Current Issues in General Insurance Conference, May 2010
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Update from the FSA
Agenda

• Update from IMAP
  – Pilot studies and thematic reviews
  – PAQC process
  – Pre-application
  – QIS 5
  – Lessons from Basel II for IMAP
• Wider Solvency II and regulatory issues
Pilot studies and thematic reviews

• Pilot exercises over
  – Tested our proposed approach to pre-application
  – Feedback suggests approach is robust and scalable

• Thematic reviews nearing completion
  – Informed views on good practice in respect of risk management and use, data management and validation
  – Largest firm-identified gaps were in area of validation
  – Firms think they are more prepared than they are!
  – Summary findings later in Q2 2010
PAQC process

• PAQC process underway
  – IMAP firms to complete PAQC template 1 month before planned entry into pre-application
  – Designed to promote effective and efficient allocation of supervisory resource
  – 35 pages means 35 pages!
• Some completed PAQC templates received, albeit fewer than planned
• Quality of submissions is generally high
• PAQC template proving to be an effective discriminant between well and poorly prepared firms
• First firms have been accepted into pre-application
• Initial feedback is positive - firms finding process invaluable in focussing Board’s mind
• Firms realising much work still to be done. Devil is in the detail!
PAQC - meeting the threshold

Steering points from early reviews, for those yet to submit

- We will aim to flag serious concerns early but PAQC process is not designed to be iterative
- Review places heavy focus on planning elements of template
  - Cross-reference project plans throughout submission (including documentation piece) – link workstream, timelines and resource
  - Workstreams should have granular, task-driven plans
- Link where appropriate to responses from thematic review questionnaires
- Want to see better evidence that contingency planning has been given due consideration
- More comfort required that budget and resource is appropriate
- Documentation piece is weak with a number having been asked to do further preparatory work

Image source: janicemanderson.com
• Will necessarily be an iterative, collaborative process
• Framework, built around the application document, is in place but we will tailor to each firm, as appropriate
• Aim is to try and perform as much of the “heavy-lifting”, in terms of our review, during pre-application. This way potential issues can be flagged and resolved early.
### QIS 5

**Key features**
- Draft technical specifications released with final specification to be confirmed by end July
- Spreadsheets to be completed between Aug. and Oct. 2010
- “Best efforts basis” no longer sufficient
- Not just about numbers, don’t forget qualitative components

**Technical specification – Non-life highlights**
- Draft QIS 5 factors generally lower than final CEIOPS advice
- Noteworthy revisions for non-life include:
  - allowance for geographical diversification
  - allowance for diversification between lines of business in the risk margin calculation
  - lower premium and reserve factors (including MAT, credit and non-proportional reinsurance business)
  - reduction in equity stress under market risk
  - eligibility of undertaking specific parameters
  - standardised catastrophe scenarios option over pure factor based approach
Lessons we need to learn from Basel II

The regime was different, the sector was different…

… but the lessons are already proving to be the same.
Good firms have done this…

- Carried out QIS4 with an attempt to identify impact of Solvency 2 requirements for valuation of assets & liabilities
- Read Directive and followed development of CEIOPS advice at Level 2 so they can anticipate requirements and influence debate
- Developed a strong system of governance and able to demonstrate decision-making informed by risk appetite at various levels
- Finding IMAP pre-app template straightforward to complete because they had followed guidance provided in earlier FSA correspondence
- Anticipated ORSA process following the Directive requirements and CEIOPS 'Issues Paper' (April 2008)
- Developed a S2 implementation plan that is detailed, costed, end-to-end but with key interim milestones, identifying resources by name, with budget signed off at board level and with rigorous programme management disciplines
Bad firms have done this…

- Ignored all QIS exercises – after all, S2 is years away, and these are only tests
- Ignored Directive and CEIOPS papers – there are far too many pages, and besides, it might all change
- Elected to rely on existing risk management and governance processes, irrespective of Directive and draft L2 requirements – implementing FSA recommendations out of ICAS / ARROW reluctantly
- Struggling with IMAP pre-app qualifying template because it seems a lot more detailed than expected
- Put off any thinking on ORSA until there is confirmation of exactly what it comprises
- Have prepared a S2 implementation plan, but no sign-off or engagement at board level, little detail, resources not identified or not yet hired, and not yet put in place programme management disciplines
Solvency II is not just about internal models...

There is a lot of focus on internal models...

- But this just scratches the surface...
- Governance
- Risk management
- Reporting
- Technical provisions
- ORSA
- Group supervision
Market Level View

Total UK Company Market
Underwriting Results expressed as a % of Net Earned Premiums
Prior Year Reserve Movements expressed as a % of reserves brought forward

UW Results  - Current Year UW Results  - Prior Year Res Mvts  - Bank of England Rate  - Return in FTSE 100
Current Issues

- Inflation outlook
  - uncertainties: quantitative easing, outlook for Sterling
  - certainties: bodily injury costs and claims frequency
  - exploring potential impacts

- More risk?
  - cost-cutting in industry, more outsourcing, more concentrated manufacture and distribution, greater risk-retention in contracting
  - impacts (e.g. Professional Indemnity and Products Liability) likely to be delayed

- An end to systematic over-reserving
  - contrast implicit v. explicit margins
  - dangers of miss-measuring
  - consequences for pricing and capital

- Asbestos
  - pleural plaques: Scotland v. England
  - Employers Liability Tracing Office
  - Employers Liability Insurance Bureau
Stress and Scenario Testing

- Policy Statement PS09/20
  - within firms: supervisors, sector, policy
  - of firms by FSA: supervisors and Prudential Risks Division
  - system-wide: Financial Stability Unit
- Firms need to establish a robust stress-testing framework
  - senior management engagement
    - set-up and challenge
  - better capital planning stress-testing
    - forward-looking hypothetical scenarios
  - suites of tests to include reverse stress testing
- Judgements net of credible management actions
- Simply relying on parental support will be challenged
Reverse Stress Testing

- 12 months from PS09/20: 14/12/2010
  - ready to be appended to ICAS submissions
- “When business model becomes unviable”
  - what needs to happen to end-up with “call from Hector”
- Infrastructure/Architecture
  - to be reviewed as part of supervisory assessment
- Must be “within realms of usefulness”
  - input to risk management process
  - we expect NEDs to challenge complacency
- We have no plans for publication of results
“Solvency II” Reserving

- Probability-weighted average of future cash flows
  - discounted for the time-value of money
    - distribution of cash flows therefore important
    - particularly if planning to apply for internal model approval
  - using risk-free discount rates

- Best Estimate = Claims Provision + Premium Provision
  - CP = future claims incurred to balance sheet date
  - PP = all future cash flows arising for all contracts
    - very different from Unearned Premium Reserve
    - includes future claims events from all contracts
    - in particular, including any contracts obligated to enter

- Data quality, documentation and justification much stricter
Good Practice aligned to Solvency II

- Data quality → design, capture and policy
  - much more explicit, less “hidden in the machine”
  - integrating legacy systems
  - computing capacity
- Case Reserving → focus and standards
  - “professionalisation” → less subjectivity
  - training and competence
  - monitoring → external / other risk indicators
  - interconnected with underwriting and capital assessment
- Governance framework
  - clarity on processes, responsibilities and authority levels
- Reporting and management information feeds
  - Solvency II balance sheet
  - cash flow modelling and monitoring
In summary…

- **Pre-application is underway**; make sure your firm does not get left behind
- **PAQC will be straightforward for well prepared firms** and **poorly prepared firms will struggle**. Make sure due thought and attention is given before submitting
- **Open dialogue with the FSA throughout pre-application will ensure problems are identified and resolved early**, with heavy lifting complete by formal submission
- Heed additional **guidance and lessons from thematics and pilots**.
- Take on board learning from previous regulatory implementation exercises around **strong project management, clear governance and executive engagement, resourcing** and **don’t leave data and IT until the last minute**!
- Plan for and **complete QIS 5**
- **Solvency II is not just for internal model firms**, remember all the aspects that you will need to comply with irrespective of how regulatory capital is calculated – especially those which will be fundamentally different under Solvency II eg. technical provisioning.
- **Solvency II will soon be BAU so the BAU issues will soon be Solvency II issues** – think about the implications of current risk environment and BAU issues; many of which will be relevant under Solvency II
Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.
The views expressed in this presentation are those of the presenter.