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Will Solvency II Deliver For Insurance What Basel II Delivered For Banks?

Mark Eyre – some personal views

Why might I have some insight?

18 years of Banking and now a year of Insurance

- 10 years running Economic Capital frameworks
- During banking career responsible for:
  - Basel II ICAAP submission
  - Stress & scenario testing
  - Risk Appetite
- Now responsible within RSA for:
  - EC framework
  - ICA submission
  - Solvency II response

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Setting the record straight (1)

Some Basel II truths are…

- Basel II went live in the year of the Banking collapse
- Banks had made only one ICAAP submission:
  - Stress & scenario testing was a new skill
  - Appropriate use of Risk Appetite is not widespread
  - Regulators hadn't understood how to assess Pillar II, e.g. concentration risk & liquidity risk
- Basel II models fed regulatory formulas (PD/LGD/EED)
- Can a new framework save an industry in its first year?

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Setting the record straight (2)

Much of what went wrong was "left out of scope"…..

- Market risk - approach not altered in Basel II yet most of the ABS risk and leverage was within DVaR
- Liquidity risk was a Pillar II risk for assessment by the firm and the regulator (and then subject to an add-on). Did anyone get a capital add-on?
- Concentration risk was to be assessed in Pillar II but again did anyone get meaningful add-ons?
- Rating agency grades were fully relied upon – only hindsight has allowed us to see this error

Rubbish in rubbish out

It wasn't poor modelling…..but poor risk assessment

- Market risk – all investment banks under-estimated ABS risk in DVaR (and consequently so did EC), e.g. Lehman
- Liquidity risk – measured but not acted upon, e.g. Northern Rock
- Poor risk management – some firms went off piste and had large concentrations of risks they did not understand, e.g. AIG, HBOS and Bradford & Bingley
- Rating agency grades of ABS – over worked staff were not checking risk of under-lying assets

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What went very well? (1)

The focus on DATA quality is forcing a step change

- Data polices – For the first time large firms established data policies
- Data dictionaries – Establishing firm wide definitions, e.g. what is a default?
- Data warehouses – Facilitating reporting and better risk management
- Data drives better MI and risk/reward decisions

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What went very well? (2)

RISK management is greatly enhanced

- Improved risk frameworks
- Enhanced risk governance
- Clearer and actionable Risk Appetite – even linked to capital engine
- Step changes in stress testing – these changes led to FSA DP at end of 2008

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What went very well? (3)

FINANCE engagement with risk and capital

- FINANCE eventually engaged
- Alignment or reconciliation of balance sheet to capital engines
- Financial control throughout capital processes
- Engagement of Auditors in capital engine
- Increased CFO engagement!

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What went very well? (4)

FSA improved their performance

- FSA inevitably reviewed more of the detail
- FSA staff absorbed learning and improved challenge
- Capital add-ons explained better
- However, Banks had bigger cheque books so FSA remain behind the curve
- Question – do the FSA Insurance team know enough about Basel II to avoid the same mistakes?

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What can Insurance do better than Banks?

With 20/20 hindsight I'd recommend:

- Use your best not worse staff
- Don't fill up on contractors who claim to know Basel II
- Remember IT suppliers over promise and under deliver
- Expect consultants to contradict each other
- QIS numbers will be woefully completed in Excel and eventually prove to have over-estimated savings
- Most mistakes won't be seen until you go live
- Get full engagement from Finance

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Some final thoughts

Crack these points and you will enjoy Solvency II!

- How do you get talented individuals involved?
- How do you get BAU teams engaged in design?
- How do you engage senior management (CFO/CEO)?
- How do you stop the CFO forcing down the answers from the capital model?

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Questions

Happy to discuss any aspect of these views

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