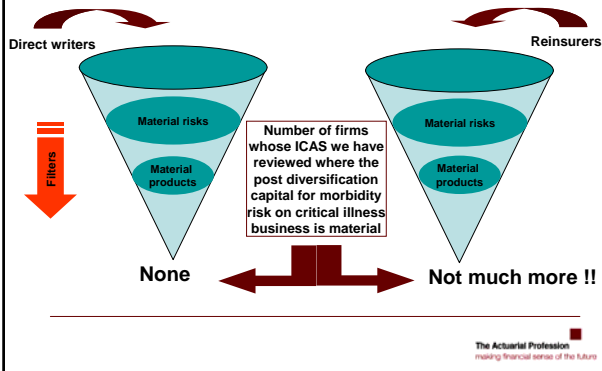


Critical Illness – MOT or Cosmetic Surgery?

Capital & Risk Management

Sid Malik
Financial Services Authority
December 2006

Proportionate regulation – important context



Overview

- How ICAS fits with Risk Management
- Current Practices
- Setting Stresses
- Issues
- Next steps

Why did the FSA introduce ICAS?

- The ICA regime is designed to increase the use of modern risk management and risk measurement techniques.
- The FSA is placing increasing reliance on principles based regulation and senior management responsibility.
- The FSA wishes to better understand the key risks facing firms and ensure that they mitigate these by setting appropriate level of capital and putting in place effective controls.

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How ICAS fits with Risk Management

- One of our statutory objectives is that firms have adequate capital resources to cover appropriately assessed capital requirements
- ICAS is our way of setting minimum standards for this objective
- Model results merely enable risk exposure and impacts of controls to be measured
- Even more important is how firms then manage these risks



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Benefits of analysing risks

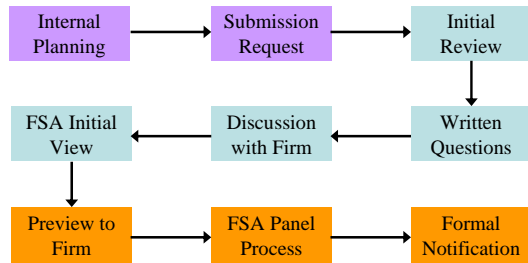
Understanding of:

- **Incidence** – how frequently do events occur?
- **Severity** – what is the impact of an event?
- **Diversification** – what is the effect on the bottom line?
- **Controls** – what actions can be taken to mitigate risk and how much do they cost?

Do you consider risks in these ways?

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FSA Process – Steps



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FSA process: People



- Reviewing team is made up of supervisors, actuaries and risk review specialists.
- They will prepare a report based on the ICA, the firm's RMP and face-to-face interviews. Policy may be involved in preparing advice for new areas.
- This report is presented to an internal independent FSA panel composed of senior management and specialists such as actuaries.

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Current Practices

Retail firms (direct writers)

- Critical illness business is a small part of overall business
- Materiality argument is used to take simplified approach
- Therefore use single uplift to claim rates or a deterioration rate
- This misses granularity of experience

Is it proportionate to allow these simplified approaches?

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Current Practices

Wholesale Firms (reinsurers)

- Critical illness business is more significant
- Some firms use stochastic methods
- However, deterministic approaches are still common

How can we ensure that deterministic methods are appropriate?

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Setting Stresses

We think it is best practice to consider the risks to claim rates under the following headings:

- Estimation risk – “is my best estimate right?”
- Trend risk – “what will happen in future?”
- Volatility risk – “what is the effect of random fluctuations?”
- Catastrophe risk – “what if things go badly wrong?”

Is there anything we have missed?

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Current Issues

- How can we satisfy ourselves that stochastic models are giving robust answers?
 - Calibration
 - Extent to which firms understand outputs
 - What the FSA needs to do to understand models
- What can be done about sparsity of data
 - Is a combined ratio appropriate
 - What level of granularity is possible

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Current Issues

- Are firms making the best use of their resources?
 - Have stresses been informed by data from marketing departments?
 - What type of medical expertise has been used?
 - Is the pricing basis the best 'realistic' starting point?
- What diversification benefits can be taken?
 - Does CI experience follow mortality?
 - Does CI experience follow other forms of health insurance?
- Management action
 - Reviewable rates - consistent with TCF and track record of having done it before?

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Where are we heading?



- Are firms understanding the messages the ICAS is giving?
- How are ICAS messages being communicated back to the business areas?
- Are firms using ICAS results to manage the business?

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