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Current Issues in General Insurance Seminar: 18 May 2007

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Update From the FSA

David Simmons

Current Issues in General Insurance Seminar 18 May 2007: Update from FSA

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Solvency II

FSA's preferred outcome – an insurance prudential regulatory regime that:

- Is as "Lamfalussy" as possible.
- Is risk responsive.
- Encourages internal capital assessments replacing standard formula.
- Gives benefit for diversification.
- Encourages sound risk management practices.
- Is practical for firms to comply with.
- Is not unduly burdensome for small firms.
- Is proportionate.
- Has a suitable gap between MCR and SCR.

Solvency II Timetable

European Commission plans to issue a draft of the Directive in July 2007.

According to the latest public statement from the Commission, it hopes the Solvency II directive will be implemented in 2010. Due to the number of parties that have to be consulted with, there might be slippage to this date.

As "Lamfalussy" as possible.

A "Lamfalussy" directive is one that contains high level principles and delegates to another body the authority to adopt "implementing measures" (i.e. to create and change the detail needed for the directive to operate). The rationale for this process is that detailed changes can be made as the world changes without the need for the European Parliament having to vote on the changes to the detail. The European Parliament can, however, object if it considers the implementing measures being adopted to be outside the scope of the original directive.

The authority to adopt implementation measures under the Solvency II directive would be delegated to the Commission. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) would advise the Commission on what implementation measures to adopt. The Commission would adopt the measures advised by CEIOPS provided the European Insurance and Occupational Pensions Committee (EIOPC) approves or does not object to the advice from CEIOPS. An example of the type of detail that might be so delegated in the Solvency II directive is the design of the standard Solvency Capital Requirement (SCR) formula.

There are signs that the Solvency II directive might be less "Lamfalussy" than FSA had hoped, i.e. there might be more detail in the directive than FSA had hoped.

A Risk Responsive Regime

A risk responsive regime is one where capital requirements, reporting requirements, regulatory constraints etc are all aligned with risk. Under a risk responsive regime the

supervisory authority is in a position to: identify risks in a firm, take appropriate intervention steps when warranted by the risks in the firm (such as requiring additional financial resources or restricting the business carried on), and enforce its powers of intervention.

Encourage internal capital assessments models replacing standard formula.

Internal capital assessments replacing standard formulae would necessitate a process of approving internal assessments. FSA's Director of Retail Firms Division, Sarah Wilson, in her speech to the City and Financial Conference on 20 March 2007, set out FSA's view on internal capital assessments replacing standard formulae. See

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0320_sw.shtml (FSA website / About FSA / FSA Sectoral Teams/Insurance/Speeches / Sarah Wilson 20 March Solvency II).

In summary, FSA's view on approval of internal assessments for the purpose of replacing standard formulae is:

- Approval criteria should be reasonable in order to encourage firms to replace standard formulae with internal capital assessments. Approval criteria should not force firms to do a significant amount of work over and above what a well run firm would do for its own capital assessment purposes. FSA is still forming its view as to what it might like approval criteria to be in practice.
- It would be a big step up from the current ICAS regime for both firms and the FSA. Though the ICAS regime has been a major step towards a process of approving internal assessments, both firms and the FSA would need to build on what has been learned and developed in the current ICAS process.

Discussions by the Pillar I working group are at too early a stage for us to have a view on what advice the CEIOPS might provide on internal capital assessment approval criteria.

Benefit for diversification.

Reduced risk arising from diversification should be recognised in reduced capital requirements. In FSA's view, diversification at group level should be recognised where funds are transferable between different group entities in the event of losses arising.

Encourages sound risk management practices

For instance a firm should benefit, whether by reduced capital requirements or reduced regulatory burden, if it demonstrates it operates good risk management, controls and governance. FSA wants to encourage real risk management, not just "box-ticking"

Proportionate

The lower the impact of the firm and the risks posed by the firm, the lower the regulatory requirements (be they capital, reporting, risk assessment visits etc).

Suitable gap between Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR).

Breaching the MCR should trigger the regulator imposing immediate material constraints on the firm's activities. The SCR should trigger the start of regulatory intervention, with a firm given time to take appropriate steps to avoid regulatory constraints having to be imposed. There needs to be a suitable gap between the two for the system to work. Precisely what constitutes a "suitable gap" is yet to be decided.

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Solvency II

What FSA is doing to achieve preferred outcome

- Active participation on:
 - The CEIOPS Pillar I, II and III and Groups working groups.
 - IAIS committees considering best practices of an insurance solvency regime.
 - IAA groups looking at risk management.
- Encouraging firms to respond to consultations and complete QIS3.
- Insurance Standing Group.
- 8-10 FSA staff currently full time, plus 3-4 staff spending some time, supporting these groups.

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CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) Pillar I working group.

Role is to produce advice on standards for valuation, capital requirements and capital definition for CEIOPS to give to the European Commission. Areas covered by this working group include:

- Valuation of technical provisions (including specification of risk margins);
- Specification of the Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR) – including the design, confidence level, time periods, assumed distributions, classification of business, types of risk to be included;
- Calibration of the MCR and SCR (i.e. deciding factors to use in the standard formulae);
- Requirements for approval of internal capital assessments (including the "use test").

Typically 3-4 FSA people attend each monthly meeting of the group. Currently the Chair of the group is from the FSA. The Chair will change in July 2007

This group along with the Financial Stability Committee of CEIOPS (on which an FSA person sits) design the Quantitative Impact Studies (QIS) questionnaires. QIS1 and QIS2 been completed and firms are now answering QIS3. QIS submitted by UK insurers are analysed by the FSA who feed the results into CEIOPS.

CEIOPS Pillar II working group

Role to produce advice on the insurance supervisory process for CEIOPS to give to the Commission. Areas covered by this group include requirements for carrying out stress testing and Own Risk and Solvency Assessments (ORSA) and how these would be subject to supervisory review, and Group supervision.

CEIOPS Pillar III working group

Role to produce advice on an insurance disclosure regime for CEIOPS to give to the Commission. Areas covered by working group include disclosure of prospective information, disclosure of firms own analysis of risks, public disclosure, disclosure to regulators.

CEIOPS Groups and cross sector working group

Role to produce advice to the Commission on the application of Solvency II requirements at group level. Areas covered by this working group include diversification at group level, transferability of capital, and supervisory co-operation amongst member states. FSA would like a proper economic focus with respect to group supervision which reflects how groups are managed. For those groups that manage their risks at group level FSA would like the predominate focus to be on group supervision whilst recognising there will be a need for some entity supervision (e.g. a group SCR and entity MCRs)

In July the Commission plans to publish the draft Directive and the above groups plan to change their Chairs. Consequently, the role of the above groups may change.

IAIS (International Association of Insurance Supervisors), IAA (International Actuarial Association)

FSA personnel participate on these committees in order to help bring about consistency between guidance on solvency regimes and risk management from the IAIS and the IAA and the insurance regulatory regime coming out of the Solvency II project.

Responding to Consultation and Completion of Quantitative Impact Study (QIS) 3

When CEIOPS consults (and QIS3 is a form of consultation) it is important that firms:

- i. Respond, preferably via their trade body, or in the case of QIS3 via the FSA;
- ii. Provide feedback that is constructive and evidence based; and
- iii. Identify what they like as well as dislike. (If you omit to identify what you like, it may disappear from the next version because someone has said they dislike it.)

The purpose of QIS3 is for the Pillar I working group to assess the impact of the currently proposed Solvency regime under Solvency II on the firms who will be subject to the regime. Completing QIS3 is likely to be a challenge and will require a significant input from firms. However, it is an important opportunity for firms to let the CEIOPS Pillar I working group know (via the FSA) whether the proposed EU requirements on firms to set technical provisions and determine their Minimum and Solvency capital Requirements are, in any way, not practical, inappropriate, unsuitable or produce nonsensical results.

Hence, it is in firms' long term interest to:

- complete QIS3 as best they can;
- communicate to the FSA and their trade bodies where they consider any Solvency II proposals (be they in QIS3, CEIOPS advice or the draft Solvency II directive when it emerges) to be inappropriate, unsuitable or just plain wrong;
- cite evidence, with costings where appropriate, to support their argument as to why a proposal is inappropriate or unsuitable.

FSA wants a regime that is practical for firms to comply with. The more evidence firms can provide to justify that something is not practical, the easier it is for FSA to argue the case at the CEIOPS / Pillar I working group.

Insurance Standing Group

This is run by the FSA and comprises FSA personnel involved in doing work for the CEIOPS working groups and representatives from the Industry. The purpose of the group is to discuss issues the industry might have arising from proposals under Solvency II and how these might be addressed.

ICAS

- New rules and guidance on ICAs (INSPRU 7.1) came into effect 30/12/2006.
- Around 130 firms (excludes non-relationship managed firms (small firms), Lloyd's syndicates and branches) are subject to requirement to submit ICA to FSA.

FSA Handbook of rules and guidance on ICAs in INSPRU 7.1

These were made to clarify requirements on firms carrying out an ICA. In particular, FSA recognises that there may be differences between a firm's capital assessments for its own and regulatory purposes. There is a distinction in INSPRU 7.1 between a firm carrying out an assessment of capital adequacy:

- i. for its own internal purposes (INSPRU 7.1.15), and
- ii. for which a written record is to be submitted to FSA (“... a 99.5% confidence level over a one year timeframe that value of assets exceed value of liabilities ...” INSPRU 7.1.42 and 7.1.49).

INSPRU 7.1 also contains requirements with regard to syndicate and the Society of Lloyds ICAs (INSPRU 7.1.3, 7.1.75 to 77, INSPRU 7.1.83 to 85, INSPRU 7.1.89 and 90).

INSPRU 7.1 came into effect via instrument 2006/62 and was the result of Consultation Paper 06/16 published September 2006 and Policy Statement 04/16 published December 2006. Instrument 2006/62 introduced a FSA Handbook definition of *Individual Capital Assessment*.

FSA expects ICAs to take into account ultimate claim cost from business covered in the assessment. This is alluded to, rather than explicitly stated, in the Handbook (see INSPRU 7.1.35 and 7.1.48). For instance it may be that if a 99.5th percentile adverse scenario were to arise, the scenario would not materialise or be known about over a one year timeframe. Nevertheless, in such a scenario an insurer would ultimately be obliged to meet the claims. Therefore the scenario should be fully taken into account in the ICA.

FSA's plans to increase the alignment of ICAS and ARROW. The ICAS and ARROW assessments should inform each other and give a consistent message to firms.

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ICAS

- FSA on track to give a first ICG to all applicable firms by end June 2007.
- Some of the larger firms have been given ICG for second time.
- Slight change in approach for giving ICG for the second and subsequent times.
- FSA reviews a sample of Lloyd's syndicate ICAs each year.
- Branch ICAs reviewed according to materiality of UK business and regulatory regime.
- Small firms: Standard ICA submission template, "batch" process.

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Review of ICAs prioritised by firm size. Firms to whom we have yet to give a first ICG are generally the smaller relationship managed firms.

Giving ICG for second and subsequent times.

The process is fundamentally the same as for the first ICG, i.e. FSA reviews the submitted ICA and gives ICG. The focus of the review of the ICA may differ for second and subsequent ICGs. We may well focus more on changes since the previous ICA (some of which may have been made to address issues FSA had raised in the previous submission), the bigger issues and on areas where we did not full get full comfort at the previous review.

Lloyd's Syndicates

FSA reviews a sample of Lloyd's syndicate ICAs. FSA will generally review different syndicate ICAs as at 1/1/08 than as at 1/1/07. Purpose of FSA reviewing syndicate ICAs is twofold. Firstly to check Managing agents are complying with relevant rules, in particular INSPRU 7.1.3, 7.1.75, 7.1.76. Secondly to ensure that input into the Society ICA is appropriate (see INSPRU 7.1.77).

Branches

FSA's decision on whether to ask a firm carrying on business in the UK through a branch to submit an ICA depends on the proportion of the firm's business carried on through the branch and the confidence FSA has in the regulatory regime to which the firm is subject.

Small Firms

There are about 50 small firms (more specifically non-relationship managed firms). Generally a small firm writes less than £10m premium. The small firm ICA process is intended to minimise burden on small firms as much as possible. FSA sends small firms a template to complete with key financial data, narrative of the nature of the firms business and customers, stress test results and an ICA result broken down by FSA Handbook risk category. The ICAs submitted by small firms are processed (ICG is given) in batches, e.g. all Health Cash Plans done together.

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ICAS

General Comments on firms' ICA Submissions

- Clearer or more prominent definition of the firm's ICA.
- Better audit trail to show how the more detailed work feeds into the overall result.
- More thorough sensitivity testing.
- More consideration of likelihood of events in stress and scenario analysis.
- More thorough consideration of the scenarios that would wipe out the firm's capital.

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Definition of the firm's ICA

Where components of the ICA result are a particular percentile (usually 99.5th) of a generated distribution of scenarios, e.g. profit arising in a year or claims arising in a class, the distribution concerned is not always clearly defined.

Audit Trail

Some submissions contain comprehensive detail on how particular components of the ICA are derived e.g. mean of loss ratios or standard deviation of claim severities etc, but little detail on how these items feed into the overall result.

Sensitivity testing

It is not always made clear which are the most sensitive assumptions, i.e. which assumptions if tweaked slightly have the greatest impact on the overall result.

Likelihood of events in stress and scenario analysis.

Sometimes scenarios are presented in stress and scenario analysis without consideration of the likelihood of the scenarios occurring. This makes it difficult for us to relate the stress and scenario tests to a 99.5% confidence level of assets exceeding liabilities.

Consideration of the scenarios that would wipe out the firm's capital

Once a firm has assessed its capital needs, by probabilistic means or by stress and scenario analysis, FSA is very interested to know what scenarios, in the firm's view, would wipe out that amount of capital.

FSA is considering putting out an Insurance Sector Briefing specifically on ICAS.

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Equitas - Retrocession and Transfer

- Retrocession agreement came into effect 1/4/07.
- “Stage 2” - a Part VII transfer.
- Good for consumer protection and market confidence in FSA’s view.
- FSA has been in discussions with Equitas, and NYID and UK Treasury.

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Retrocession agreement

With National Indemnity Insurance Company, part of Berkshire Hathaway group. Equitas Ltd passes its assets to NICO as premium. In return for this payment, NICO pays Equitas’s unpaid claims at 31/3/2006 up to a limit of undiscounted net liabilities plus \$5.7bn.

Equitas Ltd outsources its managing agency functions (settling claims, setting provisions, reinsurance collection, etc) to Resolute Management Services which is part of the Berkshire Hathaway group.

FSA's main interest is how the agreement impacts consumer protection and market confidence.

Key issues FSA considered were:

- Reinsurance credit risk over a long tail run-off;
- The inherent uncertainty of estimating Equitas's liabilities (which are long tail and contain significant amounts arising from APH) and the risk that ultimate claims turn out to be significantly higher than the estimate at 31/3/2006.

Stage 2 – The Transfer

This would be a Part VII transfer from reinsured Names to another insurance entity. If transfer takes place, the limit NICO will increase the limit of the retrocession by \$1.3bn.

FSA's discussions

NYID (New York Insurance Department) is the US regulator. FSA's discussions were regarding issues raised by the transaction that had a potential impact on consumer protection or market confidence.

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Contract Certainty

- “Complete and final agreement of all terms between insured and insurers before inception”
- FSA announced 24/1/07 that industry met challenge.
- Momentum to be kept up.
- Legacy Policy issues to be addressed.

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Challenge Met

Industry reported that 90% of contracts in the subscription market and 88% in the non-subscription market are now achieving contract certainty.

The Industry's Contract Certainty Steering Group say that at April 2007 93% of contracts are achieving contract certainty (based on information provided by brokers and insurers to the group).

Momentum kept up

Market's contract certainty groups to continue.

FSA regulatory priority in 2007.

Potential for FSA action against poor performing firms

Legacy Policy Issues

Check no non-agreed terms on old policies on which claims might still arise

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Treating Customers Fairly

- Fair Treatment of customers central to corporate culture.
- Products meet needs of consumers they are targeted at (NB Payment Protection).
- Clear information, consumers kept informed.
- Suitable advice.
- Products perform as firms have led to consumers to expect.
- No unreasonable post sale barriers to consumers.

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FSA's Treating Customers Fairly (TCF) initiative for the General insurance industry is a major retail priority. Through TCF, FSA are challenging firms to ensure that they treat their customers fairly at all stages of the product lifecycle. Through TCF FSA are aiming to achieve real change in firms' behavior to deliver fairer outcomes for customers. FSA has articulated six consumer outcomes to explain to firms what it wishes to achieve through TCF.

1. **Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.**
2. **Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.**
Some Products and services are suitable for particular types of consumer need. We expect firms to take steps to ensure that they are not sold to groups of consumers for whom they are inappropriate. For example, we have seen PPI products sold to people whose employment status means that they are ineligible to benefit from them.
3. **Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.**
4. **Where consumers receive advice, the advice is suitable and takes account of their circumstances.**
That is, that the advice must reflect their needs, priorities and circumstances.
5. **Consumers are provided with products that perform as firms have led them to expect and the associated service is both of an acceptable standard and as they have been led to expect.**
This involves being clear about what product or service is being provided and the range of possible results and experience for the consumer.
6. **Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint**

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Reinsurance Collateralisation

- US cedants allowed credit for reinsurance to non-US reinsurers only if reinsurance 100% collateralised.
- FSA's view – requirement, which impacts UK firms, is not a risk based.
- FSA discussions with NAIC.
- NAIC proposed a Reinsurance Evaluation Office (REO) to determine collateralisation requirements on a risk basis.
- At present, far from clear what changes, if any, will take place.

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Not a Risk based Requirement

A US reinsurer with poor financial strength is not required to collateralise its liabilities to US cedants, whereas a non-US reinsurer that is financially strong would be so required.

FSA discussions with the National Association of Insurance Commissioners (NAIC)

On reducing requirement on all liabilities of non-US reinsurers to US cedants to be 100% collateralised in order that the US cedant be allowed regulatory credit for such reinsurance under US regulations.

FSA considers its regulatory regime to be on a par with that in US. Therefore FSA argues that the US requirements for collateralisation of liabilities of all non-US (in particular UK) reinsurers to US cedants is not risk based and could be eased without material policyholder detriment.

An ease of the requirements with regard to UK reinsurers would benefit UK reinsurers reinsuring US cedants.

Reinsurers' collateralisation requirements on a risk basis.

The idea being that the better run, regulated and capitalised the reinsurer, the lower would be the collateralisation requirements on the amounts a US cedant has ceded to that reinsurer in order for the US cedant to be allowed credit for the reinsurance.

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International Association of Insurance Supervisors (IAIS)

FSA personnel participate on the following groups within the IAIS.
(info correct at 16/4/2007)

- Technical committee
- Budget Committee
- Solvency subcommittee (chair)
- Accounting subcommittee
- Insurance contracts subcommittee
- Financial Conglomerates subcommittee
- Reinsurance subcommittee
 - Mutual Recognition task Force
- Reinsurance Transparency Group (chair)
- Enhanced Disclosure subcommittee

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Technical Committee

- Is the committee that co-ordinates setting of technical standards.
- Many of the subcommittees whose role is to set technical standards report into the Technical Committee.

Solvency and Actuarial Issues Subcommittee.

- Reports into the Technical Committee.
- Chaired by FSA person
- Representative from European Commission sits on the subcommittee (facilitates link into and consistency with Solvency II).
- Role is to produce standards on solvency regimes.
- Has produced IAIS Framework, Cornerstone and Structure papers on common structure for Solvency assessment of insurers (input to draft Solv II directive).
- Following from these papers, subcommittee is in the process of producing:
 - Standards papers on:
 - Valuation of assets and liabilities,
 - capital resources and requirements, and
 - risk management
 - and a guidance paper on internal models.

Insurance contracts subcommittee

- Reports into the Technical Committee
- Inputs into the International Accounting Standards Board (IASB)
- Role is to influence alignment of solvency requirements and fair value accounting. (Material differences between the two would cause problems for firms, analysts and supervisors)

Reinsurance and Other Forms of Risk Transfer subcommittee

- Reports into the Technical Committee

Reinsurance Transparency Group

- Reports into the Technical Committee

FSA's purpose for being on these groups is to:

- Maintain relationships with other regulators. Insurance is a global industry, FSA needs to maintain good relations with other regulators if it is to effectively supervise UK firms that are parts of non-UK groups.
- Know what is going on.
- Influence development of standards that are principles based, risk based, and create as level a "playing field" as possible across jurisdictions where insurers can operate.

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Attractiveness of London as a place to do Insurance Business

- Reduced time taken to authorise insurers, where appropriate.
- Cedants can take credit for amounts due from Insurance Special Purpose Vehicles (ISPVs)
- Ongoing discussions with UK Treasury.
 - but corporation tax an issue for Treasury not FSA

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Time taken to process authorisations

FSA has said that at times of market pressure (e.g. as was the case in late 2005 after Hurricane Katrina), it will authorise firms known to it within 4 weeks and others within 10. The average time taken for insurance authorisations processed in 2006 was 14 weeks. Where possible FSA will work to the applicants project.

Cedants can take credit for amounts due from ISPVs

This was achieved through FSA's implementation of the EU reinsurance directive.

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Current and Planned Thematic Work

- Claims systems and controls
- Climate Change
- Contract certainty
- Delegated Underwriting Authorities
- Outsourcing
- Reserving
- Schemes of arrangement
- Treating Customers fairly
- Underwriting Cycle

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The above items should be treated as insurance market issues that the FSA is interested in looking at.

The timing and intended outcomes of these streams of thematic work is yet to be decided.

The above list consists of items likely to be of interest to the audience at this seminar. Other thematic work is not listed above.

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Any Questions