

insurance matters

Focusing on the non-life industry

**Internal models –
implementing,
embedding and adding
value to your business**

**The actuary of the
future – introducing
the Actuarial Function**


**Extracting value
from your business –
capital models in
the legacy sector**

The power of incentives

**Creditor insurance –
the big shake up**



If you would like to discuss any issues raised in this publication please contact Nick Hall – nick.hall@watsonwyatt.com
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Welcome to insurance matters

Welcome to the second edition of 'insurance matters', a publication aimed at helping our non-life Insurance and Financial Services clients stay abreast of developments in the non-life insurance industry.

Watson Wyatt continues to expand its offering to this market by adding recruits from both consultancy and company backgrounds to its already strong team. In this issue of 'insurance matters', we have showcased the breadth of talent and knowledge at all levels within our team.

2009 promises to be a challenging year for non-life insurers in many different aspects, and the articles in this publication address some of the responses insurers are likely to need to make in areas such as delivering value from run-off operations and, of course, Solvency II.

Our Insurance and Financial Services consultants can deliver practical hard-edged strategic advice to clients dealing with some of the other issues addressed in this publication, such as the huge challenges faced by the payment protection insurance (PPI) industry.

In addition, by combining non-life insurance expertise with Watson Wyatt's world-leading consultancy in other practice areas such as Human Capital, we feel that we are uniquely placed to help clients deal with some of the consequences of the recent financial crisis and, in particular, to develop a solution to the challenge of constructing a best practice remuneration policy.

Furthermore, we feature coverage from our very successful 2008 European Non-Life Forum.

We hope you enjoy reading this edition of 'insurance matters' and would welcome your comments on issues you would like us to address in the future.

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Internal models – implementing, embedding and adding value to your business

Kirsty Gray discusses the European Non-Life Forum which was held in Cascais, Lisbon in October 2008.

The Hotel Cascais Miragem, situated on the Atlantic coast only 30 minutes drive from Lisbon, was the venue for Watson Wyatt's annual European Non-Life Forum 2008.

Clients from the UK, France, Spain, Italy, Belgium, the Netherlands, Switzerland, Poland and Russia joined members of Watson Wyatt's European Insurance and Financial Services practice for a day and a half of presentations, discussions and workshops on internal models.

Martin Pike, European practice director, IFS opened the event with a presentation entitled **'The carrot and stick – why bother with internal models?'** Luckily the carrot and stick metaphor seemed to translate well from English into other European cultures. The audience grasped the fact that management will gain a better understanding of their business by going through

the process of building an internal model, which should lead to a competitive advantage over companies who do not choose this route. The time, effort and cost involved in building an internal model should compare favourably against the alternative option of using the standard model to calculate capital, which will almost certainly result in a higher Solvency Capital Requirement (SCR) and will leave management without a good foundation for risk management and strategic decision-making.

Martin also stressed the need for companies to consider how best to change the whole culture of their business, with a greater emphasis on risk and capital measures, and suggested that extensive training was likely to be required. "Solvency II [was] not just for actuaries, but for the whole of the senior team, and Solvency II programmes [would] need to engage the whole business."

Simon Harris, team managing director, Moody's Investors Service then gave a presentation on **non-life insurance and capital from a rating agency view**. Simon explained Moody's

insurance rating methodology and how their approach to assessing capital has evolved over time. Companies in the future can expect rating agencies to carry out detailed assessments of their internal models both from a qualitative and quantitative point of view and integrate this with their perception of the company's risk management before deciding on the rating.

Simon also gave his view on the credit crunch, which stemmed from poor lending and extensive securitisation. In general, European insurers' exposure to sub-prime and other highly structured assets has been limited and underlying insurance business performance has remained strong. Refinancing and additional capital requirements have been modest and although there have been a few high-profile casualties, there has been limited direct rating impact on the industry to date, although there has been negative rating pressure due to the economic downturn. The question for the future is whether or not insurers can learn from the mistakes made in the banking world and avoid the same over-reliance on models.



Kirsty Gray

Delegates then adjourned to the bar where they were treated to a lesson on the history of port and enjoyed sampling a range of White, Tawny and Ruby varieties before heading off to Casa del Mar, one of the area's most popular seafood restaurants, for a lively dinner with local food and wine.

Manel de la Rosa, the Madrid non-life practice leader, opened the session the following day with a presentation on **embedding internal models**. To be able to use models to calculate solvency capital in place of the standard formula under Solvency II, companies must satisfy the 'use test' by integrating the model into business decisions on strategy, operations and management actions. Embedding the model will also be important to satisfy rating agency requirements for enterprise risk management (ERM).

Manel looked at the lessons which have been learned from other risk-based capital regimes, specifically the Individual Capital Adequacy Standards (ICAS) framework in the UK and the Australian Prudential Regulation Authority (APRA) in Australia. He found that one of the main aims of the regulators, encouraging a greater risk management culture in companies, seems to be being met. Senior management now have a greater knowledge and understanding of the model results and methodology and progress is being made in the quality of oversight and governance. Although decisions on reinsurance strategy and portfolio acquisitions or divestitures are being made using these models, significant work is still required to embed the models into firms' risk management frameworks and use them for day-to-day risk management decisions.

How firms can use models to help with **performance measurement and management** was the topic presented by Benoit Verbrigghe, a consultant from Watson Wyatt's Milan office. For best practice, executive compensation should be aligned with the risk framework in an organisation. Currently, the majority of performance measures are based on financial year profits with no consideration of the risk associated with the underlying business, performance over a longer-term or the alignment of corporate and individual interests.

However, with internal models, a range of methods exist to allocate risk capital to lines of business to reach a fair, consistent and applicable risk-adjusted performance measure. An example was provided of an organisation choosing operating ratio as the performance measure and equal percentile probability of impairment as the capital allocation method. Issues of dealing with group reinsurance arrangements, diversification benefits and long-term soft performance drivers were also discussed. The conclusion was that internal models are an excellent base to build performance measures at all levels of an insurance company.

In the next two sessions Pierre-Jean Vouette from Autorité de Contrôle des Assurances et des Mutuelles (ACAM) who is a member of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) presented on the **Regulator's perspective on Solvency II** and Richard Bulmer, a principal actuary from the UK, gave a **Solvency II Update** with a timetable of actions to enable companies to prepare for implementation.

The key messages were that there are strong incentives for companies to develop internal models to improve their risk management and that preparation should start now to ensure companies are able to meet the requirements in four years' time.



The key actions which need to take place now are:

- A gap analysis looking at people, systems and processes to identify what needs to be improved or changed to meet the needs of the business under Solvency II.
- A financial impact analysis. If companies have not participated in Quantitative Impact Study 4 (QIS4) then they should complete the spreadsheets on a best efforts basis to see the impact on their capital of the new calculations.
- A Solvency II implementation plan – identifying someone senior in the company as responsible for the Solvency II project.
- Risk management documentation.

Firms which start planning now and work with their regulators over the next four years to build internal models and develop their Own Risk and Solvency Assessment (ORSA) framework should be well placed for Solvency II when it is implemented.

Developing an optimal business strategy

was the topic presented by Rob Collinson, a principal consultant from the UK. Rob spoke about how you can rank strategies objectively to support strategic decision-making using an internal model. The key is to be able to analyse the information in a short enough timescale to be useful to the business, and then be able to present the complex information in a way that is informative, easy-to-understand and includes the key features pertinent to the decision. Strategies which are broadly reasonable and attainable,

taking into account the risk appetite and capital available can be identified and used to inform strategic decisions.

Following the presentation, Rob ran an **optimisation workshop** to demonstrate some practical examples of different strategies and let the teams identify the optimal business decisions given a set of parameters within which they could operate.

Ryan Warren, a principal actuary from the UK, then presented on **mergers and acquisitions – deal pricing using an internal model**. He examined the key elements of the due diligence process and how models can be used to determine the economic value of an owner's interest in a business, the valuation of in-force business and the assessment of goodwill using an economic value and market consistent appraisal valuation framework.

This process can be used to identify synergies or diversification benefits from new books of business and to prioritise potential targets or books of business to sell. The benefits of this approach are that shareholder expectations regarding risk and reward can be identified and there is a clear link between profitability and valuation. It is expected that models will be used more often in the future to inform decisions in merger and acquisition deals.

The final topic of the forum was on **lessons arising from the sub-prime banking crisis**. This presentation was given by Graham Fulcher, the UK non-life practice leader. Drawing from a number of recent reports by regulators throughout the world including the Senior Supervisor's Group (SSG), the President's Working Group on Financial Markets (PWG), the Counterparty Risk

Management Policy Group (CRMPG) and the Financial Stability Forum (FSF), Graham highlighted the key factors which contributed to the crisis. These factors were broken down into four areas:

- **Model features** – firms which suffered significant losses exhibited excessive reliance on credit ratings, did not consider how hedges would perform in stressed conditions and did not take into account that correlations would be different in stressed, rather than benign, market conditions.
- **Model limitations** – firms which experienced significant problems tended to apply a mechanical risk management approach, accepting the estimates challenges based on other tools and expert judgement.
- **Impacts on models** – a combination of a benign macroeconomic environment – which meant that firms had not observed how products would behave during a significant market downturn – and competitive pressures to grow and maintain market share – which led to an erosion of sound underwriting practices – resulted in business volumes growing more quickly than investments in supporting infrastructure and controls.
- **Model uses** – in a number of firms, compensation and other incentives were not sufficiently designed to achieve an appropriate balance between risk appetite and risk controls, and risk management tended to be simply a monitoring function rather than part of the strategy and planning process.

In planning for Solvency II, companies should consider these factors and involve the risk management function from the beginning of the planning process to test how their targets fit with the firm's risk appetite.

Summary

'Internal models – implementing, embedding and adding value to your business' was viewed as an important topic by the delegates who attended the annual Watson Wyatt European Non-Life Forum and the feedback on the quality and content of the presentations was extremely positive.

For further information on the topics discussed, copies of the presentations or to register for the 2009 European Non-Life Forum, please contact:

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Association of Run-Off Companies:

capital modelling in the legacy market

Rob Collinson presents headline results from a recent Watson Wyatt survey

Watson Wyatt recently conducted a survey of members of the Association of Run-Off Companies, with the intention of gauging current trends in capital modelling in the legacy market. The survey was based on questions completed by delegates of the 2009 ARC Congress who attended the capital modelling session.

The survey showed that the top four issues in the market are as follows:

■ Use of capital models

Whilst 27 per cent of the survey respondents currently use a capital model to help manage their run-off business, an overwhelming majority of 73 per cent do not currently use a model in the day-to-day management of their business.

■ Financial crisis

Over 70 per cent of the respondents felt that the current financial crisis will put greater pressure on companies to use modelling techniques to manage their capital. However, 27 per cent did not think the crisis would have any impact on their use of capital models.

■ Adding value

50 per cent of the respondents believed that a capital model adds most value in managing capital requirements of a run-off business, 33 per cent felt that capital models add most value in the optimisation of business strategies, while 17 per cent thought the area to gain the most value from capital modelling to be the identification of commutation opportunities.

■ Desirable features in a capital model

Of all the features in a capital model, 46 per cent felt that easy-to-interpret results were the most important factor, whilst 33 per cent cited auditability and transparency, 13 per cent thought having a model that was quick to set-up and run and finally, 8 per cent felt that ease of use was the most important factor.

“As the principle of risk-based capital takes root throughout Europe and as shareholders look to improve the efficient management of their capital, companies will increasingly need to create and maintain capital models as part of the daily management of their business.”

Paul Corver, ARC Chairman

insurance matters in the numbers

47

The anticipated role for the Actuarial Function as currently proposed in the Solvency II draft directive is defined in Article 47.

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2003

The FSA introduced one of the world's first fully risk-based capital regulatory requirements in 2003 with the inception of the ICAS regime.

See page 13

12

‘Long-term’ incentive plans typically relate to a performance period of more than 12 months, with three years being the most common timescale.

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£4 billion

PPI is a large market with approximately £4 billion of premium written in 2007.

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The actuary of the future

introducing the Actuarial Function

Dean Swallow and Sanjiv Chandaria
explore the challenges of this new role.

One of the most significant changes proposed under Solvency II is the introduction of the defined 'Actuarial Function'. This will be the first such actuarial statutory requirement for UK non-life insurers since the introduction of the requirement for Lloyd's managing agents to obtain an annual statement of actuarial opinion (SAO) on the reserves of their syndicates.

Even though most UK insurers already have an Actuarial Function, the responsibilities under Solvency II differ, in our view, from the responsibilities currently assumed by non-life actuarial teams. In this article, we try to shed some light on what is likely to be required and what can be done to prepare for this important new role.

The anticipated role for the Actuarial Function as currently proposed in the Solvency II draft directive is defined in Article 47 and is reproduced in Figure 1.



Sanjiv Chandaria

Figure 1 | Article 47 – Actuarial Function

→ Insurance and reinsurance undertakings shall provide for an effective Actuarial Function to undertake the following:

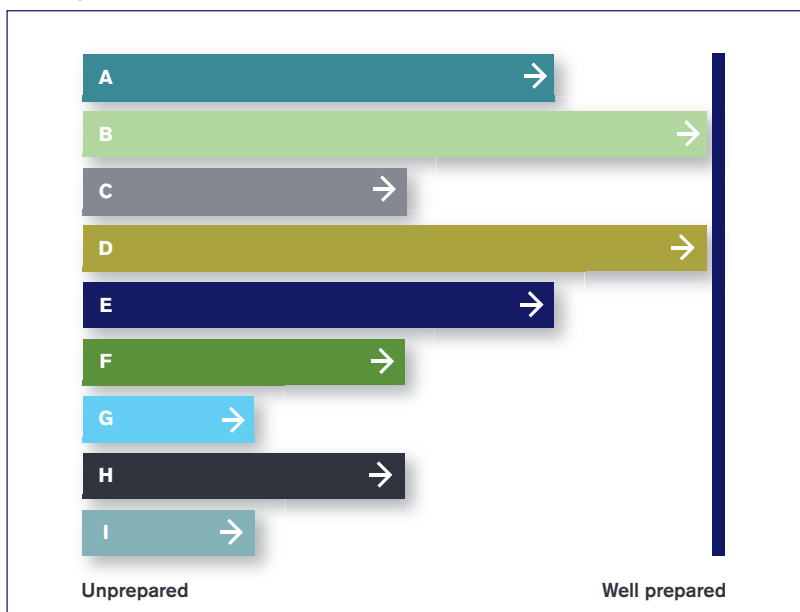
- A** to co-ordinate the calculation of technical provisions
- B** to ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions
- C** to assess the sufficiency and quality of the data used in the calculation of technical provisions
- D** to compare best estimates against experience
- E** to inform the administrative or management body of the reliability and adequacy of the calculation of technical provisions
- F** to oversee the calculation of technical provisions in the cases set out in Article 8¹
- G** to express an opinion on the overall underwriting policy
- H** to express an opinion on the adequacy of reinsurance arrangements
- I** to contribute to the effective implementation of the risk management system referred to in Article 43², in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5³ and the assessment referred to in Article 44⁴.

→ The Actuarial Function shall be carried out by persons with sufficient knowledge of actuarial and financial mathematics and able where appropriate, to demonstrate their relevant experience and expertise with applicable professional and other standards.

¹ Areas not suited to actuarial analysis ² Risk management ³ Solvency Capital Requirement and Minimum Capital Requirement
⁴ Own Risk and Solvency Assessment (ORSA)

Source: http://www.gcactuaries.org/documents/amended_sol2_framework_dir_feb08.pdf

Figure 2 | Actuarial Function – how prepared are UK actuaries?



How does this compare with what actuaries are typically already doing?

From an initial inspection of Article 47, we can see that some of the Actuarial Function requirements are already included within an actuarial team's current responsibilities, although to considerably varying degrees. However, others are currently not part of an actuary's typical duties.

In Figure 2, we give an indication of the potential gaps in a typical UK non-life Actuarial Function. In practice, the extent of current compliance with the proposed Solvency II requirements will vary from firm to firm.

From Figure 2 we can see that in general, UK non-life actuaries are reasonably well prepared for requirements 'A', 'B', 'D' and 'E', many of which are necessary to comply with GN 12 (actuarial guidance relating to formal reports).

However, reserving approaches and systems will need to be changed to enable calculation of technical provisions in line with the Solvency II proposals. In particular, reserves may need to be determined from

probability-weighted average cash flows (current methods often do not allow for the most extreme claim scenarios) and will need to allow for additional risk margins and be discounted for the time value of money.

Another important area for consideration is how best to structure the actuarial team in order to meet these requirements, as it may not be necessary for a single actuary to assume all of the AF responsibilities. Current practice varies; some firms have reserving and pricing actuaries together, other firms pricing and capital actuaries together and others have pricing actuaries working in underwriting units and carrying out all functions for their firm.

Where are the most significant gaps?

Figure 2 identifies five key areas which seem likely to require an expansion of an actuarial team's responsibilities. These are discussed in turn below.

Sufficiency and quality of data (C)

In accordance with GN 12, an actuary is already required to comment on

data accuracy and completeness, and on the implications of any material data limitations. However, in practice this will often only comprise reasonableness checks on the data with the actuary stating that he has used the data provided without independent verification. We agree with the latest report from CEIOPS which suggests that the Actuarial Function will have much greater responsibility for the adequacy of data used to determine technical provisions. This may involve taking account of data from the wider market, or even providing a formal sign-off of data quality.

This requirement may be onerous for actuaries working in commercial lines and, particularly, in the London Market. Liability lines such as D&O and PI spring to mind: with claims experience being linked to economic conditions, it is often difficult to assess how relevant the historic data is for projection purposes. Data quality in Lloyd's and the London Market has improved considerably over the last 15 years but it is still far from perfect.

Oversee calculations in areas not suited to actuarial analysis (F)

This requirement relates to circumstances where the nature of the business does not lend itself to standard actuarial analysis, such as where there is insufficient relevant data for projection purposes. In these cases, use is generally made of work or reports from various sources including loss adjusters, underwriters, brokers and legal advisers.

Rather than simply relying on the figures provided, the Actuarial Function will be required to oversee the calculation of technical provisions. In many cases this is likely to be quite a daunting task, particularly in the London Market, where claims frequency is generally



lower and claims are of a highly individualistic nature. This contrasts with personal lines where claims frequency is much higher and claims are more homogeneous.

Clearly, the Actuarial Function will need to obtain an understanding of the calculations and procedures used to determine technical provisions in these cases. It will also be necessary to assess whether or not these represent a best estimate, and if not then to determine appropriate adjustments.

Express an opinion on underwriting policy (G)

The Actuarial Function will need to state that they are satisfied, or otherwise, with the overall underwriting policy of the insurer, and include an appropriate level of justification. Of all the requirements, this one in particular stands out as being the most significant extension to the role typically currently assumed by an actuarial team. In particular, whilst the “new Lloyd’s” (that is, post-Equitas in 1996) is more efficiently run and leading the world in some respects, many agencies are still underwriter-led organisations and so actuaries could find themselves in a difficult position when expressing an opinion on the underwriting policy.

To be able to sign-off on underwriting policy, the Actuarial Function will need to obtain a deep understanding of the decision-making process. Some of the steps that could be taken to develop this include:

- Becoming familiar with underwriting systems and procedures.
- Understanding the extent to which underwriter judgment is applied for risk acceptance and premium rating.
- Investigating the impact of writing business via different distribution channels or intermediaries.

- Understanding the scope for variation of terms and conditions, and the possible effects on claims development.
- Developing a rate adequacy measure.

Express an opinion on reinsurance adequacy (H)

Generally, the Actuarial Function may be more comfortable expressing an opinion on reinsurance adequacy than on underwriting policy. This type of opinion lends itself more readily to quantitative analysis, with capital models providing a means of exploring the risks involved. If not already the case, this requirement provides further incentive for actuaries to provide input into reinsurance purchasing strategy.

One area where additional work might be needed is in assessing reinsurance adequacy on reserves, particularly where commutations have taken place. More sophisticated modelling of reserve run-off might prove useful here – for example, explicit modelling of significant claims or events and their interaction with the remaining reinsurance cover.

Contribute to the effective implementation of risk management systems (I)

Although the ICA regime has led to an increased focus on risk management, in our experience many UK non-life actuaries have limited involvement with the actual implementation of risk management systems. As such, this requirement will involve a step-up in responsibility in most cases, although the extent will vary between insurers.

Involvement of the Actuarial Function in this area will ensure there are appropriate ongoing links between risk management and capital modelling, thereby helping to

demonstrate that the capital model is embedded in the wider business (the ‘use test’).

Summary

What might be done now to prepare?

It can be seen that the Actuarial Function is likely to look and feel very different to the current position. In addition to undertaking a gap analysis and developing an implementation plan, we believe there are two fundamental questions that firms will need to address now:

- How should the Actuarial Function be structured under Solvency II? In particular, should all actuaries be grouped together or, at the other extreme, be employed in the various business units?
- Should some of the Actuarial Function responsibilities be outsourced? Might there be perceived or actual conflicts of interest between some of the requirements of the role and the existing role of the in-house actuarial team as part of the internal management?

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Extracting value from your business — capital models in the legacy sector

Paul Hewett and Rob Collinson
explain how to tackle the challenges
facing run-off companies.



The biggest change to the UK insurance market in the past decade has debatably been the formal recognition by the regulator that the risks faced by insurance entities are complex and cannot be adequately described in terms of premium income or reserves held. Having acknowledged the need for capital requirements to more closely reflect the risks facing the business, the FSA introduced one of the world's first fully risk-based capital regulatory requirements in 2003 with the inception of the ICAS regime.

Arguably, firms have primarily focused upon compliance with regulation. However, over time, FSA advice to firms has increasingly focused upon the principle of 'embedding'. Under this approach, the capital model and all the considerations and processes around it are used to inform the day-to-day decision-making of an organisation. Looking forward, the embedding approach has been embraced and further extended within the Solvency II framework as the 'use test'.

To date, risk-based capital regulation has impacted relatively lightly upon firms within the legacy sector. Whilst all UK firms must have an ICA available, those businesses wishing to undertake some material transaction are required to undertake a review of capital which must be presented to the FSA.

Capital modelling platforms can offer considerable strategic benefits beyond mere regulatory compliance. In this article, we consider a possible application for legacy companies.

An example – inwards commutations

Two of the key drivers of value within a run-off company include the ability to identify profitable commutation opportunities and the rate at which the supporting capital may be removed from the organisation and usefully applied elsewhere.

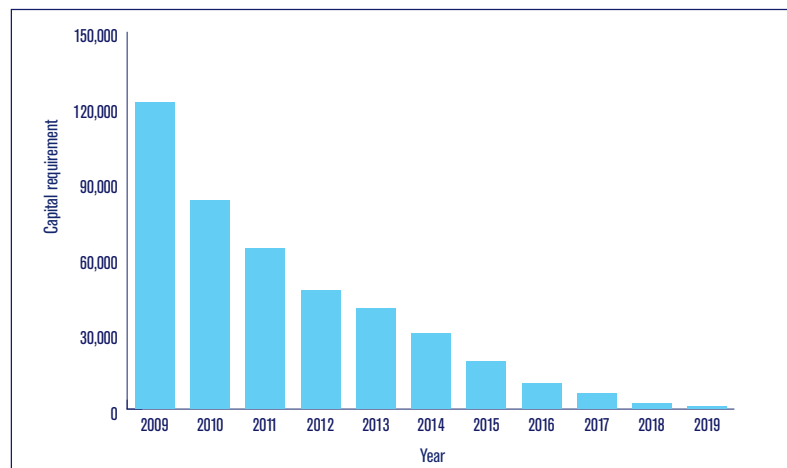
Typically within a run-off company, capital is held so that the percentage payment on claims will only fall below the desired value (100 per cent for solvent run-offs) in extreme conditions (say one in 200). However, as time progresses, if the performance of the firm has been broadly as expected then the requirement for capital will decrease as the scale of the uncertainty surrounding future claims payments reduces.

An appropriate capital model will reflect this behaviour and, as a result, may be used to prepare a schedule demonstrating the timescales under which capital may be removed from the business. This is of particular benefit for those firms looking to set appropriate prices for portfolio transfers into or out of the company and requiring regulatory sign-off.

Figure 1, below, sets out a typical capital repatriation schedule for a run-off company. From this we can see that the resources required in order to maintain solvency falls by 50 per cent within two years, but thereafter the reduction in capital is considerably slower.

However, a key benefit of an appropriate capital model is the ability to test a range of scenarios. In this case, we consider the commutation of a significant proportion of liability. Figure 2 sets out the capital requirement schedule following commutation during 2008.

Figure 1 | Capital repatriation schedule – no commutations



In this case, it can be seen that the total capital requirement of the business is materially lower than the pre-commutation position for all years post-2008, implying that this deal allows for a significant release of capital.

The final decision of whether to commute the business now depends crucially upon the cost at which this can be achieved. This analysis enables the calculation of the maximum price at which such a deal is appropriate.

Reinsurance and outwards commutations

The example shown in the previous figures illustrates how we can use capital models to assist with managing a run-off company's inwards commutation strategy. However, similar principles can be applied to aid in the understanding of the risk-reward trade-off surrounding outwards reinsurance commutations.

Whereas the analysis of an inwards commutation is focused on the resulting change in the company's insurance risk, an outwards commutation must also consider the

potential reduction in the credit risk through crystallising the liabilities at an earlier date. The modelling process must therefore be able to combine a model of the insurance liabilities flowing to a contract or group of contracts with the creditworthiness of the reinsurance companies involved.

In addition to assisting with the commutation strategy, a capital model can be used in pricing a reinsurance commutation by enabling us to consider the value of the contract to the company as a whole, in terms of the expected additional claims cost, but also the impact upon the capital requirement.

For example, when pricing a commutation on an excess of loss reinsurance contract, it would be typical to initially model the anticipated recoveries on the contract at a range of different risk percentiles. The required price would then be chosen based upon a particular point or average in the distribution.

However, this technique only considers the risk on the book of business covered by the individual

contract in isolation. Using a capital model, we can simulate the change in the economic capital requirement caused by removing the risk protection provided by the contract, and taking into account all the correlations and dependencies which have been built into the model. If these results showed that the contract in question had only a marginal impact on capital (for example, if the contract covers a relatively small book), you may be prepared to price at a lower percentile level than you would for a contract which has a more material impact on capital.

Summary

This article has provided a brief illustration of the benefits of capital models to legacy organisations. The modelling platform may be used to inform a wide range of strategic decisions including the strategy surrounding and the pricing of commutations, asset allocation and the pricing of portfolio transfers. The use of such models will undoubtedly become more widespread and it is likely that failure to embrace this opportunity will be a significant competitive disadvantage.

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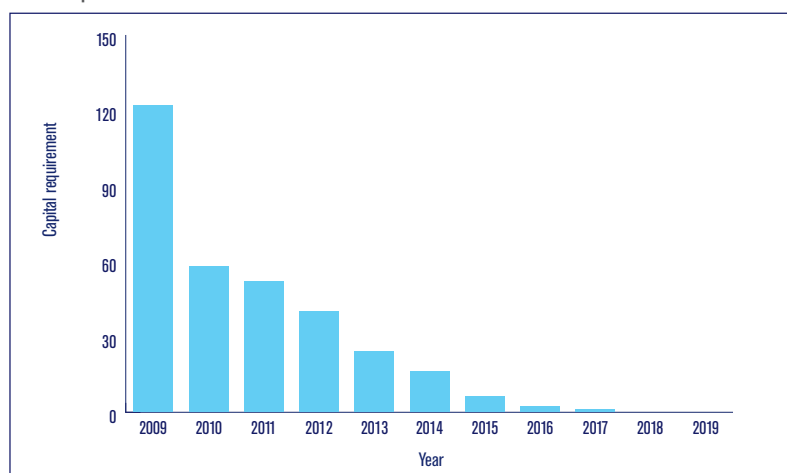
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Figure 2 | Capital repatriation schedule – post commutations



Unravel the complexity

A new capital modelling tool designed specifically for the non-life insurance industry

Watson Wyatt has called on its extensive experience in strategic capital modelling to create a completely new version of Simulum, a practical, cost-effective solution for the management and analysis of risk. Fast to implement and intuitive to use, Simulum will efficiently and rapidly deliver capital modelling reports that support vital business decisions and enable compliance. Complexity suddenly became simpler.

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The power of incentives

Kate Angell and Geoffrey Strickland discuss the challenges with insurance companies' incentive arrangements.

There is no doubt that people respond to incentives, whether it is a sale in a shop attempting to influence people to purchase a particular item, or encouragement to travel out-of-peak hours by offering reduced train fares. Few people would disagree that the best way to get people to act in a certain way is to reward them for doing so.

Incentive pay arrangements, and their influence on the way employees act, have recently come under the spotlight and are under significant pressure from a variety of sources – a difficult economic environment, highly volatile financial markets, continued criticism from pay watchdogs and new legislative initiatives.

From its initial focus on the banking sector last year, the spotlight is now moving to all firms regulated by the Financial Services Authority (FSA), including the insurance industry. The FSA sent a 'Dear CEO' letter on this topic in October last year, and in a CEIOPS Issues Paper issued in November last year the issue was referred to in relation to the control environment of insurers – "... remuneration policies should be structured to avoid potential incentives for unauthorised or unwanted risk taking". More recently, at the end of February 2009, the FSA published a draft code of practice on remuneration policies relevant to all FSA regulated firms, with consultation

and further proposals from the FSA on this topic to follow. The principles specified in the code of practice published by the FSA are set out in Figure 1 overleaf. Indeed, some people believe that the power of management incentives is in some ways greater than the regulatory framework, and unless acknowledged and addressed, could result in the Solvency II framework being less effective than it could, or should, be.

The focus is not on what is, or is not, an appropriate level of reward for an individual, but more specifically on how the pay arrangements are structured to encourage the right behaviour. And, it is not just about executive pay arrangements – the impact of the structure of pay arrangements is an issue for staff across all levels within organisations.

The concept of establishing pay arrangements to encourage the right behaviour is simple. The difficulty begins when it comes to designing incentives that motivate employees to act in the desired way, while also being acceptable to all the parties involved (including the employees themselves, the employer, shareholders, the regulator, rating agencies and industry bodies). The FSA's focus is to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls and with the firm's stated risk appetite, and which do not expose the firm to excessive risk. In addition to this, individual firms will want to ensure that their remuneration



Geoffrey Strickland

policies are also aligned with the company's stated strategy and, for listed companies, with the interests of shareholders. Conflicting with these is the tendency for discretionary incentives to become a fixed, or expected component of an individual's remuneration package, particularly in industries where there is a shortage of skilled talent.

So what features does a good incentive arrangement possess? The main three components of a typical package are a salary, an annual bonus and a long-term incentive plan. Annual bonuses are typically referred to as 'short-term' incentives, and have a performance period of 12 months or less. 'Long-term' incentive plans typically relate to a performance period of more than 12 months, with three years being the most common timescale.

It is useful for employers (and, indeed, employees) to consider all of the incentive components together to form a 'total reward' view, which should also include the value of pension and risk benefits and so on. This can allow more robust comparisons with peer companies.



Figure 1 | Principles from the FSA's draft code of practice

General principle	
	Firms must ensure that their remuneration policies are consistent with effective risk management.
Specific principles	
Governance	Boards and relevant remuneration committees should exercise independent judgement and demonstrate that their decisions are consistent with the firm's financial situation and future prospects. Their members should have the skills and experience to reach an independent judgement on the suitability of the remuneration policies, including the implications for risk and risk management.
	The procedures for setting compensation within the firm should be clear and documented, and they should include measures to avoid conflicts of interest. Risk and compliance functions (in consultation with the firm's HR function as may be deemed appropriate) should have significant input into setting compensation for business areas.
	Compensation for staff in the risk and compliance functions should be determined independently of the business areas. They should have different performance metrics, with greater emphasis on the achievement of their own objectives.
Measurement of performance for the calculation of bonuses	Assessments of financial performance to calculate bonus pools should be principally based on profits. The bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.
	Firms should not assess performance solely on the results of the current financial year.
	Non-financial performance metrics, including adherence to effective risk management and compliance with regulations, should form a significant part of the performance assessment process.
Measurement of performance for long-term incentive plans	The measurement of performance for long-term incentive plans, including those based on the performance of shares, should also be risk-adjusted.
Composition of remuneration	The fixed component of remuneration should be a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy.
	The major part of any bonus which is a significant proportion of the fixed component should be deferred, with a minimum vesting period.
	It is highly desirable that the deferred element of variable compensation should be linked to the future performance of the division or business unit as a whole.

Starting with the salary, this should be good but not too excessive, or in the FSA's original words, "large enough to meet the essential financial commitments of the employee". In the FSA's latest guidelines, this has changed subtly to "a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy". In other words, companies should be able to award small, or nil bonuses without feeling that this impacts unduly on an employee's basic living standard.

Other variable elements of the pay arrangement should provide the opportunity for individuals to earn significant rewards for superior performance. This links with the argument that discretionary incentives should only be used to reward exceptional performance, and that they should not be paid merely to encourage the right behaviours – behaviours which it is reasonable for the employer to expect from employees without being additionally rewarded.

For the annual bonus element, it is often appropriate to establish an arrangement whereby the maximum amount payable is capped at a certain percentage of salary. This prevents employees receiving 'windfalls' in excessively profitable years. In its February 2009 guidance, the FSA also suggested that not less than two-thirds of larger bonuses should be deferred and that payment of the deferred element should be linked to future performance.

“ Other variable elements of the pay arrangement should provide the opportunity for individuals to earn significant rewards for superior performance. ”

The long-term incentive part of any arrangement is typically made in the form of company equity, helping to encourage equity ownership of the company and strengthening the alignment of the shareholders' and employees' economic interests. One difficulty here can be ensuring that the employee appreciates the value of such equity arrangements, particularly when a number of different hurdles need to be achieved in order for the equity to be awarded. Too many complicating factors can result in the employee placing little, or no value on such awards.

For the discretionary elements of an incentive pay arrangement, it is important to be able to measure an employee's performance against the strategy of the company and the interests of the FSA. Part of any discretionary element may therefore be linked to non-financial targets, such as adherence to risk management procedures (although the argument remains as to whether such adherence should be rewarded or expected). The remainder may depend on financial performance, but this area gives rise to a multitude of issues that need to be considered and addressed when designing appropriate pay arrangements. Some of these issues are:

- Different lines of business are naturally more volatile than others, and require different levels of capital to support them. Consider, for example, the different features of a motor book and a property cat book.

- The final results for some lines of business are not known with a reasonable level of confidence for some years after the business was written. Should adjustments be made if significant reserve deteriorations are experienced on a particular book of business?
- The performance of an individual book of business may be protected through the purchase of low level reinsurance, which may not make economic sense when considering the company in totality.
- Depending on the line of business and the position of the underwriting cycle, in some cases it may be most sensible for an underwriter to severely limit the amount of business being written.

Summary

Good incentive arrangements will reward the right behaviours which align with the company's strategic goals – it just does not make sense to expect a certain strategic outcome while rewarding different behaviours. A more sophisticated approach to designing incentive pay arrangements for insurance companies is long overdue and, if carefully designed, should both motivate high calibre individuals and benefit the organisations with whose performance they are entrusted.

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Creditor insurance — the big shake up

Naomi Couchman and Kate Angell advise how companies can gain competitive advantage.

Creditor insurance has caused much debate in the industry over recent months, and this is set to continue. The way in which creditor insurance can be sold is about to be shaken up following the Competition Commission's investigation and, with the UK at the beginning of a recession, this is a testing time for both distributors and insurers of creditor business. So what effect will these changes have on the creditor insurance industry and what can be done by businesses to overcome these challenges?

What is creditor insurance?

Creditor insurance, also known as payment protection insurance (PPI), is a product sold primarily alongside credit products such as unsecured loans, mortgages and credit cards. If the borrower is unable to make their repayments due to accident, sickness, unemployment or death, the insurance policy covers the repayments for a specified period of time.

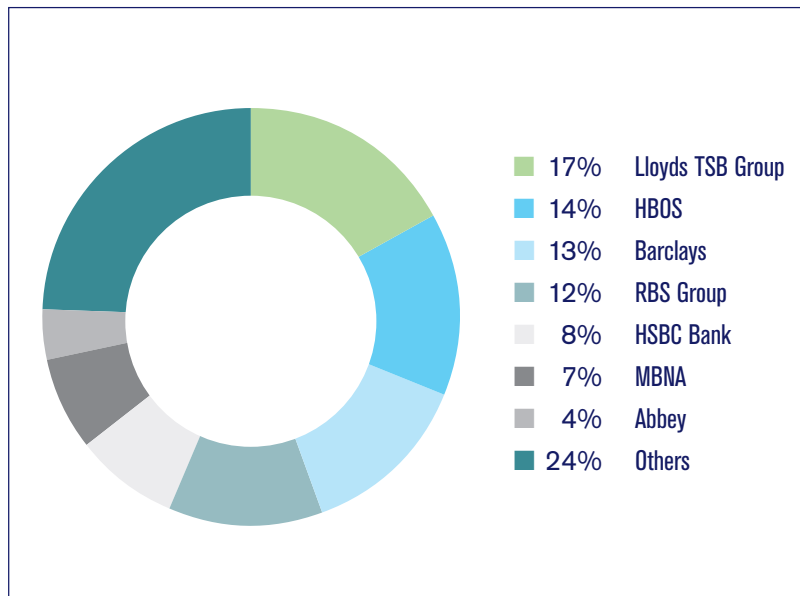
What triggered the Competition Commission to step in?

PPI is a large market with approximately £4 billion of premium written in 2007. The market is dominated by a relatively small number of players – 10 distributors were responsible for 84 per cent of the premium written in 2006, and it is a similar story for insurers – the top 10 insurers accounted for 93 per cent of the premium written in the same year, as shown in further detail in Figures 1 and 2.



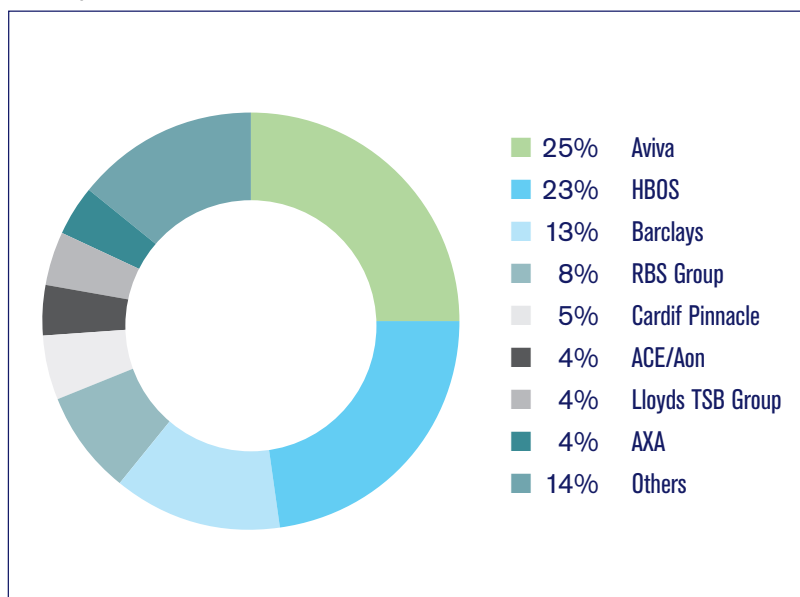
Kate Angell

Figure 1 | Distributors' share of written premium (2006)



¹Source: Mintel report 'Creditor Insurance – UK, Financial Intelligence, July 2008'

Figure 2 | Insurers' share of written premium written (2006)



¹Source: Mintel report 'Creditor Insurance – UK, Financial Intelligence, July 2008'



The investigation into the sale of PPI began following a referral from the Office of Fair Trading (OFT) in February 2007, with the OFT becoming involved following a 'super-complaint' from the Citizens Advice Bureau in September 2005.

What did the Competition Commission's investigation conclude?

The key finding of the Competition Commission was that businesses which offer PPI alongside a credit product face little, or no competition. As a result, they felt that:

- Consumers faced higher prices and less choice than a fully competitive market would give.

- It is highly profitable for distributors to sell PPI.

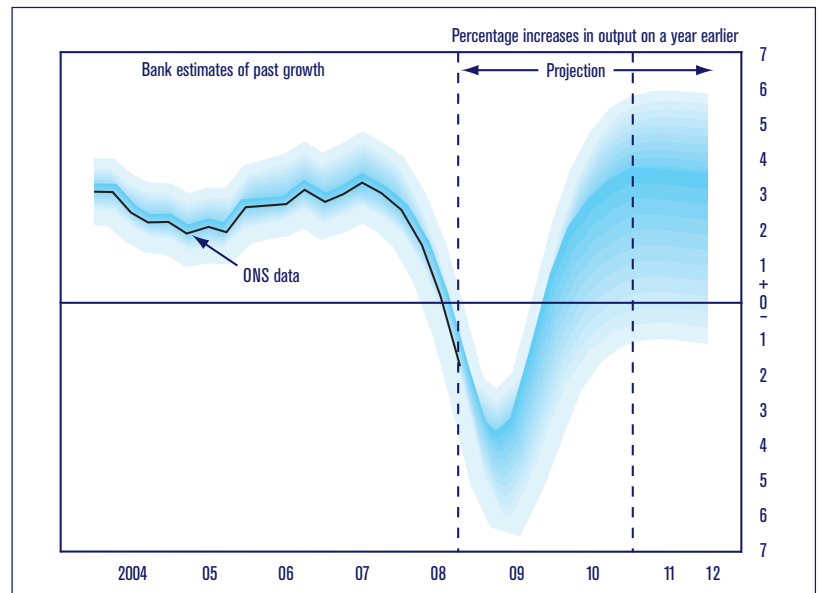
The Competition Commission found that many consumers were unaware that it is possible to buy PPI from other providers — separately from the credit product, that consumers rarely shop around to compare prices and terms and conditions of PPI policies, and that consumers also rarely switch providers.

The remedies

In response to their findings, the Competition Commission has recently announced a number of remedies which they expect to come into force during 2010. These remedies include:

- A ban on the active sale of PPI by a distributor or intermediary to a customer within seven days of the associated sale of credit to that customer.

Figure 3 | A projection of future economic growth, measured by growth in GDP




- A prohibition on the selling of single premium PPI policies. All future PPI policies must be monthly or annual premium.
- A requirement to provide improved information to consumers to make it easier for them to compare products, either at outset or at a later date. Such improved information includes a 'personal PPI quote' which will clearly state the cost of the PPI policy individually, and when added to the credit product, as well as a requirement to provide an annual statement for customers throughout the duration of their PPI policy.
- A requirement to provide premium information on PPI policies to the FSA and OFT, with a recommendation that the FSA use this information in their publicly available PPI comparison tables.

Following the Competition Commission's published remedies, the FSA sent a 'Dear CEO' letter in February 2009 on the subject of single premium PPI policies. Clearly hoping that companies will quickly switch to selling monthly or annual premium policies, this letter requests that firms stop selling single premium PPI policies as soon as possible, and in any event by 29 May 2009.

How does the recession affect the situation?

In its February 2009 inflation report, the Bank of England set out their projection of future economic growth, measured by growth in GDP. This is set out in Figure 3 and projects that GDP growth will be lowest in the middle of 2009 and will not return to levels previously seen in 2006 and 2007 until 2011.



“ There is no doubt that the upcoming changes should lead to a more competitive PPI market, with premium rates and sales volumes falling. ”

Claims experience on PPI business is highly correlated to the economic cycle, with an economic downturn leading to both lower volumes of PPI sales – due to lower lending activity – and increasing claims ratios. In addition to the obvious increase in unemployment claims, a secondary effect observed in past recessions is an increase in sickness claims, for example, due to stress-related illnesses.

One key issue for companies will be making an assessment of the likely impact of the recession on the claims ratios for their PPI business. One way of estimating the likely deterioration in claims ratios over the coming months is to compare the current economic projections with the actual economic statistics seen in previous recessions, together with the actual loss ratios experienced historically. Relevant economic statistics include the growth in GDP, together with historical employment levels and the historical flows into and out of unemployment – the latter of these often being more relevant than the actual nominal employment levels when considering PPI claims.

More recent statistics can also help. Data from the ABI shows that unemployment claims on PPI policies increased by 118 per cent when comparing November 2008 with the same period one year earlier.

What effects will there be on the PPI market?

The amalgamation of the remedies being imposed by the Competition Commission and the difficult UK economic environment is likely to have a number of (sometimes

conflicting) effects on the PPI market. Possible impacts include:

- A reduction in sales volumes, as lending levels continue to be affected by the credit crunch and the benefit of selling PPI to consumers at outset is lost. PPI has historically been sold, rather than bought, and with the prohibition of selling PPI at the time of the accompanying credit product the level of PPI sales are likely to fall, perhaps substantially. Some of this reduction may be offset as consumers recognise the benefit of creditor insurance in the current economic environment.
- Increased competition between PPI providers as consumers ‘shop around’ for cover following the purchase of a credit product. This competition may be further increased through the greater use of comparison websites.
- Increasing claims volumes, which in the short-term are likely to result from the tough economic conditions. Looking further forward, claims volumes may increase due to anti-selection effects, as only those consumers who deem themselves more likely to make a claim may actually decide to purchase PPI. In addition, consumers will be reminded of the existence of their cover due to the provision of the annual statement; this information may remind some people to claim, while others, who may feel they are unlikely to ever claim, may cancel their policy.

There is no doubt that the upcoming changes should lead to a more competitive PPI market, with premium

rates and sales volumes falling. This should present an opportunity for providers to capture a much larger market share than they have had historically. Critically, those providers who understand which risk factors drive their claims experience, and are therefore able to rate their insurance products accordingly, should be able to benefit from the increasingly competitive market while managing their claims costs.

Summary

The future

The combination of the challenging economic environment, together with the current regulatory intervention, means that the future is uncertain for the PPI industry. But challenges also give rise to opportunities, and those companies which have a coherent strategic plan to maximise their benefit from the current environment are likely to benefit from the current upheaval in the PPI market, at the expense of their competitors.

The shake-up may be about to start but, as long as distributors and insurers act now to make appropriate changes to their businesses, they can hopefully weather the storm.

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