THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

22 December 2008

Our ref: ICAEW Rep 147/08

Financial Services Authority
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Canary Wharf
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By email: solvency2@fsa.gov.uk

Dear Sirs

DISCUSSION PAPER 08/4 – INSURANCE RISK MANAGEMENT: THE PATH TO SOLVENCY II

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on *Insurance Risk Management: The Path to Solvency II.*

Please contact me or Iain Coke, Head of the Financial Services Faculty, should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 147/08

FSA – INSURANCE RISK MANAGEMENT: THE PATH TO SOLVENCY II.

Memorandum of comment submitted in December 2008 by The Institute of Chartered Accountants in England and Wales in response to the FSA discussion paper 08/4.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Discussion Paper *Insurance Risk Management: The Path to Solvency II.*

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators

SPECIFIC QUESTIONS

5. Our answers to the specific questions raised by the FSA are set out below.

Chapter 3 – Systems of governance (Pillar 2) and reporting requirements (Pillar 3) under Solvency II:

Question 1: What views do firms have on the process for the transition from ICA to ORSA?

This is really a question that it is more appropriate for individual firms directly affected by the Solvency II Project to answer nonetheless we felt that it might assist if we made a couple of general observations. The information that has currently been provided in relation to the ORSA is at a very high level rather than a template for implementation. We do not believe therefore, that there is currently sufficient information available for any meaningful comments to be provided at the current time on how the transition should be undertaken. We believe it would be helpful to all parties if the FSA when giving its feedback response was to supply a gap analysis identifying in its view the differences between the ICA and the ORSA and proposing a transition plan.

We would not expect the progression to be excessively difficult between the ORSA and ICA where a reasonable ICA is currently being produced. There will typically be a need to better integrate the business plan with any ICA calculations in order to produce an ORSA. As the ORSA rules are high level rather than very detailed it will probably be more of an issue as to whether the supervisor considers that the overall ORSA is in their view adequate.

Question 2: How do firms consider supervisors should respond to breach of targeted economic capital requirements?

We believe that it is important for a firm to notify the FSA of a breach of its targeted economic capital requirements but equally important that the FSA's response should be proportionate. It is essential to recognise that this would not be a regulatory breach as such and should not necessarily be a trigger for a prescribed supervisory response. There could be many differing reasons behind the breach of targeted economic capital requirements eg a business acquisition and providing the notification of breach was accompanied by sufficient explanation from the firm as to why it had occurred and the firm's response, in most cases the appropriate reaction from the FSA would probably be the adoption of a watching brief to see how the situation developed.

It is important that firm's are able to manage their affairs without unnecessary intrusion from supervisors if the firm's failure to meet economic targets does not result in a threat to the firm's solvency. Firms should be encouraged to set and use realistic capital targets for the business for good commercial reasons, without being totally driven by regulation. It is appropriate that supervisors should be kept advised of developments where there is a significant deterioration in results that may have implications for solvency. However, merely modestly undershooting on cautious targets should not provoke any excessive levels of reporting and supervisory response if this does not impact upon the SCR or MCR.

Chapter 4 – Demonstrating adequate financial resources (Pillar 1)

Question 3: What steps are firms taking to develop the appropriate valuation systems to calculate technical provisions under Solvency II?

We believe that firms do not want to have a single methodology and believe that different techniques may well achieve equivalent answers. Nonetheless until there is both clarity and certainty a significant number of firms can be expected to be both unlikely and unwilling to commit to begin significant development work. We would therefore recommend that the FSA should, as a matter of urgency, clarify whether there will be a mandatory valuation methodology for arriving at the required best estimate and provide as much certainty as possible as to the boundaries of the firm's discretion in tailoring their own methodology. It would undoubtedly be helpful for example if there were an official list of anticipated differences between IFRS and Solvency II agreed and published by CEIOPS, the IASB and the FSA.

In our experience non-life firm's participating in QIS4 are mostly working with their actuaries to develop models calibrated to best estimates excluding any elements of built in prudence, but allowing for the possibility of future events such as catastrophes. This value is then discounted for the time value of money until cash flows are forecast to occur. At present a risk margin is then added based upon an estimate of the cost of capital which is in line with QIS4 guidance, rather than a more sophisticated calculation. For firm's that have not been involved in QIS4 their reserving is likely to be on a similar basis to previously with no separating out of prudence elements and no discounting. In our experience there is limited evolution of different approaches to valuing technical provisions beyond this at present as the new IFRS standard's ultimate requirements are unclear and the QIS4 approach provides a workable solution. A key area that remains to be resolved for IFRS at present is deferred acquisition costs.

How is this work linked to the implementation of IFRS standards?

We would note that there is unlikely to be full harmonisation of IFRS and Solvency II because of their different objectives. The risk margin required for IFRS for example is unlikely to be as prescriptive as that required by a regulator. However, there is a strong desire among firms that the valuations of technical provisions for IFRS and Solvency II purposes should be as consistent as possible, with any differences being identifiable as specific clearly understood prudential 'filters'. Firms will want though to co-ordinate the development work for Solvency II and IFRS as far as possible so as to reduce costs and consequently the greater the certainty and in particular the greater the congruency between Phase II and Solvency II, the more likely they are to commit to the development of systems.

Question 4: What steps have firms taken to consider whether they have the right quality capital to meet the capital requirements?

We note that this is really a question for firms to answer. Nonetheless we would point out that if you look at the recent QIS 4 results 95% of capital is Tier 1 capital so from our perspective there would not appear to be a problem as to quality. We would recommend that the FSA should highlight any issues that they believe will potentially be problematic going forward. It would also be particularly helpful if the FSA would explain any expected differences in treatment between banks and insurers.

Question 5: What further guidance, in addition to that in the QIS4 technical specification, would be useful for firms on the application of the SCR standard formula for their business?

We believe that further guidance on partial models would be helpful for firms. If the hurdle for full use of own models is set very high, partial models may need to be more extensively used to address a number of potential issues which do not fit easily into the standard formula. In addition it appears that the SCR must be calculated at least annually whereas the MCR must be calculated quarterly. It would be helpful for firms if the FSA could clarify how you are meant to calculate the MCR quarterly without also calculating the SCR, given the SCR related 'corridor' inside of which the MCR must fall.

Question 6: How do you think firms could best demonstrate compliance with the Pillar 1 requirements on a real-time and prospective basis?

We note that this is really a question for firms to answer. We would suggest however that in practical terms it is not possible to calculate the SCR on a real time basis. It is not a one day exercise if it is done properly. Firms will have undertaken stress tests of their internal models and in reality will know how particular stress points will impact on their capital. It is probably more appropriate to require a system of monitoring compliance by say approximate calculations based on the firm's quarterly management accounts to assess a firm's solvency between full annual SCR calculations. This would be supplemented by a need to perform ad-hoc calculations if there were significant economic or trading developments. A full real-time SCR should only be necessary if impairment of the firm's SCR is indicated.

Firms should be required to notify the FSA if the above tests suggest there is a material likelihood of a breach in the next three months, together with any mitigating action planned.

It is important that regulators avoid demanding information at short notice unless it is demonstrably a proportionate response to a particular set of circumstances.

Chapter 5 – Use and approval of internal models

Question 7: To what extent does this description reflect firms' current and planned future internal models?

We believe that the definition itself is fine. The real issue though is how that links to the capital model and the use test.

Question 8: Solvency II is likely to require clear and demonstrable integration between capital measurement systems and capital management. How should firms demonstrate the link between or integration of their internal model and their risk management framework?

We would expect this level of information to be provided in the implementing measures for the ORSA which have not as yet been published. Our view is that firms will need to have a plan for their business that is integrated with their internal model, systems and processes. This plan will then need to be monitored and evidence provided to demonstrate that a firm is indeed managing against it.

That would include the board approving a plan that is linked to the ORSA and ensuring monitoring and reporting lines and processes are in place to ensure that this linkage is controlled and reported upon throughout the year as part of business processes and regulatory monitoring.

Question 9 i. Does this outline cover all the key dimensions of capital management activities within the industry?

We believe that this outline does not cover diversification or go down to an appropriate level of granularity and hence oversimplifies matters. For example capital may be allocated within classes before and after reinsurance and possibly including and excluding catastrophe exposures. Groups are also ignored within this context. There would also be capital allocated to central functions such as treasury and IT, particularly for many operational risk matters.

ii. How does this compare with current industry practice?

We are confused as to why the FSA are asking this as they currently receive the ICAs which should provide a good overview of current capital management practice albeit not to the same level of granularity as is required for Solvency II. The definition though is also oversimplified and ignores the variables. Many insurers will for their ICAs already be working to a level of granularity beyond that outlined.

Question 10: i. What are firms doing to evaluate and improve data?

We believe that the nature of this question infers that the there are generic problems with data quality that the FSA are expecting firms to address. If this is the case we believe that it would be helpful if the FSA were to provide details. Clearly it is always important for firms to work on continually improving data quality. but we are unaware of any specific issues relating to Solvency II that we consider to be major data problems. An area that we anticipate may require more attention is documenting of data sources and evidencing its control back to core data.

ii. What further work (including industry-wide initiatives) might be helpful (for example, flood claims, large motor claims) to improve the completeness of firm data along the lines of the Operational Risk Insurance Consortium (ORIC)?

We refer you to our answer to Question10 (i) above. There is always room for improvement and additional data sources will help but we are not aware of any areas that we feel present a major gap that requires addressing to comply with Solvency II.

Question 11: What further guidance would be useful on good practice in respect of data?

We refer you to our answer to Question10 (i) above. It would be helpful to know where the FSA perceive problems to lie.

Question 12: Which approaches do firms use within their capital model? How and why are these approaches used? ('Approaches' can be defined or applied at a high level, eg stochastic/deterministic)

We note that this is really a question for firms to answer. We are seeing though a trend towards stochastic modelling.

Question 13: Do you consider that there are areas where industry or the professions should be focusing their research capabilities to improve internal models? Please provide examples.

We would suggest that this something that the FSA will already have a view on as a result of the ICAs they receive. Other than that we would suggest the FSA approach the ABI and see if they have any generic suggestions. If the FSA do believe that there are areas where improvement would be beneficial we are of the view that it would be helpful if this information were to be shared sooner rather than late with firms. At the present time systemic risk across global economies is a very real issue which may be appropriate for solutions that are at least partially generic.

Question 14: i. Firms are invited to comment on how explicitly their risk appetite links to their credit rating, where applicable?

As this question is aimed at firms it is difficult for us to comment in detail. We do note that some firms have systems that closely link their pricing of risks to business plans and cost of capital calculations. It is however likely that most firms probably adopt a two stage process. The first step is to calculate an expected volume of business and evaluate the capital that is expected to be required to support that volume by both the regulator and any rating agency or other requirements. That usually sets an expected level of capital against which a more detailed plan is developed to fit within taking into account all the various factors including in particular expected premium volumes and reinsurance purchases. This will then be flexed to balance the capital requirements and risk appetite at what management consider is a reasonable level.

ii. How do you think we should test the adequacy of internal models – for example, should we require evidence of peer review, benchmark by industry sector, require external audit, run benchmark portfolios or develop our own capital model? What other possibilities do you consider appropriate?

We do not believe that there should be an external audit of internal models although firms may wish to utilise external expertise in obtaining their own assurance regarding their models. Over time we would expect the FSA to conduct peer reviews and establish a benchmark by industry sector against which to assess individual models. We would expect there to be a minimum set of standard stresses.

Due to confidentiality of information, peer review is likely to be difficult to achieve and it would be difficult to lay down meaningful standards for the quality of this. It would seem reasonable to develop benchmarks by industry sector for comparison against answer's produced by firm's models. Such an approach should be capable of being shared between supervisors in different countries. For supervisors to develop a capital model of their own would be very challenging as it would need to address a vast array of different factors and models which may require even more extensive collection of data by supervisors to enable a valid comparison with a firm's model to be made. In addition if there is to be consistency between countries then the model would need to be used and understood by all of the different national supervisors.

Question 15: How do firms presently carry out this activity [profit and loss attribution] and how will it be developed towards Solvency II implementation?

No comment.

Question 16: How do firms validate internal models currently and to what extent do their processes meet the indicated criteria?

No comment.

Question 17: i. One simple guideline for documentation might be that it is extensive enough for the firm to replicate its model in a different platform and in the absence of original developers.

To what extent do firms already have this in place?

In our view this would be an extremely impractical guideline to expect firms to follow and we would not realistically expect anyone to have this in place currently.

ii. What do you consider should be the balance between hard and soft copy documentation?

We believe that the balance between hard and soft copy is irrelevant in this context. The requirements should be the same as for any other business critical system and related processes in a regulated business.

iii. Where do you consider the balance should rest between internal model documentation and the ORSA requirement – for example, should use test compliance be primarily a matter for internal model documentation or for the ORSA?

We do not believe that it is appropriate to answer this question until further information is provided on how the ORSA will be implemented.

Question18: Should the internal model be subject to formal independent challenge? If so, what form should this take – for example, peer review, internal audit or external audit?

The internal model should undoubtedly be subject to formal independent challenge from the FSA in its approvals process and on an ongoing basis by the firm's internal auditors, the risk management department, non-executive directors, the audit committee and at a strategic level by the Board. We would not support a regime where the same information was subject to scrutiny by multiple parties as this will lead to excessive costs for business. For example where an FSA supervisor is satisfied that an internal model is fit for purpose we would not also want to see an external auditor being required to review the internal model for a similar purpose

As there will be elements of the model that will potentially be commercially sensitive, peer review is unlikely to be appropriate. However, insurers will be keen for there to be a level playing field across Europe. It may therefore be desirable to evolve certain approaches, which might include the suggested use of particular source data as a recommended benchmark approach to an acceptable model. Insurer groups might develop such guidance which should lay a guideline methodology for less sophisticated insurers that might count as a safe harbour but also require more sophisticated insurers to justify any departure from. The supervisor could then test models against these benchmarks.

To ensure the model is fit for purpose it is to be expected that such a model would be subject to some internal audit review. The level of such review should not be prescribed but would form part of the supervisor's evaluation of the reliability of the model.

An external audit should only be required where the supervisor has particular concerns about a particular aspect of a model that it requires to be tested.

Question19: How might firms ensure that senior executives acquire the relevant knowledge and understanding to fulfil the duties imposed upon them in respect of internal models review under the risk management framework? How might this be demonstrated?

The important fact to remember in relation to internal models is that they should contain the information that the Board is utilising to manage the business against. Therefore it is reasonable to expect senior executives to both understand the model, the high level assumptions behind it and understand any variances between it and the risk management framework. Our understanding from what has been published at a high level in terms of the ORSA is that this is what is currently envisaged.

Minuted board briefing sessions might provide documentary evidence of senior executives acquiring the necessary knowledge.

Annex B: – Impact assessment – scope and process

Question20: Which of these issues do you expect to generate additional costs of more than minimal significance for firms and how do you intend to approach quantification of those costs?

No Comment

Question21: Which of these issues do you expect will generate the most significant additional costs for firms?

No Comment

Question22: Where these issues are likely to generate additional requirements to your firm's current regulatory commitments, what do you think the benefits are to firms and their customers?

Although much of these costs will involve embedding good practice within insurers there is potential for a significant amount of this additional cost to be merely to demonstrate certain aspects of best practice in a particular specified way to regulators rather than in a way that solely meets the needs of the firm. It is recognised that supervisors will need to see that controls are effective and have certain standard approaches to enable the regulator to make valid comparisons between firms to ensure a consistent level of security. This is a necessary part of policyholders having confidence in insurers and their regulators. However, it will be important to ensure that these requirements to overlay reporting and processes beyond those firms need to run their businesses are kept to a minimum.