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Solvency II:
How to keep your supervisor happy

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Overview

- Review of activity to date
- Stocktake – where firms are, and where they should be
- Internal model approval process
- Key activity towards 2012

How to keep your supervisor happy

- **Solvency II represents a big step change for all stakeholders**
  - **Especially for FSA – for us it is a major change to the basis of supervision**
    - ***We already have in place a team of people preparing to rewrite the FSA handbook***
- **We are most impressed with firms who demonstrate that risk management is core to their business**
  - **Rather than merely a compliance burden**

How to keep your supervisor happy

- Supervision during- and post-crisis can be expected to be more intrusive
- Solvency II will not reduce the supervisory challenge, but it will change the nature of that challenge
  - Greater responsibility on the firm to evidence good behaviours and high quality risk management, from board down and throughout the organisation
  - Greater responsibility on FSA to assess, review, challenge firm behaviours and activities

Source: Guardian

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Lamfalussy legislative framework

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Communicating with firms

- Letters were sent to 460 UK firms (within SII scope) asking for the following information:
  - Governance arrangements for SII implementation and nomination of the key SII executive
  - Plans for the development of a formal risk management structure including plans for the ORSA
  - Details of any gap analysis performed to date and progress on implementation planning
- Also asking for details of internal model intentions:
  - Letter includes Pre-Application Qualifying Criteria and a request to confirm that the firm will engage with FSA in the first pre-application process
  - Request to identify the key executive with specific accountability for development and implementation of the internal model
  - FSA need to evaluate demand to ensure adequate resourcing

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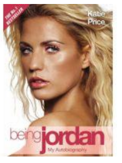
Stocktake – where you need to be now

- Evaluate implications / changes "gap analysis"
- Outsourcing an activity does not remove management responsibility for it
  - Did Jordan really write her autobiography ?
    - Has she read it yet ?
  - We won't forgive insurers for not having read – and understood and actioned - their "own" gap analysis



Source: http://static.bookdepository.co.uk/assets/images/book/medium/9781/8445/9781844541324.jpg

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Stocktake – where you need to be now

- Gap analysis leads to implementation planning
  - The best gap analyses also identify:
    - skills and experience (recruitment, training)
    - start and finish of activities (which can be deferred ?)
    - milestones (how to check progress against plan)
    - project management / budget
- Without senior management endorsement, implementation plans are of little value

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Stocktake – where you need to be now

- Firm should understand the likely implications of the standard formula
  - This requires completion of QIS4, and resource planning to participate in QIS5, where a "best efforts" basis is unlikely to be adequate to demonstrate the impact
  - QIS5 is now scheduled for August – November 2010, which will leave little time for analysis of implications
- A year ago, we flagged that firms should be familiar with the Solvency II Directive
  - Knowledge is still poor in some firms
  - You cannot plan around "level two" without a strong sense of the overriding Directive text

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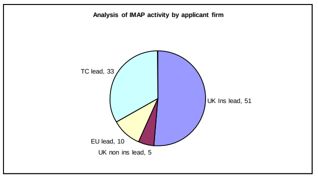
All large firms, most London Market (including Lloyd's) and many medium-sized firms are intending to apply for internal model approval

Only half of "UK" firms going for internal model approval have a UK insurer as their lead entity:



Balance of skills and experience for FSA is roughly:

- 35% actuarial
- 15% technical non-actuarial
- 25% supervisory and governance
- 10% policy and legal input
- 15% project management, reporting and MI

Challenges beyond the actuarial discipline – but not beyond the actuary !

- Stress and scenario testing traditionally involves the quantification of specific events (e.g. natural hazard, macro-economic)
  - This is an essential discipline, but provides an incomplete picture
- Reverse stress testing requires a firm to identify the kind of event that might cause a loss of a given amount
  - This is often – but wrongly – called "test to destruction"
  - Reverse stresses can be applied throughout a probability distribution, at group / firm or at a much more granular level (e.g. single class of business reserve risk)
  - So the concept can be applied at the level of P&L volatility, moderately bad year (1 in 20 ?), regulatory capital, economic capital

Source: FSA Consultation Paper CP08/24, Stress and Scenario Testing
http://www.fsa.gov.uk/pubs/cp/cp08_24.pdf

What you have told us…

- More research is required, especially on:
  - Modelling dependencies – especially tail dependencies
    - what about identifying them first?
  - Running stress tests during already stressed conditions
    - what about future stresses?
  - Catastrophe models
    - why are they always "wrong"?
  - Operational risk models
    - what is their purpose?
  - Meaning of 1-in-200 VaR
    - who has any "confidence" in our ability to understand what this "confidence level" actually means?