clear this will grow in importance under Solvency II
- Fat-tail distributions are indeed often used in modelling market and insurance risks, particularly for modelling extreme events
- There is already a significant emphasis in the ICA regime on stress testing (and indeed the FSA has been requesting stress testing of Pillar I requirements recently too)