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2020 Capital – Market Messages

Presentation to the Lloyd's Market C-suite

10 June 2019

Contents

Why are we here?

Integrity and equality of capital is a key pillar for the market

Lloyd's Corporation

- Provide
- Promote
- **Protect**

the Lloyd's market

Finance

- Protect the Central Fund
- Enforce equality across participants
- Ensure regulatory requirements are met

Pressure on capital requirements is visible to our process

We are committed to improving transparency and engagement

Overcoming challenges within this process is in our mutual interest

We are asking:

- Submit numbers with supporting analysis that is clear
- Provide complete analysis of change
- Manage change to ensure reflection of risk profile and appropriate validation
- Reflect objectively on your recent performance

We are offering:

- Transparency of decision making
- Differentiated oversight based on risk factors – joined up with PMD on light touch
- Faster turnaround speed for higher quality submissions
- We will make pragmatic adjustments

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Joining the dots

Ajay Shah, Syndicate reserving

– Getting the full picture for capital

What do we mean by joining the dots?

Bringing together parts of the business to reduce risk of understating capital

A number of areas contribute to the assessment of overall capital appropriateness.

There is a <u>risk of understatement of capital</u> if business assumptions are not joined up.

Actuarial team is key to communicating the uncertainties associated with the business plan, capital number, reserving and pricing.

These uncertainties should be incorporated in the capital calculation.

<u>Opening balance sheet</u> represents an appropriate exposure estimate

<u>Prospective loss ratio assumptions</u> incorporate track record

Allowance for risk in capital/reserving/pricing/ operations is clearly articulated

Capital appropriately reflects the full range of risk to the entity

Lloyd's expect Syndicates to have taken remedial action where there is evidence of increased risk of understating capital. If not, Lloyd's will consider if this is a breach of Minimum Standards

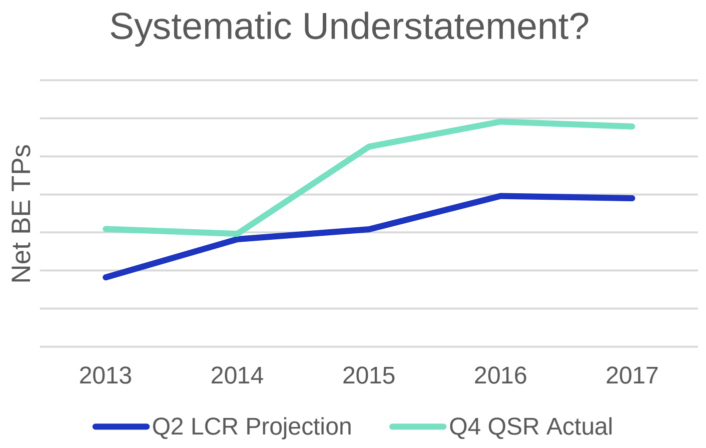
Balance sheet projections

Important that roll-forward process doesn't systematically understate Balance Sheet position

The projected Q4 Balance Sheet is the starting position for the 2019 Solvency Capital Requirement, where the Q4 Technical Provisions (TPs) are estimated from a Q2 roll-forward process.

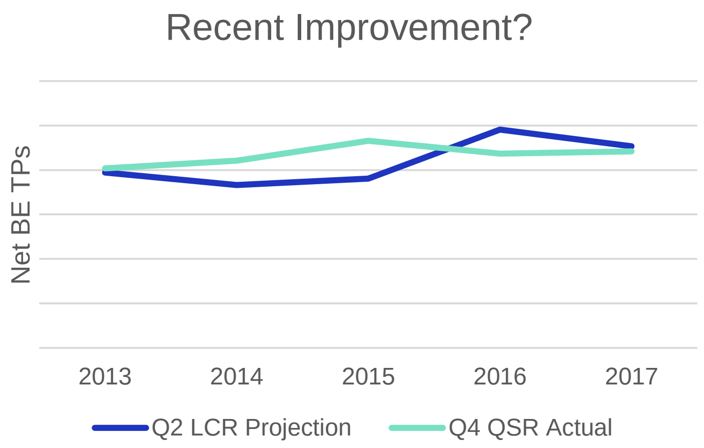
- Need to question if this position has been an accurate estimate historically or if there is systematic risk of understating
- Lloyd's will apply a capital load if historical experience suggests roll-forward process is inadequate and this has not been remedied by the Managing Agent

Syndicate A



Evidence of systematic understatement of reserve position may indicate capital is systematically understated.

Syndicate B



Evidence that there have been improvements to the roll forward process, but this needs to be validated, e.g. with back-testing.

Lloyd's will apply a capital load to a Syndicate showing significant deviation in Q2 projected TPs to Q4 actual TPs.

Lloyd's will not apply a capital loading where improvements have been made, but will require this to be validated.

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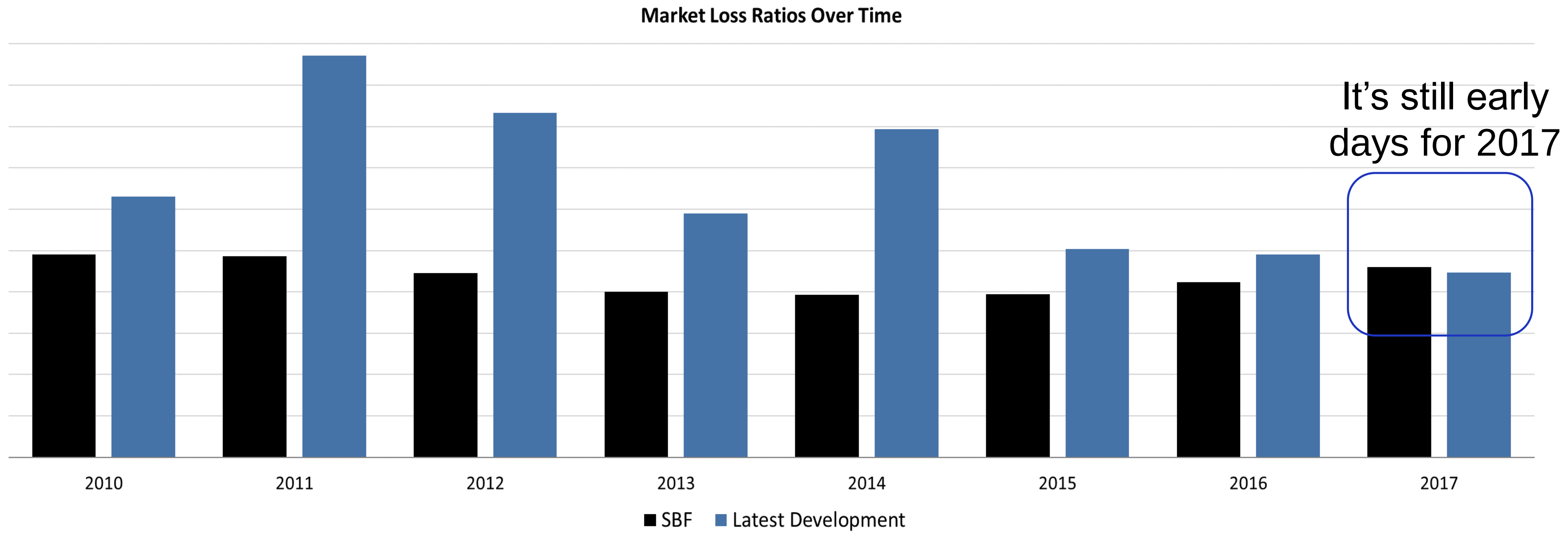
Performance against plan

Need to consider the history of performance deteriorating significantly from plan

Comparison of Syndicate Business Forecast (SBF) against Actual Loss ratios shows a clear, material and systematic deterioration to plan



SBF assumptions have been shown to be inadequate over time.
These movements should be affecting reserving and prospective loss ratio assumption setting.

Business planning

Prospective loss ratio assumptions should not include improvements without proven record

- Consistently not meeting plan suggests optimism or some other deficiency in the planning process

- Historical deviations from plan should be analysed
  - Model loss ratio higher than the plan where deviations unexplained
  - Some additional analysis undertaken where other reasons could be possible. E.g. changed the planning method and can prove.

- Explicit consideration, reporting and validation of the prospective loss ratios should be used for capital setting.
  - These prospective loss ratios should not take account of improvements without a clear track record of these being delivered

Market risk profile and oversight process

Catherine Scullion

2020 Capital

Range of areas to bring to board attention

- Reflect on existing feedback
- Ensure your change planning is coherent, manageable and clearly prioritised
- Value your validation
- Ensure the links between capital and risk profile are clearly understood and articulated
- Lloyd's review is risk-based, with process updates based on market feedback

Central vs Market view

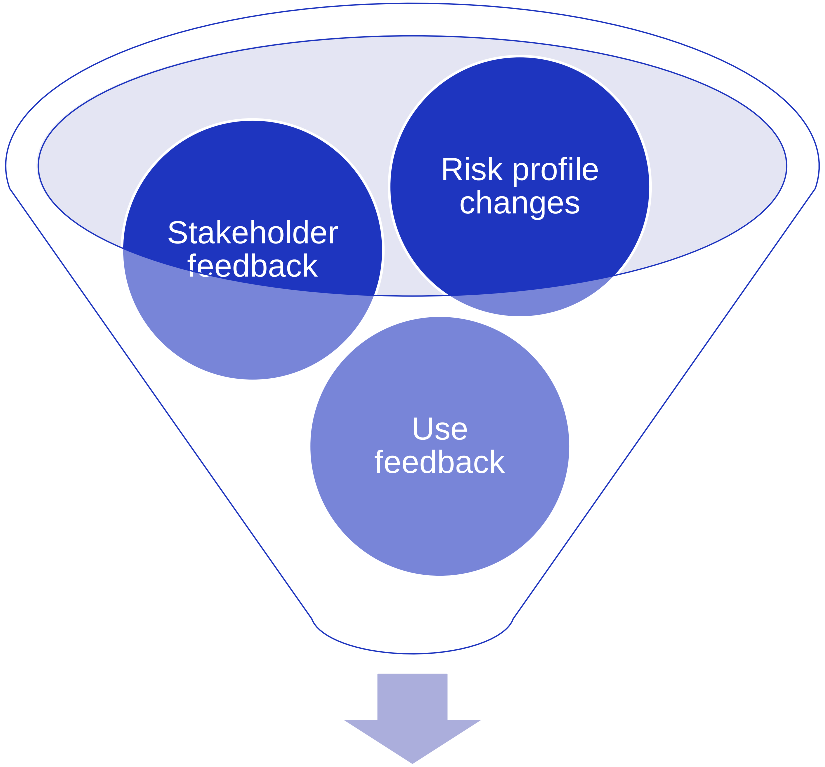
Lloyd's monitors syndicate model drift against Standard Formula and the Lloyd's Internal Model

- Syndicate Internal Model view is lowest by a material amount
- We recognise that the numbers can be materially different
- The focus is on understanding and quantifying the driver of these differences and monitoring over time
- Unlike the standard formula, the LIM is calibrated based on market experience and designed to reflect the market risk profile
  - Does have limitations
  - Still provides insight

We will be transparent about this comparison; we ask that the market is more open to what this may be telling them

Managing Change

Change should be prioritised and clearly managed and validated



Coherent change planning

- Balance between stability and development
- What has been prioritised, and why
- Assess the expected impact of changes prior to implementation
- Change acceptance should have a feedback loop to this expectation
- If a change is not practical, other action can be used to ensure capital adequacy

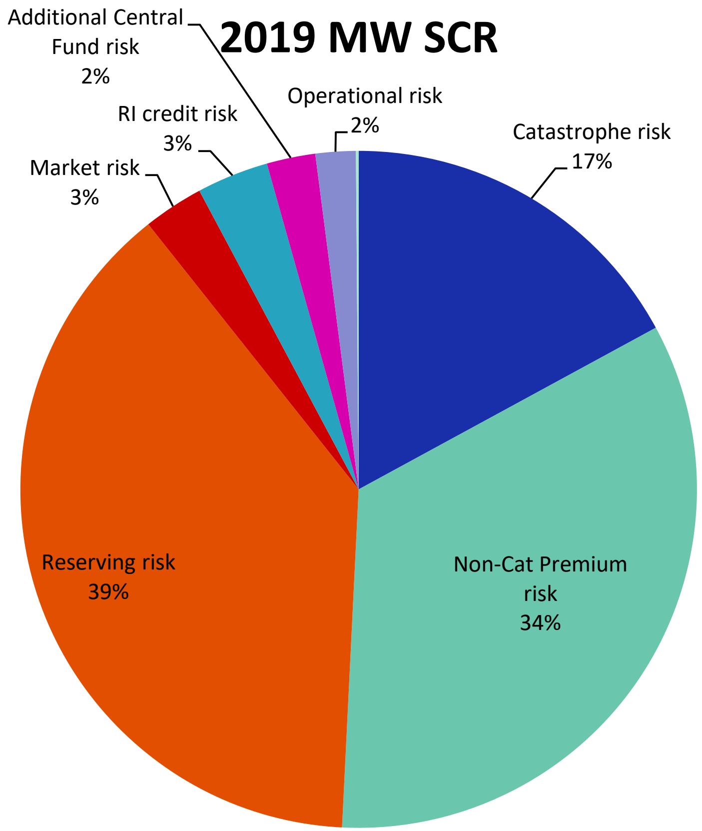
Value your Validation

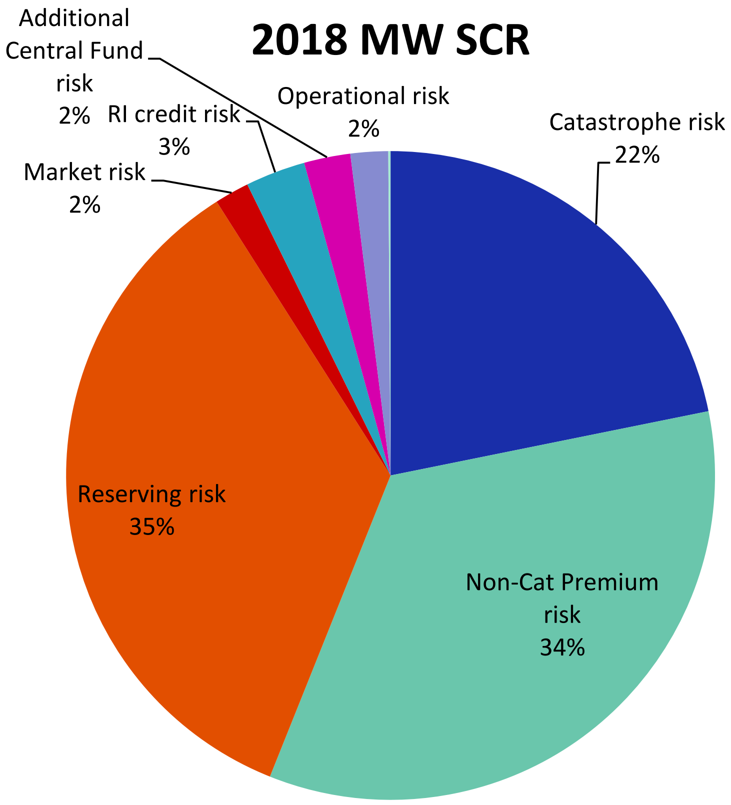
We expect the board to value robust, independent validation

This is a key tool for your decision making, not a box-ticking exercise

How is risk profile evolving?

Movements in capital should have clear, intuitive links to risk profile





Reserving risk

- Benign, or adverse, experience does not necessarily indicate a change in risk profile
  - Drivers need to be fully understood to make this judgement
- Balance between data and expert judgement
  - What range of results is suggested by the data?
  - What events are not in the data?
  - How is stress/scenario testing used to assess risk profile?
  - Is external data used, how should it be adjusted?
- Reinsurance modelling can be material and is usually not at individual contract level
  - Approximations should allow for parameter/methodology uncertainty
- We have seen poor 2018 market experience in the following lines:
  - Accident and health, General aviation, FI Non US, Hull, Medical malpractice (US), Non Marine Casualty (US)

Non-(Natural) Catastrophe Premium Risk

- Volume changes need to be considered in volatility parameterisation
  - Reductions in volume may increase volatility, especially if limit/aggregate exposures don't change
- Potential for event losses is particularly uncertain for premium risk
  - Scenario testing is a key tool to assess this
- We do not expect to see classes which are profitable in all outcomes
- Reinsurance should have realistic commercial performance
  - If allocation affects this ensure reporting considers performance on a relevant basis
- We have seen poor 2018 market experience in the following lines:
  - Accident and health, Airline, BBB, Cargo, Contingency, EL (US), PI Non US, Property Binders (US), Property pro rata and Property XS

Diversification

- Area that is challenging for parameterisation
  - Should be a focus for validation
- Diversification within the market is material; this is appropriate but has limits
  - Minimum requirement that addition of risk adds capital to at least the level implied by independence
  - For correlated risks the addition should be beyond the level of independence – we are defining a test with this through a market working group
- Stress/scenarios testing and reverse stress testing are particularly useful
  - If you woke up tomorrow to be told your business had lost £Xbn, what would you assume had happened
  - Target areas of assumed linkage and independence to ensure the model reflects these appropriately
  - Consider events and emerging risks – e.g. 2008 insurance and asset performance, cyber scenarios

Other risks

— Catastrophe risk needs to include assessment of model completeness and relationship between gross and net

— If other risks or capital reduce because of an increase in reinsurance use, we expect an increase in reinsurance credit risk

  — Are any risks related to the nature of the contract clearly modelled e.g. collateral assets

— Market risk movements should be considered in terms of what they imply about the asset risk/return profile and reflect any changes to this. Is this realistic?

  — How has liquidity risk been quantified?

  — Lloyd's is providing a number of guidance clarifications on market risk profit, discount rate internal consistency

  — We will provide items that are acceptable and those that are not in guidance

— Operational risk should ensure that the full range of risks to the business are incorporated

Risk based oversight

Further steps towards a risk based approach planned for 2020 reviews

Certain minimum requirements must be met

We apply a risk based approach

- Different levels of review apply based on submission and syndicate metrics

For 2020 SCR will be clearer on what feedback requires immediate remediation versus development points

Your feedback is welcome

Review level based on

- Level of divergence from exposure measures
- Outlying experience
- Large movements
- Model drift
- Change justification/analysis
- Quality of documentation
- Quality of validation
- Other items – governance, underwriting, reserving

Review Process

Loadings are to account for uncertainty, not give the “right” answer

Pre-Submission

- —Ongoing: Discussion on existing loadings
- —June: Draft guidance circulated
- —June: Syndicate specific issues highlighted (capital and reserving)
- —July: Final guidance published

Submission

- —Phased submission schedule
- —Validation information included with submission

Review

- —Review timing depends on submission quality and alignment with market messages
- —Defined timescales for query response
- —Loadings applied if uncertainty cannot be resolved

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Summary

Our request of you…

as the **leaders** of your individual businesses

1. Provide support and challenge to your teams

2. Ensure model changes are appropriate and documentation is clear and complete

3. Value independent, robust validation

4. Ensure governance reinforces the above and results in objectively reasonable movements

5. Continue to provide feedback to us

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Any questions?

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