The Gibraltar Insurance Institute

Governance, Solvency & Risk -
A changing landscape for insurers

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Agenda

- Introduction & context
- Governance
- Solvency
- Risk
- Questions

Governance

- What is corporate governance?
- Overview
- Background/History
- Developments

What is corporate governance?

"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place…

The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

The UK Corporate Governance Code, June 2010

Corporate Governance - an overview

Clarity on who does what → **Right people doing the right jobs** → **Right processes to do the job** → **Proof that it works**

Directors' Roles and Responsibilities

- Separation of Chairman and CEO roles
- Balance of executive and non-exec directors
- Independence of directors
- Independent audit and remuneration committees
- Board responsibility for risks and controls
- Collective responsibility for results
- Clear policies for risks and controls

Competence of Directors

- Selection and appointment of directors
- Training (induction and ongoing)
- Evaluation of performance (individual and collective)
- Rotation and re-appointment
- Effective supervision

Internal Controls and Risk Management

- Sound system of internal controls and financial reporting
- Embedding of internal controls
- Risk-based management approach
- Identification, measurement and control of risks
- Risk-based capital management
- Quality of management information
- Clear structure and reporting lines

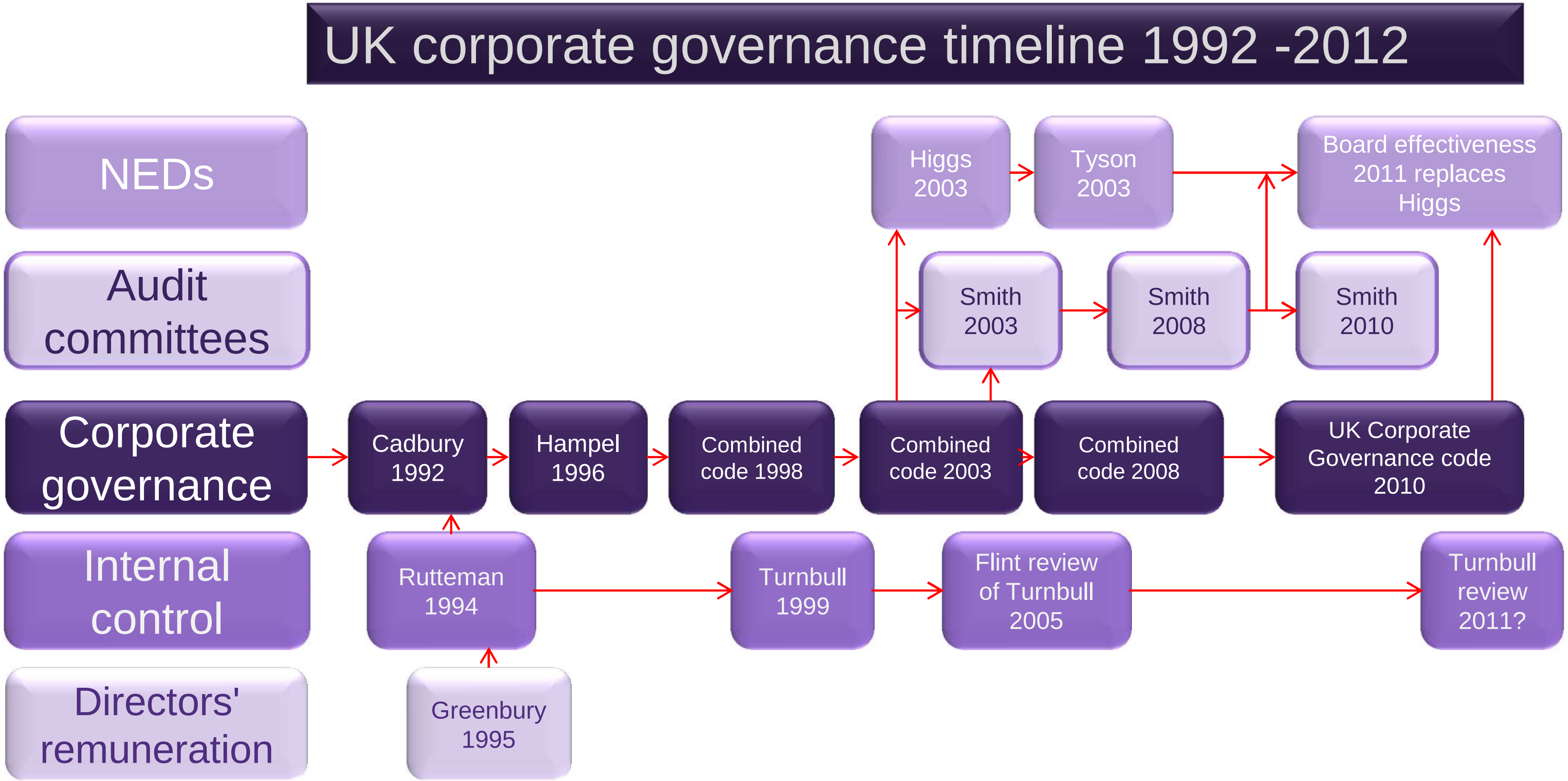
Disclosure and Reporting

- Director remuneration
- Board's activities
- Financial reporting
- Communication with shareholders
- Evidence of embedded principles, standards and processes

Corporate Governance is about managing, and demonstrating you are managing, your business risks. The challenge is to build effective governance into the way business gets done, without swamping other priorities.

Source: FSMA, PSB, The UK Corporate Governance Code (formerly the Combined Code), Turnbull, Higgs, Smith

History/Timeline



Key UK papers, guides or other legislation

- The UK Corporate Governance Code
- The Walker Report
- FSA's PS10/15 (Effective corporate governance)
- Companies Act, 2006

The UK Corporate Governance Code

- The UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders
- Most recent version issued in May 2010
- Applies to listed companies only, but should be seen as best practice for the industry in general
- The Code contains both broad principles and more specific provisions
- Comply or explain…
- Main principles of the code:
  - Leadership
  - Effectiveness
  - Accountability
  - Remuneration
  - Relations with Shareholders

Walker Review

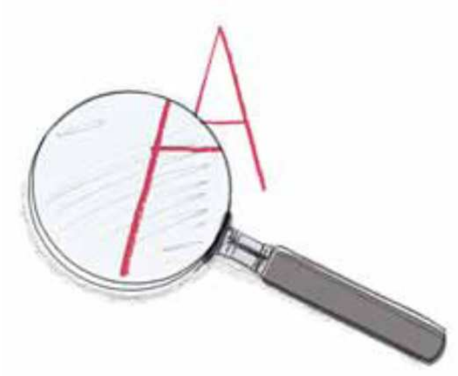
Background

- The Prime Minister requested a review by Sir David Walker of corporate governance in the UK banking industry
- Scope of recommendations was extended to identify where any recommendations also applied to banks and other financial institutions (BOFIs)
- Developed particularly for UK listed companies, but also broadly applicable to UK subsidiaries of foreign owned BOFIs
- The recommendations in the report are proposed as best practice, with a view that their adoption will benefit BOFIs
- Some recommendations have been incorporated as guidance and provisions in the UK Corporate Governance Code, whilst the FSA will take responsibility for others
- Final report was published on 26 November 2009 following three months consultation

Walker Review

Recommendations

- Governance failures contributed materially to excessive risk taking in the lead up to financial crises
- The report recommends a need for balance between more robust regulatory framework (without affecting enterprise) and improved corporate governance within financial institutions
- The report highlights 5 key themes and approximately 40 recommendations



Walker Review - themes

1. Combined Code (now the UK Corporate Governance Code)
2. Board construction and behaviour
3. Risk Management
4. Shareholder engagement
5. Remuneration

Walker Review

NED areas to consider

- Adequate knowledge and understanding of business to be able to contribute effectively
- To be provided with adequate training, including thematic business awareness sessions and substantive personalised approach to induction and training & development
- Board to provide NEDs with dedicated support on any matter which they require advice (separate from or in addition to normal board practice)
- Required to give greater time commitment than has been done so in the past which should be formally recorded in letters of appointment, including limiting number of appointments elsewhere
- FSA to use industry experts to interview NED
- Encouraged to challenge and be satisfied that Board decisions are made on accurate and appropriately comprehensive information using external input, where relevant, to ensure adequacy of information

Turner Review

Summary

- Chancellor of the Exchequer requested a review of the causes of the economic crisis, and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system in the future
- Main focus of report and discussion paper is on banking and bank-like institutions, and not on other areas of financial services industry
- However, some of the issues identified in the discussion paper are likely to have some application to other sectors:
  – FSA's new Intensive Supervisory model
  – Focus on governance and risk management
  – Quality of capital
  – FSA's approach to Group companies

Policy Statement 10/15

Effective Corporate Governance

- Response to the financial crisis
- Implementing the Walker recommendations
- Wide-ranging changes to the Approved Person regime
- Increased expectations of NEDs
- New enhanced supervision
- 'Governance, management and culture' given a *double weighting* at ARROW

Policy Statement 10/15

Key Governance Issues

- The FSA highlights three main areas of governance where issues are found;
  - Lack of sufficient challenge
  - Poor understanding of higher risk activities
  - Lack of adequate management information

Company Structure

Issues to consider…

- Committee remit
- Composition (members and attendees)
- Delegation
- Frequency of meetings
- Standing or ad hoc?
- Reporting lines
- Management information
- Evaluation of performance

Management Information (MI)

"The Board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties." UK Corporate Governance Code, Jul 2010

- **MI should be:**
  - timely, reliable, relevant, actionable, complete
- **MI should be tailored to:**
  - the needs of the Board
  - the needs of the sub-committees of the Board
  - the needs of individual business units
- **MI should help the Board and management:**
  - understand the firm-wide risks
  - determine whether the firm is prudently managed with adequate financial resources
  - make decisions within its remit
  - oversee the execution of tasks and activities

Strategy and risk appetite

"The Board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The Board should maintain sound risk management and internal control systems." UK Corporate Governance Code, Jul 2010

- Often difficult for senior management to clearly articulate
- Not just a business plan and budget for the next 12 months!
- Must be outwardly focused, including external factors likely to affect your business
- Must be a direct link between strategy and risk

Strategy and risk appetite

Evidencing link between strategy and risk

- Documenting the Board's and firm's mission statement
- Who is responsible for the strategy?
- How is it communicated?
- What measures are used to assess progress against this?
- What risk management processes are in place?
- How is this linked to the strategy?
- Who is responsible for this?
- How is risk considered in business decisions on an ongoing basis?

Summary

- Good corporate governance is primarily the result of the culture of the business and the behaviours of board members, ably supported by an appropriate governance framework
- Clarity around roles and responsibilities is crucial at all levels
- The right framework needs to be in place and effective to support the board including:
  - sub-committees with appropriate membership
  - adequately resourced risk, compliance, and internal audit functions
- Management information needs to be robust and actionable
- Evidence is key to satisfying the supervisor
- Emerging regulatory requirements and expectations will remain a challenge for 2012 and beyond.

Recommended additional reading

The UK Corporate Governance Code

http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf

Walker report

http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

The Turner review

http://www.fsa.gov.uk/pubs/other/turner_review.pdf

FSA's PS (Effective corporate governance)

http://www.fsa.gov.uk/pubs/policy/ps10_15.pdf

FSA's PS (Reforming remuneration in financial services)

http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf

Solvency

- Current regulatory landscape
- The drivers of Solvency II
- Capital requirements under Solvency II

Current European regulatory capital requirement

- Based on either 18% of premium written
- Or 26% of the average claims incurred over the last three years, which ever is higher
- ONLY considering insurance risk
- However, insurance risk is not the only cause of insurer failure in many cases!

The causes of insurer failure

- Under reserving
- Under pricing
- Rapid expansion
- Management issues
- Unforeseen claims
- Entry into new areas
- Delegate authority
- Fraud
- Catastrophes
- Reinsurance

Why the change?

- Dramatic changes in financial markets over recent years
- EU / EEA solvency rules have not kept pace
- Many member states have introduced their own rules
- Undermines development of single market in insurance
- Need for consistency with direction of solvency supervision internationally

What is happening?

- Review of the capital adequacy regime for European insurance industry
- Establishes new, strengthened set of capital requirements and risk management standards
- Reduces likelihood of insurer failure
- Promotes strong culture of risk management
- Requires integrated management of risk and capital
- Will fundamentally change the way European insurance companies are run
- Bifurcation

Comparison with current solvency regime

Solvency I

- Insurance risks
- Capital determined by applying ratios to premiums and reserves
- Very simplistic
- No risk management requirements

Solvency II

- All risks
- Capital is required to be held in respect of all material risks
- Very complex
- Requirement to embed a robust risk management process

Benefits

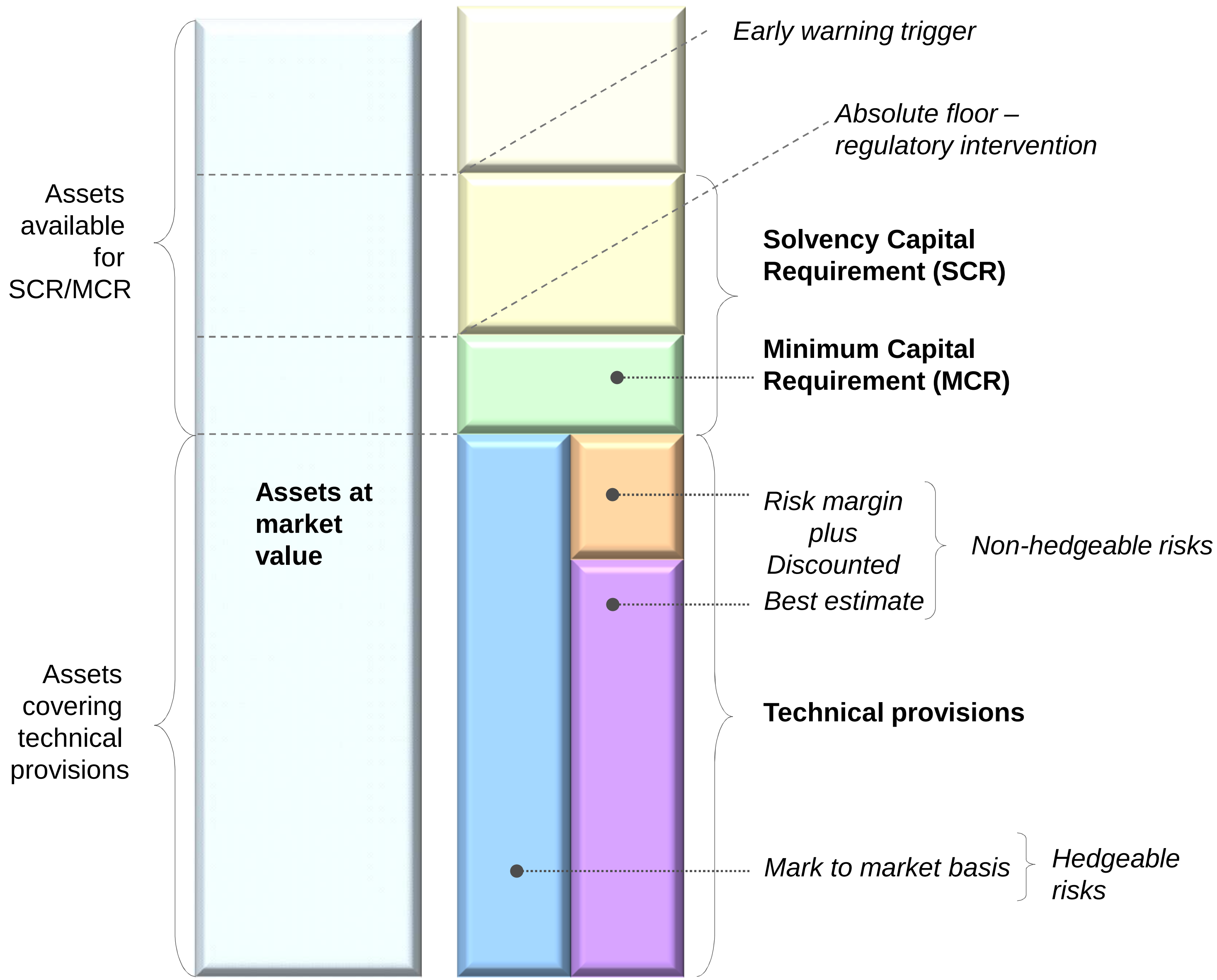
- A better model of the insurer
- A fully embedded risk framework
- A deeper understanding of the risks to which the firm is exposed
- An improved suite of management information

- ✓ More informed management decisions
- ✓ More efficient use of capital
- ✓ Improved performance
- ✓ Improved profitability
- ✓ Competitive advantage

Capital levels under Solvency II

- Solvency Capital Requirement (SCR)
- Minimum Capital Requirement (MCR)
- Economic Capital Requirement (from ORSA)
- Capital held

Figure 3 – Pillar 1 Quantifiable Requirements



Source: CEIOPS

Calculating the SCR

Unadjusted Standard Formula	Standard Formula with undertaking specific parameters	Partial Internal Model	Full internal model

Increasing accuracy in reflecting the company's risk profile

Reducing capital requirement

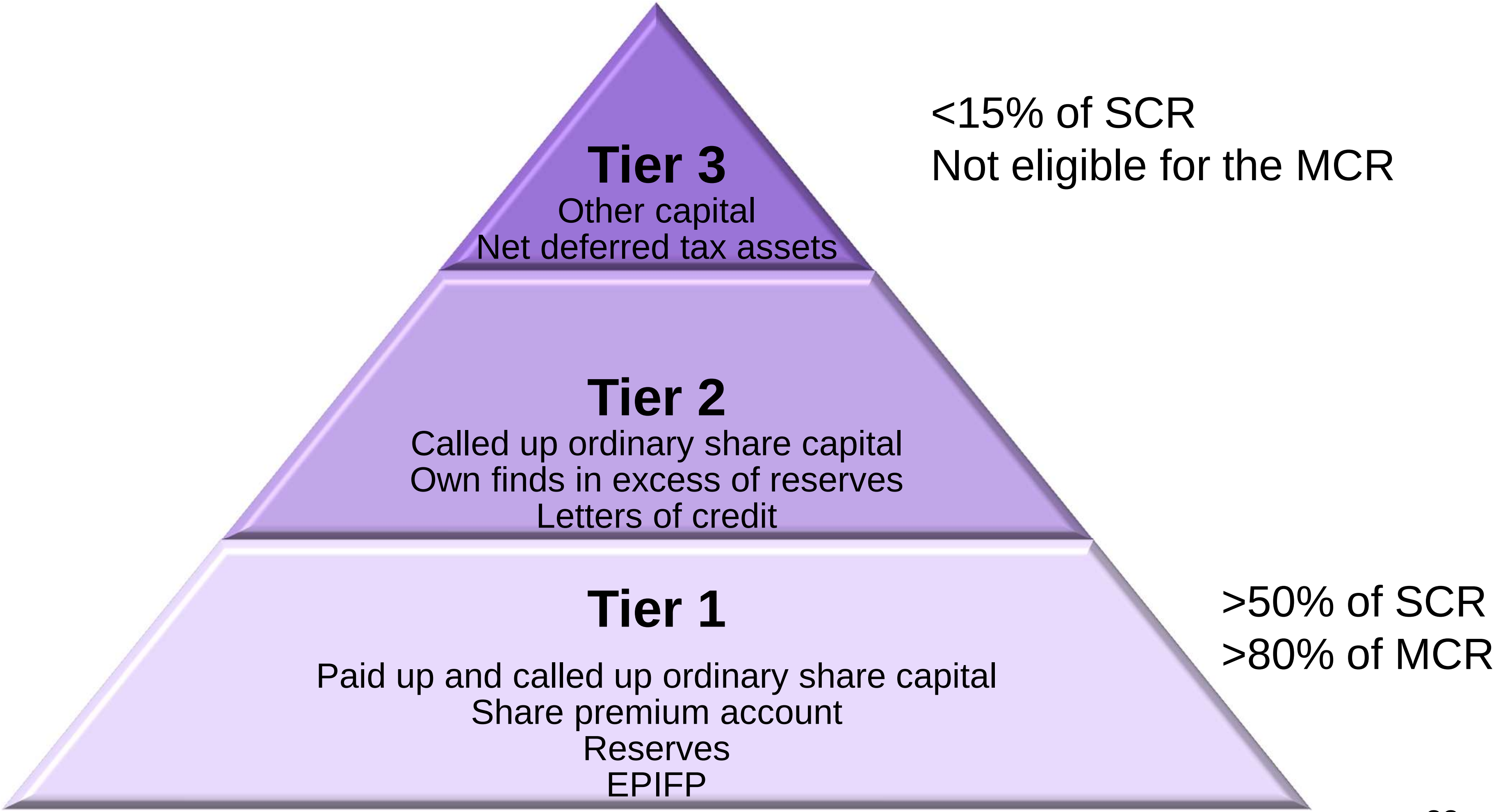
Increasing complexity

Increasing amount of resource required

The MCR

- Some percentage of the SCR
- Floor : 25% of the SCR
- Cap: 45% of the SCR
- Absolute floor: €2.2 million

Own funds



Tier 3
Other capital
Net deferred tax assets
<15% of SCR
Not eligible for the MCR
Tier 2
Called up ordinary share capital
Own finds in excess of reserves
Letters of credit
Tier 1
Paid up and called up ordinary share capital
Share premium account
Reserves
EPIFP
>50% of SCR
>80% of MCR

Economic capital requirement

- Included in ORSA
- Insurer's own assessment of capital needed
- May be at different confidence level to SCR
- May be over different time horizon from SCR
- Must use internal model if you have one
- If not:
  – stress and scenario testing
  – develop model

Risk management

- Developments
- Governance and risk management
- Benefits of integrated approach
- Value of MI

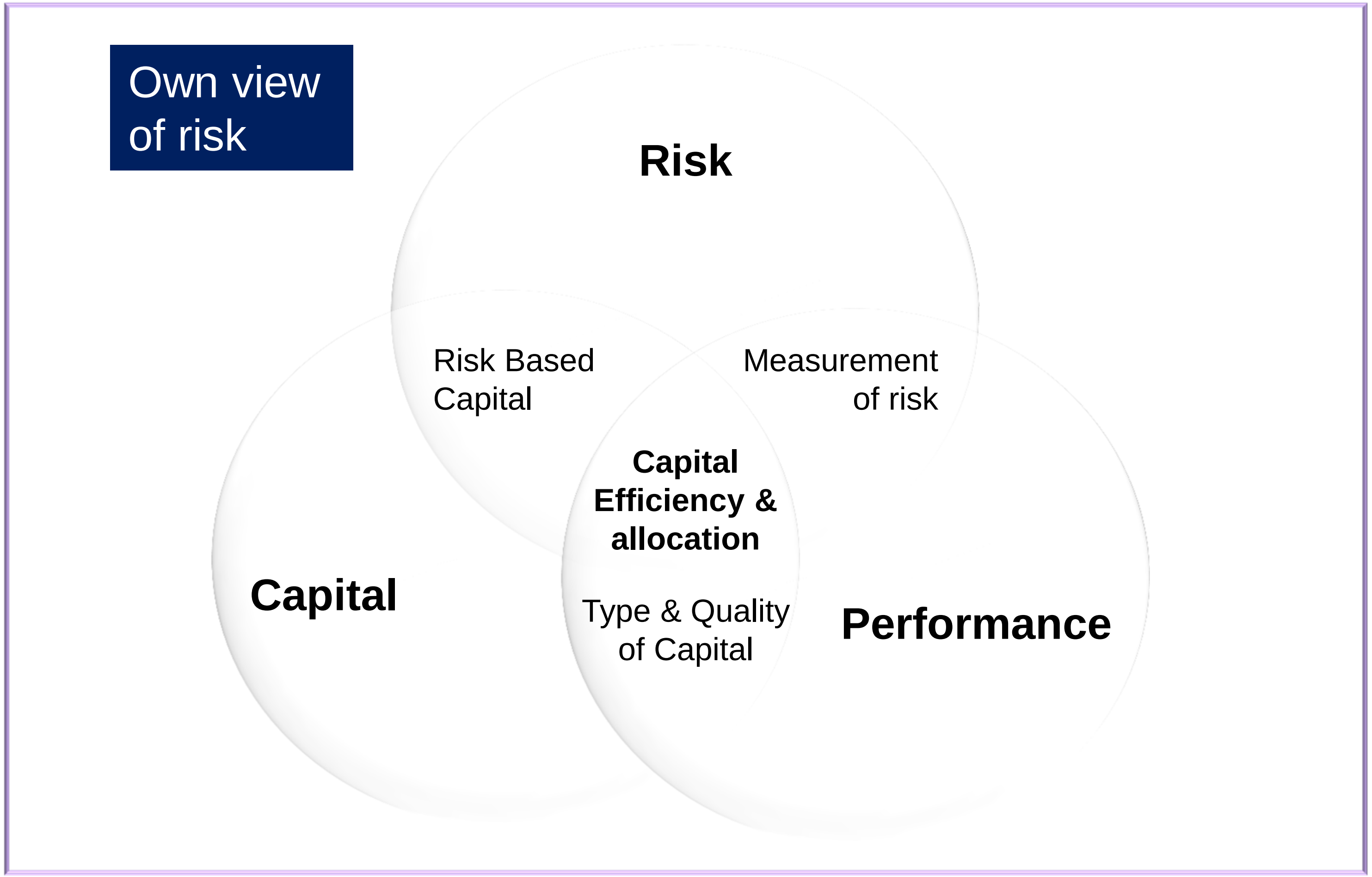
Background and developments

- Background
- COSO
- AS/NZ 4360
- IRM/AIRMIC
- ISO
- ERM

Governance and risk management

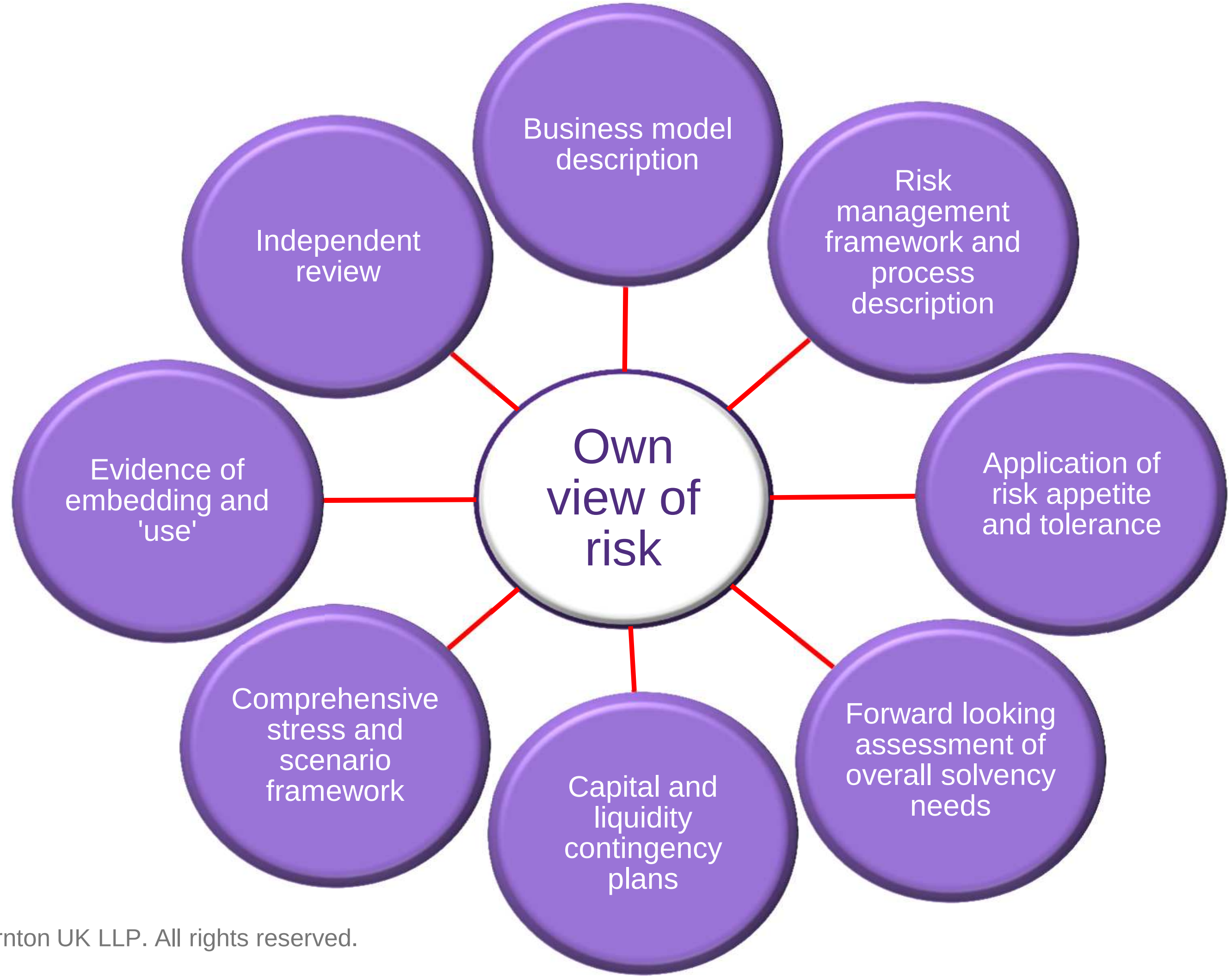
- Systems of governance
- Risk management
- Embedding
- ORSA
- Internal Audit
- Compliance
- Actuarial function
- Fit & proper
- Supervisory review

Benefits of an integrated approach

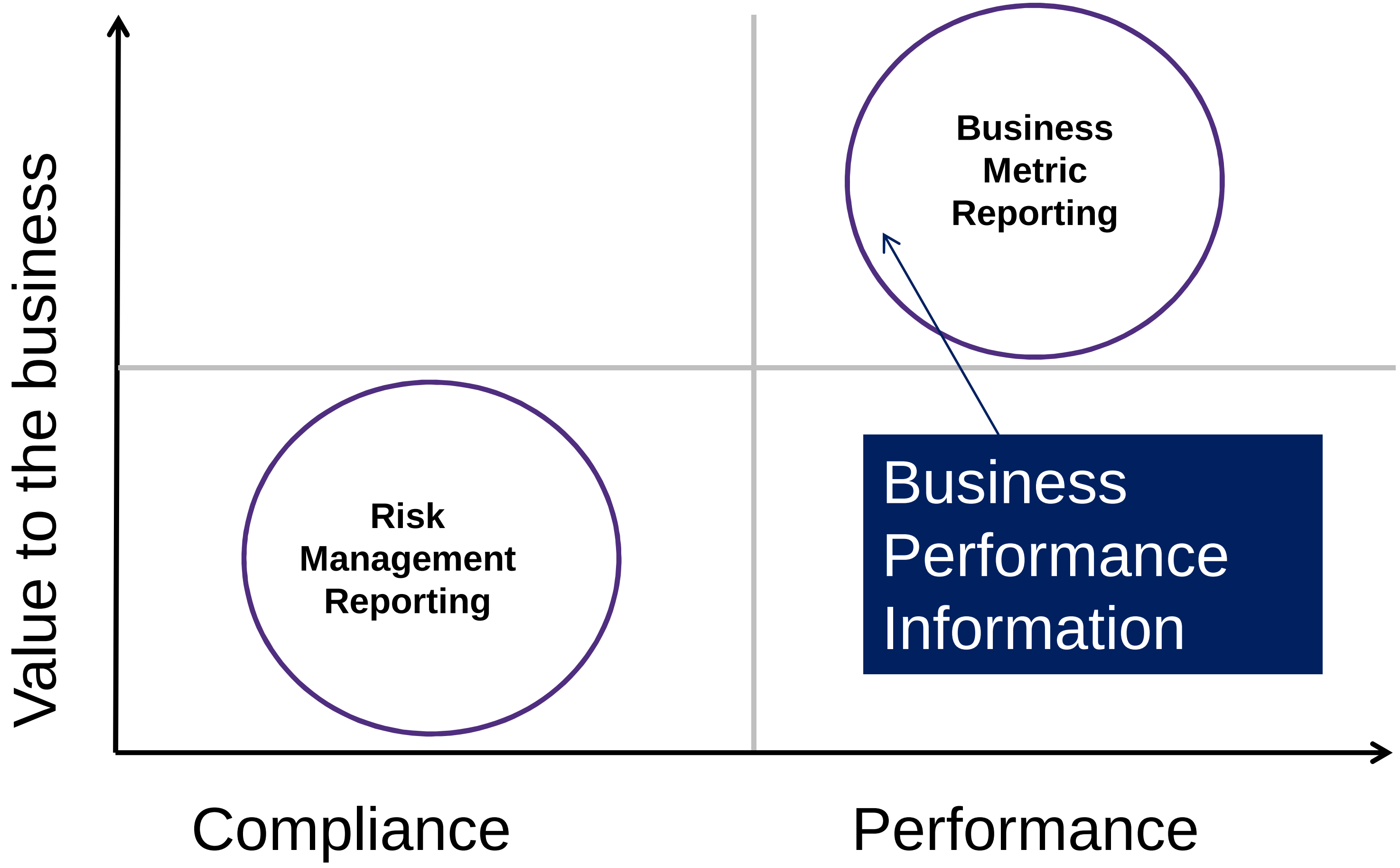


Grant Thornton

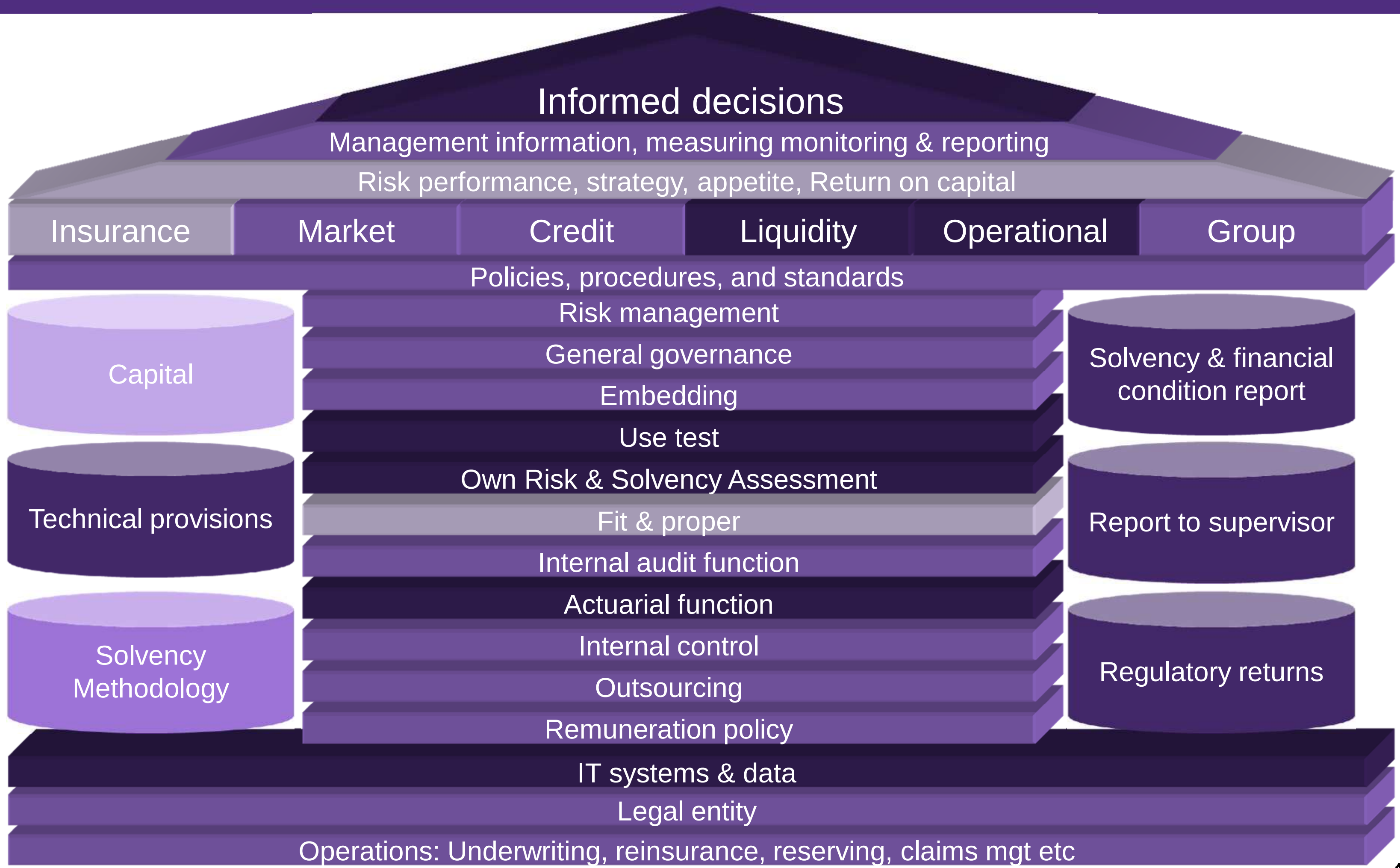
Own view of risk



Value of Management Information



Bringing it all together



Questions and discussion

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