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HOW THE FSA IS GOING TO AFFECT YOU!
(OR HOW TO AVOID GOING TO PRISON)

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Proposed FSA rules – Opportunities for GI Actuaries & 2 pleas for help

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This paper describes some matters which we expect to be contained in FSA rules coming into force in Autumn 2002. The Board of an insurer should satisfy itself that it has adequate resources. One way of doing this is to commission a Financial Condition report, or at least ensure that similar work is carried out.

The purpose of the paper is to encourage comment from actuaries on the draft rules, due to be published in the spring and to encourage them to continue and to develop their involvement and expertise in general insurance.

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1. <u>Introduction</u>

1.1 The Financial Services and Markets Act 2000 became law on 14 June.

1.2 From "N2", which is expected to be about July 2001, most existing legislation relating to the supervision of insurers[1] will be replaced by rules and guidance made by the FSA under the Act. Significant changes will be introduced in many areas but there will be little change in the financial supervision of insurers as an immediate result. The Interim Prudential Sourcebook will restate existing legislation relating to financial supervision with minor modifications.

1.3 The Integrated Sourcebook, which is expected to come into force in Autumn 2002, will make significant changes. It is hoped to publish a consultation paper in the spring containing draft rules. **Our first plea for help is that you should read that consultation paper and comment on it.** We will not get it 100% right first time, and the more informed comment we get the better. This paper describes some matters which we intend the Sourcebook to cover.

1.4 A fundamental defect of existing prudential insurance legislation, primarily the Insurance Companies Act 1982 and Regulations made under it, is that it provides little guidance to the regulator about the purpose of regulation, and lays down little in the way of standards of behaviour for insurers.

1.5 However:

- insurers must maintain a required minimum margin of solvency;
- they and their controllers and managers and Directors must be "fit and proper";
- the business must be carried on in accordance with the criteria of sound and prudent management[2], including having "due regard to the interests of policyholders and potential policyholders";
- if there is a "risk that the company may be unable to meet its liabilities", then this provides grounds for regulatory intervention.

1.6 This looks impressive, until it is deconstructed.

- The required minimum margin is much too small in most instances.
- "Fit and proper" is usually taken to mean being honest (or at least not having been detected in fraud) and having adequate experience and knowledge. It has proved

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[1] Including Friendly Societies: though this note is written primarily with insurance companies in mind, most of it applies to Friendly Societies also. It does not apply directly to Lloyd's, though it will be necessary for Lloyd's to apply similar standards. Indeed the Lloyd's risk based capital system and other monitoring exercises carried out by the Lloyd's are intended to address similar concerns to those underlying the material in this paper.

[2] Schedule 2A of the Insurance Companies Act 1982.

difficult to use it to bar controllers etc who take (or who are suspected of taking) risks at policyholders' expense.

- The meaning of "due regard" is unclear. Guidance is needed so that both the regulator and insurer know where they stand.
- There is always a risk that something may happen to make a company unable to meet its liabilities. How great may this be before the regulator can intervene? Again some guidance or precedent is needed.

So what do we want to introduce to remedy these gaps? And what opportunities will it give to general insurance actuaries?

1.7 The FSA must have regard to "the responsibilities of those who manage the affairs of authorised persons"[3]. Thus, with one exception, none of the new requirements to be introduced are intended to impose additional burdens on competent and responsible insurers. Rather they are intended to bring all insurers up to the standards of the best. The exception is that compliance will need to be documented, so that FSA can periodically check compliance.

2. <u>Basic requirements</u>

(1) An insurer should:

- <u>understand</u> the risks and commitments that arise under insurance contracts; and
- manage them with prudence.

(2) Systems of control must include adequate controls over:

- underwriting;
- claims management;
- provisioning; and
- <u>determining the overall adequacy of its resources</u> to support its insurance business.

2.1 A lot of detail flows from these two basic requirements. The detail includes business plans, underwriting limits, limits on aggregations and so on.

2.2 We would emphasise that we are not asking insurers to do more than is needed to manage their business properly. Indeed, leaving aside the specific insurance aspects, any commercial business (including the smallest corner store) should be able to meet these requirements. The degree of detail that would be appropriate depends on the nature and scale of the business and the extent of the resources available.

- An insurer writing one line of business with no major uncertainties might be able to construct an adequate business plan on the back of an envelope. There may be

[3] Section 2(3) of the Financial Services and Markets Act 2000.

no concentrations of risk, the maximum sum insured may be relatively small, and it may need just one reinsurance contract.

- An insurer writing diverse lines of business with major concentrations, catastrophe exposure, third party liability and exposure to latent claims will need a detailed and complex business plan. There will need to be projections for each line. There will need to be a complex reinsurance programme and controls on aggregations. Procedures for measuring and managing latent claims will need to be described in the plan. And so on.

- If the resources available are relatively slender, then a lot of work will be needed to demonstrate that they are adequate. If they are considerably more than adequate, it should be relatively easy to demonstrate this.

2.3 At present there is no formal requirement for insurers to produce business plans except in specific circumstances. However Insurance Division meets insurers regularly as part of the supervisory process: among other things, it uses these meetings to satisfy itself is that insurers have adequate business plans, and that these are monitored so that appropriate action can be taken if things go wrong. So we are not for the most part asking insurers to do anything new.

3. Business plans, underwriting, claims management, provisioning

3.1 We do not intend to discuss these in any detail in this paper. We just mention a few points.

3.2 As noted above the degree of detail appropriate to a business plan would depend on the nature of the insurer and business it intended to carry on. The insurer should measure its progress against the plan, and, as experience diverges from the plan, modify it and take appropriate action (not necessarily in that order). Adequate triggers to enable this process need to be within the plan.

3.3 There will need to be controls on the amounts and nature of business accepted. Aggregations and business mix will need to be monitored and appropriate reinsurance arrangements put in place.

3.4 Significant claims and aggregations of claims will normally require active management.

3.5 As regards provisioning, readers of the paper will be well aware of the importance of accurate and complete data, and the need to carry out appropriate analyses and to justify the conclusions reached. The feed-back loop from provisioning to rating and underwriting strategy is a critical factor in controlling an insurer.

4. Adequate resources

4.1 The new Act requires as part of its "threshold conditions"[4] that resources of a person (e.g. an insurer) must, in the opinion of the FSA, be adequate in relation to the regulated activities it carries on or seeks to carry on. The FSA cannot[5] grant an application to carry on insurance (or indeed any other regulated activity) unless the threshold conditions are met. It may withdraw permission to write new business or impose other requirements[6] if the threshold conditions are not met.

4.2 This criterion relates to all resources, not just financial. An insurer has insufficient resources if it has insufficient depth of management or inadequately trained staff. To some extent additional capital can cover for inadequacies elsewhere as it allows gaps to be covered by buying in expertise.

4.3 There is a subtle but important difference from the current regime. Under the current regime maintenance of the required minimum margin is treated as the major requirement. Under the new regime adequacy of financial resources is to be a fundamental requirement and there is no presumption that meeting the required minimum margin is sufficient. The required minimum margin remains (as it must to comply with European Law) but will clearly be a minimum.

4.4 The importance of the difference is that an insurer will need to convince the FSA that it has sufficient capital. The most nearly equivalent current condition is that there should not be a "risk that the company may be unable to meet its liabilities", and as explained above this can be a difficult criterion to satisfy. None of this means that there will be any vast increase in FSA intervention. The FSA may not act capriciously and its opinion will need to be reasonable, but it is for the insurer to demonstrate that its resources are adequate. Thiswill allow the FSA to intervene more easily and quickly when necessary for the protection of policyholders.

4.5 As far as new authorisations[7] are concerned there will be little change in this respect. Current practice is already that if FSA considers that more capital is needed, then an application for authorisation may be refused[8]. However the wider use of the criterion that resources be adequate is likely to lead to improved techniques for estimating the resources required.

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[4] Schedule 6 of the Financial Services and Markets Act 2000.

[5] Section 41(2) of the Financial Services and Markets Act 2000.

[6] Section 45 (and 43) of the Financial Services and Markets Act 2000.

[7] Under the new terminology, a Part IV permission or a variation of an existing permission.

[8] An application needs to have significant capital in excess of the minimum requirements, if there is to be any chance of convincing the regulator to grant an authorisation.

5. Demonstration of adequate financial resources

5.1 The resources available include all resources that may be reasonably relied on. They include reinsurance and assets supporting capital and technical provisions, as well as the investment return that these assets will generate.

5.2 The provisions need to cover expected liabilities, but the overall resources need to be able to protect policyholders against significant risk that valid claims will not be met. Realistic adverse scenarios (including any specific contingencies which have been insured against) and realistic combinations of them will need to be considered. Adverse scenarios may affect either assets or liabilities or both.

5.3 In considering what scenarios are reasonable, insurers will need to bear in mind that risks may be correlated. A natural disaster may not only cause direct loss to an insurer, but may also reduce the value of its investments. In addition not all the risks are stochastic in nature. For instance, a management failure in the insurer (whether a past failure which has yet to manifest itself or a future failure) can cause loss in a number of apparently unrelated areas.

5.4 There is no settled methodology for determining how much capital (and other resources) an insurer needs in order to protect policyholders. This does not mean that this is not a topic in which insurers are uninterested, just that individual insurers have devised individual answers to the question where necessary.

5.5 Many insurers are believed to maintain more capital than they need for policyholder protection for reasons that include the protection of shareholders from fluctuations and the maintenance of public image. In such cases they may not have formally considered whether resources are adequate to protect policyholders, because informal consideration convinced them that this was the case.

5.6 We expect that the FSA will find that different insurers will adopt varying standards for both methodology and prudential criteria. Comparison between insurers will identify those whose methodology or criteria are unduly weak, enabling the FSA to intervene[9].

5.7 The experience of insurers who get into difficulties or have large losses in future is another potential source of information (the way the Civil Aviation Authority investigates near misses shows what can be done, though FSA do not propose anything on a similar scale). Where appropriate FSA intends to use such experience as one means of to identifying scenarios that are insufficiently robust.

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[9] Intervention often involves no more than discussion. Formal exercise of powers is often unnecessary if the insurer knows they are available to be used.

6. Transfers of engagements

6.1 Under the Act, the FSA will not be able to determine applications to transfer general insurance business from one insurer to another. Application will be to the Court, as now happens for long-term insurance business. The application will have to be accompanied by a report on the terms of the insurance business transfer scheme by a skilled person.

6.2 The report must be in a form approved by the FSA. The FSA has yet to consider in any detail what it would normally expect such a report to contain for general insurance business. However the amount of the liabilities will always be a material consideration for the Court and it will often be appropriate for them to be determined by an actuary. Additional comment on variability and other liabilities of the transferor and transferee may be appropriate in many cases.

6.3 At present, it is not unusual when a transfer of engagements is contemplated for the FSA to ask for an actuarial report to be produced when the amounts involved are material. Procedures governing transfers have yet to be determined but there may not be a major increase in actuarial involvement.

7. Use of actuaries

7.1 It is not envisaged that there will be any requirement for insurers carrying on general insurance business to employ actuaries. (However when justified by the circumstances of a specific case, the FSA has the power to place such a requirement on a company.) The FSA encourages the use of people with an adequate mix of skills, and it is obvious that actuaries could contribute to a number of the activities described in the paper.

7.2 As noted above, the standard content of a report on the terms of an insurance business transfer scheme has yet to be determined. There may be some increase in formal actuarial involvement.

7.3 Although the Board of Directors are responsible for ensuring that systems and controls are adequate, we expect that they should be "audited" by people who are operationally independent and have an adequate mix of skills (underwriting, claims handling, accounting, actuarial and legal). We envisage that in many cases actuaries would have to be employed to advise on the adequacy[10] of financial resources. The financial condition working party, which intends to report early next year, is

[10] We do not envisage that any actuary is likely to say whether his company has adequate resources. But he can advise on what scenarios the company can survive and how much capital is needed to meet any chosen criterion.

considering what the content of a financial condition report might be and the methodology that might be used.

7.4 Our second plea for help is that actuaries should continue to be involved in general insurance and contribute and develop their expertise. The development of financial condition reports into a major tool for the management of insurers depends on the contribution of actuaries.