Introduction

- Use test?
- Effective basis for decision making?
- BOTH?!

We will discuss:

- The requirements of the Use test
- Possible interpretations (use-ful or use-test?)
- Practical next steps
The Use Test – what’s it all about?

“Letter ” of the Use-Test:

“The undertaking’s use of the internal model shall be sufficiently material to result in pressure to improve the quality of the internal model.”

“Spirit” of the Use-Test:

• Aligning interests;
• Preventing “gaming of the system”, paying “lip service”; 
• Ensuring faith in the numbers;
• Continuous investment.

---

The Use Test – what’s it all about?

A Familiar Context: Theory of Incentives

• Principal-Agent Problem and Asymmetric Information.
• e.g. Delegated Underwriting Authorities, Reinsurance Submissions
The Use Test – from the regulator’s viewpoint

- Which means that:
  1. Focus is on the 1-in-200: “Use” should enhance the confidence in the regulatory capital derived
  2. Focus is on the numbers, not the platform: “Use” may be decoupled from using the DFA platform itself
  3. “Use-Test” does not necessarily imply Usefulness to the business
- In the background it also sends “signals” about the company’s risk management.

The Use Test – from the company’s viewpoint

- Which means that:
  1. Range of return periods: E.g. 1 in 5 is more useful, to understand short to mid-term volatilities in the financials
  2. Complexity vs usability: Simplifying approximations/ faster run times would make the model more “useful
  3. Mapping existing/planned uses of the model that the business is bought into is better than “creating” uses to fit the requirements
- The more the model gets used and challenged the better it gets
Use-Test Vs. Use-ful – examples of Use

Risk ranking
Reinsurance planning
Managing fraud risk
Business planning
Monitoring against risk appetites
Exposure management e.g. catastrophes
Investment portfolio allocation
Capital allocation to risk type and/or lines of business
Performance management
Capital setting
Stress and scenario testing
Negotiating capital with rating agencies
Managing extreme tail events (>1 in 500yr)
Asset liability management
Setting benchmark prices
Determining reserve sufficiency levels
Remuneration

Use-Test Vs. Use-ful – let’s talk

Key Business Decisions:

1. Working Reinsurance Pack/Purchasing
2. Cat Reinsurance Pack/Purchasing
3. Risk load for pricing individual policies
4. ROC Performance Measurement at class-level
5. ROC Performance Measurement at business unit-level
6. Underwriter Remuneration
7. Business Planning
8. Risk Ranking
9. Raising Capital
Use-Test Vs. Use-ful

- Where should you sit on the scale?

Minimum compliance
- I do not believe my model
- I just need to cross the line this year
- ....

Model "informs decisions on my x-y key business decisions"

Model "makes my x-y key business decisions"

Model cornerstone of every business decision – nothing happens without the model .......

Next steps
Possible plan to implementation

- Workshop to determine:
  - What might be useful and where are the information gaps?
  - What might be possible?
  - Any areas where validation needs to be strengthened?
- Feasibility study
  - Focus on small number of big wins
  - Test MI ideas on relevant parties
- Plan the “Solvency II feedback loop”
  - Make sure you are addressing specifics of “Use test”
- Implement
Conclusions/wrap up