Update from the FSA
CIGI – 12th May 2011, Royal College of Physicians

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Outline

- Outline and Key Messages
- Regulatory Reform
- Solvency II
- Integrated / Enterprise Risk Management
Key Messages

- ‘Twin Peaks’ of prudential and conduct regulation
  - organisational alignment since April 2011
  - legal / legislative division during 2013

- More intensive and intrusive supervision
  - greater use of specialist resource
  - broader deployment of supervisory powers

- Focus of specialist resources under IMAP pre-application
  - to concentrate on smaller population of firms
  - reflecting risks to FSA’s statutory objectives

- Looking to a more complex and inter-related future
  - expectations of ERM and CROs are rising
  - actuaries and other risk specialists need to be better equipped and better enabled

Regulatory Reform – New Vision

Three key players:

- The Financial Policy Committee
  - a committee of the Bank’s Court of Governors
  - responsible for delivering systematic financial responsibility through macro-prudential regulation

- The Prudential Regulation Authority
  - an operationally independent subsidiary of the Bank
  - responsible for the safety and soundness of banks, insurers and other prudentially significant firms

- The Financial Conduct Authority
  - responsible for maintaining confidence in financial markets
  - particular responsibilities for consumer protection and for markets

The Bank of England itself will be responsible for:

- Crisis management, including the resolution of failed or failing banks
- Regulation of key infrastructure, such as payment settlement systems and central counterparties

Please note: the FCA’s role in CCPs and settlement infrastructure is still under discussion
Regulatory Reform – New Vision

• Expectations of firms (and of Supervision) remain
  – prior shift to ‘More Intensive and Intrusive’ supervision
  – evidenced by ‘Reserving Governance’ visits to GI firms
• Shift to new operating structure from April 2011
  – Prudential Business Unit or ‘PBU’ in anticipation of PRA
  – Conduct Business Unit or ‘CBU’ in anticipation of FCA
• Move to ‘Twin Peaks’ legal split expected in 2013
  – will require Act of Parliament
• In the meantime
  – focus on smooth transition within business plan constraints
  – continuing to actively challenge and influence firms in the management of their risks
Reserve Governance Reviews

- Largely a Q1 2011 exercise
  - reflects "More Intensive and Intrusive" supervision strategy

- Prompted by crystallised risks
  - what is the current state of practices?
  - what issues are firms dealing with?

- A series of visits to a sample of insurance firms
  - looking at governance processes
  - how do we get from premium, claims and business system data to booked reserves?
  - what qualitative information feeds into process?
    - rates, underwriting mix, terms & conditions, business plan

- Visits have led to some RMP (Risk Mitigation Plan) points

Dear CEO Letter – March 2011

- Prompted by concerns at state of environment, crystallised risk and some observed practices

- A reminder as to senior management responsibilities
  - must have proper understanding of, and be able to explain, their risk appetite…
  - …and the consequences of that risk appetite in setting reserves

- Raising awareness of potential pressure on reserving function and that pressure’s influence on decision making

- Processes need to
  - be considered and proportionate
  - be robust and subject to adequate internal challenge
  - capture the risks associated with an increasingly challenging claims environment
**Solvency II – 18th April Conference**

- **Speech by Julian Adams, Director of Insurance**
  - “…as we build the new regulator, we will be embedding Solvency II in all that it does, whilst preserving the best of the FSA’s existing approach.”
  - “…a large and vibrant insurance market here in the UK…”
  - “…significant level of appetite for the use of internal models…”

- **On the ORSA**
  - “…the principal means by which Solvency II draws together risk management, governance, controls and capital…”
  - “…into a single picture which is squarely the responsibility of firms’ senior management…”
  - “…and which must be used in decision making.

**Solvency II – IMAP pre-application**

- **FSA resources available to devote to IMAP pre-application**
  - have decided to focus these on a smaller population of firms
  - those having the highest potential impact on the FSA’s objectives

- **Focus on firms comprising the following sets**
  - major UK life and non-life firms – broadly the UK top ten
  - firms which have operations in the Lloyd’s market
  - subsidiaries of major European groups where we will be obliged to participate in a college of supervisors
Solvency II – IMAP pre-application

- Other firms in pre-application will receive a reduced level of engagement
  - small degree of interaction with actuaries and other risk specialists
  - supplemented as always by interactions with supervisors to ensure that firms remain on-track with their plans
- Proposing to develop various tools to facilitate review
  - stress-testing of general insurance firms
  - reference portfolios to test model treatment of certain types of asset or business
  - industry standards on catastrophe models
  - specified models for certain esoteric types of firms
  - working with ABI and others
- Introducing elements of external review into our approach
  - pilot on data standards

Solvency II – IMAP pre-application

- Directive is clear that the same standards apply to all firms
- Pre-application is now closed
  - firms not in pre-application should not expect to receive a pre-day-one decision on an internal model
- Being in pre-application
  - does not guarantee a firm day-one approval of its model
  - we are striving to be in a position to make a decision
- Reduced level of attention to some firms
  - does not necessarily imply firms less likely to have a decision prior to day one
  - focus of resources on largest and most complex…
  - …also, cannot make decisions about group internal model applications in isolation
Solvency II – IMAP applications

• Open from 30th March 2012
  – later than originally envisaged
  – reflects dependence on EU policymaking process

• Plan to remain open for two months
  – expect to close on 31st May
  – firms planning to submit formal application later than the end of May next year are unlikely to receive a decision before day one

• Our processes designed with regular review points
  – firms felt likely not to be able to meet the required standards in time…
    • will be invited to leave the process…
    • and invoke their contingency plans at these checkpoints…
    • which will allow us to conserve our resources

Solvency II – Contingency plans

• Non-approval of model
  – revert to standard formula
  – …either for firm’s whole business or parts not covered by approved elements of a partial model

• Using standard formula not that simple
  – responsibility to assess its suitability
  – confident it properly reflects risks inherent in business
  – should be reflected in their ORSA
  – make use of Undertaking Specific Parameters (USPs) or other adjustments to the standard formula

• If regulatory capital requirement increases
  – explain approach to meeting those additional requirements
Integrated / Enterprise Risk Management

- Actuaries
  - history and strength in liability risks
    - e.g. GI underwriting and reserving
  - some involvement with asset risk
    - more for Life side than GI
    - limited look-through to traded markets, securitisation and use of complex derivatives

- Other risk specialists
  - can help complete integrated risk management offering, and broaden actuaries’ skills-set
  - encompasses credit, market, liquidity, operational and securitisation risk

Pricing, Capital and Reserving

- Pricing Risk is central to insurance business
  - the “cost of production” – but it’s really difficult…
  - …you might not know the right answer for years
  - also, expected profit can play a key role in capital assessment

- Reserving should show us the expected cost of claims

- Accurate Capital assessment plays a dual role
  - completing the Risk Price picture
  - illuminates the risk profile and solvency position
    - feeds into allocation of capital across lines of business
    - crucial role in wider risk management

- So, get the Reserving wrong and you might…
  - overstate your capital
  - misprice the cost of claims and price of risk
  - accept too much risk, in the wrong places
Pricing, Capital and Reserving

Insurance Firm Value Chain

- Design & Distribution
  - Products (inc. design)
  - Distribution (Underwriting)
  - Pricing

- Claims Management and Investment
  - Investing
  - Matching
  - Managing

- Finance, Risk Management and Actuarial Control
  - Valuation
  - Reserving
  - Capital
  - Solvency
  - Risk Management
  - Internal Audit and Compliance

Value added:
- Commission
- Ancillary sales via high margins
- Expense control

Value added:
- Claims control
- Higher yields
- Risk control
- Expense control
- Optimal reinsurance strategy

Value added:
- Optimal capital management
- Diversification benefits

Integrated / Enterprise Risk Management

- A threat and an opportunity for actuaries
  - remain in a deep and narrow specialism
    - vital, but ultimately limited role within business
  - a more complex world
    - increasing the pressure for innovation within firms
    - greater(?) scope for external threats to business
  - strong cues from Solvency II
    - Risk Management and Actuarial Functions
    - Opinions on Underwriting and Reserving Strategies
  - greater responsibilities and authority(?) for CROs
    - still in the era of ‘trail-blazers’
    - ideal fit not yet apparent

- So, the question arises
  - “What skills and behaviours do actuaries and other risk specialists need to rise to this challenge?”
Questions?

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