Update from the FSA

CIGI – 12th May 2011, Royal College of Physicians

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Outline

- Outline and Key Messages
- Regulatory Reform
- Solvency II
- Integrated / Enterprise Risk Management

2

Key Messages

- **'Twin Peaks' of prudential and conduct regulation**
  - organisational alignment since April 2011
  - legal / legislative division during 2013
- **More intensive and intrusive supervision**
  - greater use of specialist resource
  - broader deployment of supervisory powers
- **Focus of specialist resources under IMAP pre-application**
  - to concentrate on smaller population of firms
  - reflecting risks to FSA's statutory objectives
- **Looking to a more complex and inter-related future**
  - expectations of ERM and CROs are rising
  - actuaries and other risk specialists need to be better equipped and better enabled

Regulatory Reform – New Vision

Three key players:

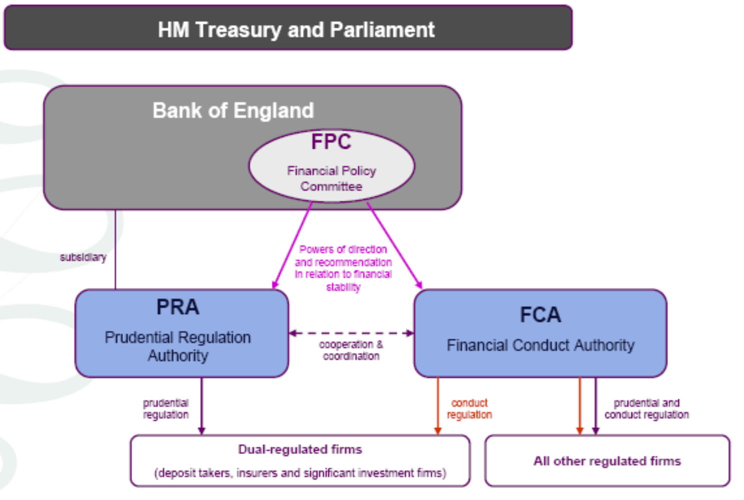
- **The Financial Policy Committee**
  - a committee of the Bank's Court of Governors
  - responsible for delivering systematic financial responsibility through macro-prudential regulation
- **The Prudential Regulation Authority**
  - an operationally independent subsidiary of the Bank
  - responsible for the safety and soundness of banks, insurers and other prudentially significant firms
- **The Financial Conduct Authority**
  - responsible for maintaining confidence in financial markets
  - particular responsibilities for consumer protection and for markets

The Bank of England itself will be responsible for:

- Crisis management, including the resolution of failed or failing banks
- Regulation of key infrastructure, such as payment settlement systems and central counterparties

Please note: the FCA's role in CCPs and settlement infrastructure is still under discussion

Regulatory Reform – New Vision



5

Regulatory Reform – Present Day

- **Expectations of firms (and of Supervision) remain**
  - prior shift to 'More Intensive and Intrusive' supervision
  - evidenced by 'Reserving Governance' visits to GI firms
- **Shift to new operating structure from April 2011**
  - Prudential Business Unit or 'PBU' in anticipation of PRA
  - Conduct Business Unit or 'CBU' in anticipation of FCA
- **Move to 'Twin Peaks' legal split expected in 2013**
  - will require Act of Parliament
- **In the meantime**
  - focus on smooth transition within business plan constraints
  - continuing to actively challenge and influence firms in the management of their risks

6

Reserve Governance Reviews

FSA

- **Largely a Q1 2011 exercise**
  - reflects "More Intensive and Intrusive" supervision strategy
- **Prompted by crystallised risks**
  - what is the current state of practices?
  - what issues are firms dealing with?
- **A series of visits to a sample of insurance firms**
  - looking at governance processes
  - how do we get from premium, claims and business system data to booked reserves?
  - what qualitative information feeds into process?
    - rates, underwriting mix, terms & conditions, business plan
- **Visits have led to some RMP (Risk Mitigation Plan) points**

7

Dear CEO Letter – March 2011

FSA

- **Prompted by concerns at state of environment, crystallised risk and some observed practices**
- **A reminder as to senior management responsibilities**
  - must have proper understanding of, and be able to explain, their risk appetite…
  - …and the consequences of that risk appetite in setting reserves
- **Raising awareness of potential pressure on reserving function and that pressure's influence on decision making**
- **Processes need to**
  - be considered and proportionate
  - be robust and subject to adequate internal challenge
  - capture the risks associated with an increasingly challenging claims environment

8

Solvency II – 18th April Conference

FSA

- **Speech by Julian Adams, Director of Insurance**
  - "...as we build the new regulator, we will be embedding Solvency II in all that it does, whilst preserving the best of the FSA's existing approach."
  - "…a large and vibrant insurance market here in the UK…"
  - "…significant level of appetite for the use of internal models…"
- **On the ORSA**
  - "…the principal means by which Solvency II draws together risk management, governance, controls and capital…"
  - "…into a single picture which is squarely the responsibility of firms' senior management…"
  - "…and which must be used in decision making.

9

Solvency II – IMAP pre-application

FSA

- **FSA resources available to devote to IMAP pre-application**
  - have decided to focus these on a smaller population of firms
  - those having the highest potential impact on the FSA's objectives
- **Focus on firms comprising the following sets**
  - major UK life and non-life firms – broadly the UK top ten
  - firms which have operations in the Lloyd's market
  - subsidiaries of major European groups where we will be obliged to participate in a college of supervisors

10

Solvency II – IMAP pre-application

- **Other firms in pre-application will receive a reduced level of engagement**
  - small degree of interaction with actuaries and other risk specialists
  - supplemented as always by interactions with supervisors to ensure that firms remain on-track with their plans
- **Proposing to develop various tools to *facilitate* review**
  - stress-testing of general insurance firms
  - reference portfolios to test model treatment of certain types of asset or business
  - industry standards on catastrophe models
  - specified models for certain esoteric types of firms
  - working with ABI and others
- **Introducing elements of external review into our approach**
  - pilot on data standards

11

Solvency II – IMAP pre-application

- **Directive is clear that the same standards apply to all firms**
- **Pre-application is now closed**
  - firms not in pre-application should not expect to receive a pre-day-one decision on an internal model
- **Being in pre-application**
  - does not guarantee a firm day-one approval of its model
  - we are striving to be in a position to *make a decision*
- **Reduced level of attention to some firms**
  - does not necessarily imply firms less likely to have a decision prior to day one
  - focus of resources on largest and most complex…
  - …also, cannot make decisions about group internal model applications in isolation

12

Solvency II – IMAP applications

- **Open from 30th March 2012**
  - later than originally envisaged
  - reflects dependence on EU policymaking process
- **Plan to remain open for two months**
  - expect to close on 31st May
  - firms planning to submit formal application later than the end of May next year are unlikely to receive a decision before day one
- **Our processes designed with regular review points**
  - firms felt likely not to be able to meet the required standards in time…
    - will be invited to leave the process…
    - and invoke their contingency plans at these checkpoints…
    - which will allow us to conserve our resources

Solvency II – Contingency plans

- **Non-approval of model**
  - revert to standard formula
  - …either for firm's whole business or parts not covered by approved elements of a partial model
- **Using standard formula not that simple**
  - responsibility to assess its suitability
  - confident it properly reflects risks inherent in business
  - should be reflected in their ORSA
  - make use of Undertaking Specific Parameters (USPs) or other adjustments to the standard formula
- **If regulatory capital requirement increases**
  - explain approach to meeting those additional requirements

Integrated / Enterprise Risk Management

- **Actuaries**
  - history and strength in liability risks
    - e.g. GI underwriting and reserving
  - some involvement with asset risk
    - more for Life side than GI
    - limited look-through to traded markets, securitisation and use of complex derivatives
- **Other risk specialists**
  - can help complete integrated risk management offering, and broaden actuaries' skills-set
  - encompasses credit, market, liquidity, operational and securitisation risk

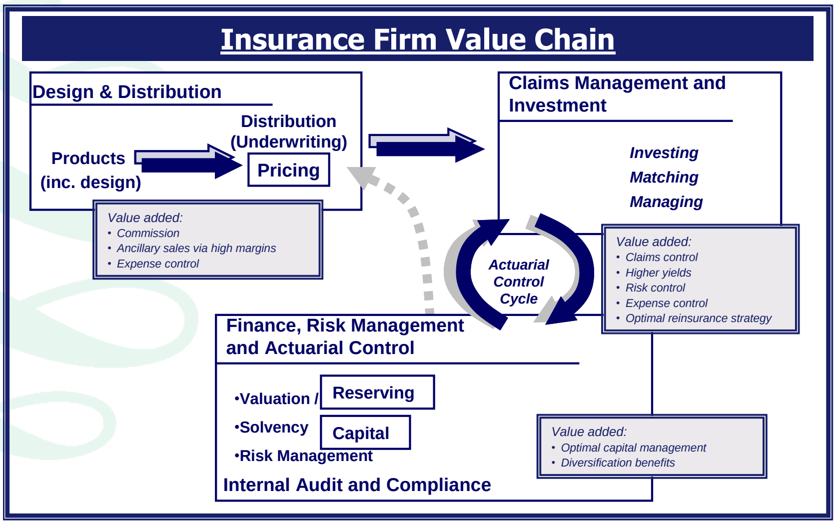
15

Pricing, Capital and Reserving

- **<u>Pricing</u> Risk is central to insurance business**
  - the "cost of production" – but it's really difficult…
  - …you might not know the right answer for years
  - also, expected profit can play a key role in capital assessment
- **<u>Reserving</u> should show us the expected cost of claims**
- **Accurate <u>Capital</u> assessment plays a dual role**
  - completing the Risk Price picture
  - illuminates the risk profile and solvency position
    - feeds into allocation of capital across lines of business
    - crucial role in wider risk management
- **So, get the Reserving wrong and you might…**
  - overstate your capital
  - misprice the cost of claims and price of risk
  - accept too much risk, in the wrong places

16

Pricing, Capital and Reserving



17

Integrated / Enterprise Risk Management

- **A threat and an opportunity for actuaries**
  - remain in a deep and narrow specialism
    - vital, but ultimately limited role within business
  - a more complex world
    - increasing the pressure for innovation within firms
    - greater(?) scope for external threats to business
  - strong cues from Solvency II
    - Risk Management and Actuarial Functions
    - Opinions on Underwriting and Reserving Strategies
  - greater responsibilities and authority(?) for CROs
    - still in the era of 'trail-blazers'
    - ideal fit not yet apparent
- **So, the question arises**
  - *"What skills and behaviours do actuaries and other risk specialists need to rise to this challenge?"*

18

Questions?

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