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Lloyd’s Loadings

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26 April 2019

Syndicate Capital Submissions

1. SBF / Planning

2. Capital

- Negative post diversification credit
- Model / Risk specific loading
- SII compliance

Syndicate Internal Model

3. Reserving

- Q2 to Q4 best estimate roll forward
- Q4 best estimate reserves
- Planning vs actual loss ratios

4. SCR → Loadings → SCR

ECA

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Overview

- 2019 SCR Capital review at Lloyd's
  - Lloyd's receives a capital return, documentation and validation report from all syndicates and undertakes review of this prior to agreeing capital for coming-into-line
    - Any areas of deficiency or particular uncertainty within the modelling will have a capital loading applied
    - We do not validate models again upon submission, the requirement is for syndicates to provide assurance that risks are appropriately incorporated
    - Our review focussed on key output metrics, links between capital and risk profile changes and validation findings
  - We expect boards to value high-quality, independent validation that challenges the first line view
    - The market should not be surprised if we ask about issues identified in the validation report
    - The CIL timetable is challenging
    - No early view on capital, limited advanced notice
    - An area of review for next year

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Lloyd’s review

- High level tests supplemented with detailed investigation

<table>
<tr><th>Test Area</th><th>Metrics considered</th><th>Questions asked</th></tr>
<tr><td>Overall</td><td rowspan="9">Stress/Exposure
Movement from previous submission and identified drivers
Market decile and movement in this
Comparison to Central view
Sum of Squares test of Diversification</td><td rowspan="9">Does the position match the risk profile – are the key risks driving capital?
Does the movement match the risk profile change? Has it been explained?
Is it consistent across risk types – e.g. premium risk down due to greater RI means greater RI credit risk
How has experience been responded to?
What model developments have been responded to and why?
Are risks contributing greater than under independence</td></tr>
<tr><td>Reserve risk</td></tr>
<tr><td>Premium risk</td></tr>
<tr><td>Catastrophe risk</td></tr>
<tr><td>Credit risk</td></tr>
<tr><td>Market risk</td></tr>
<tr><td>Diversification</td></tr>
<tr><td>Operational risk</td></tr>
<tr><td>One Year</td></tr>
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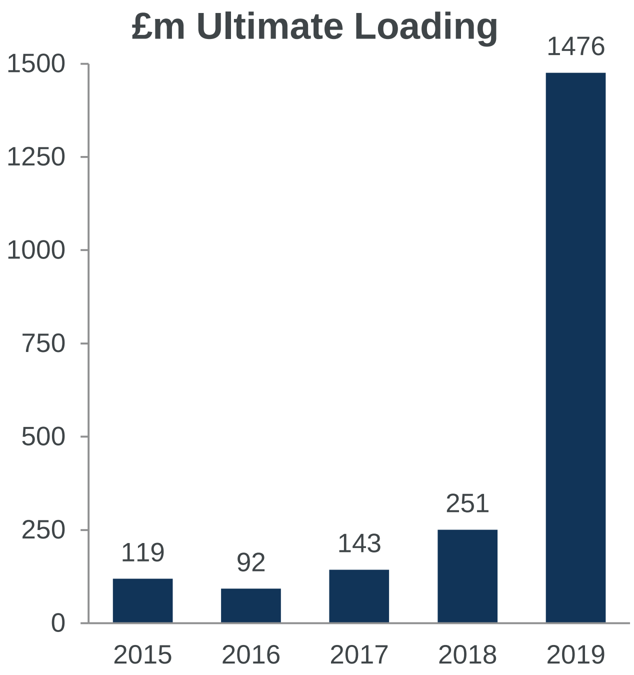
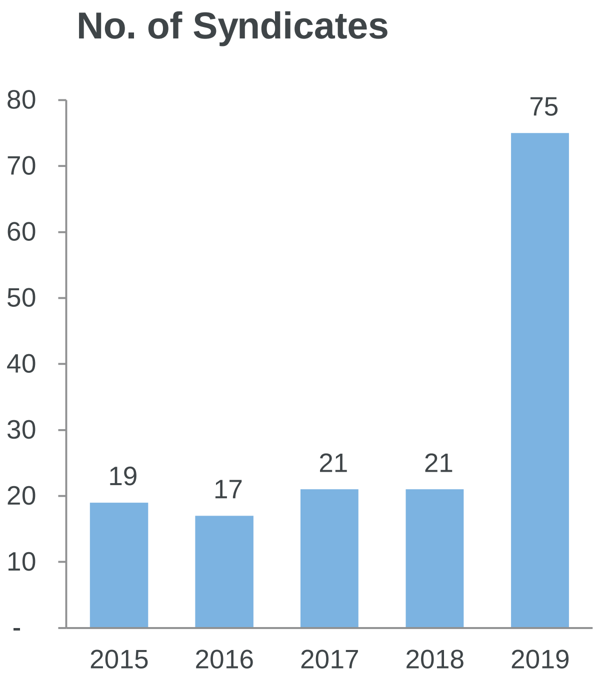
The quantum and frequency of loadings within the market has increased significantly…





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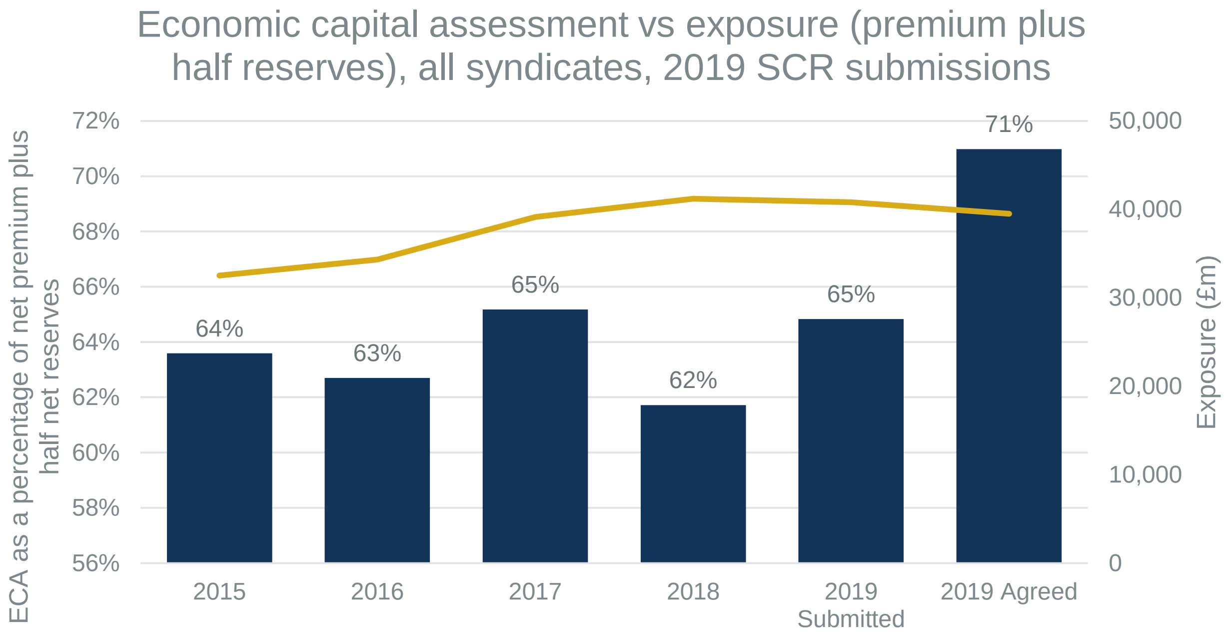
…and an increase as a proportion of overall exposure, which includes the most material risk driver, claims reserves



An increase on submission was strengthened by loadings during the review process

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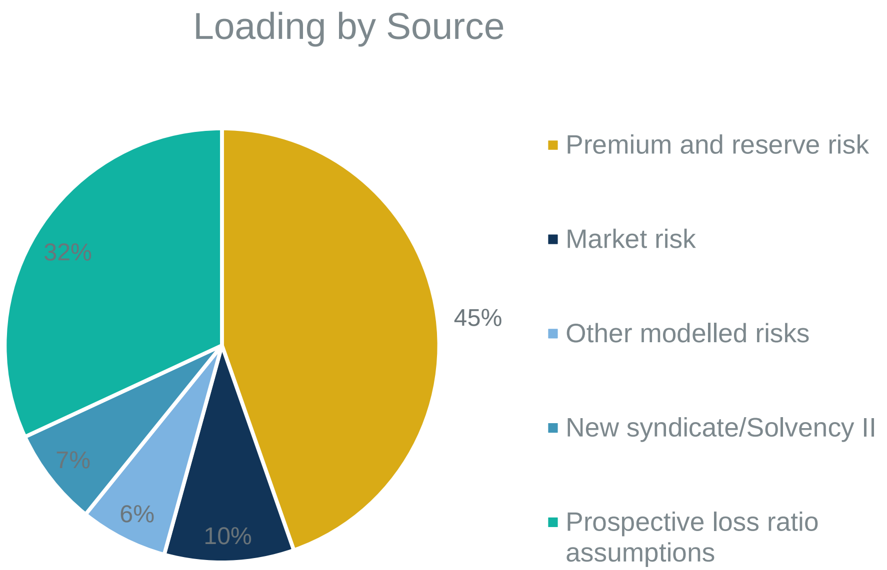
…With loadings applied across a range of risk areas…



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Reserving thematic areas of focus

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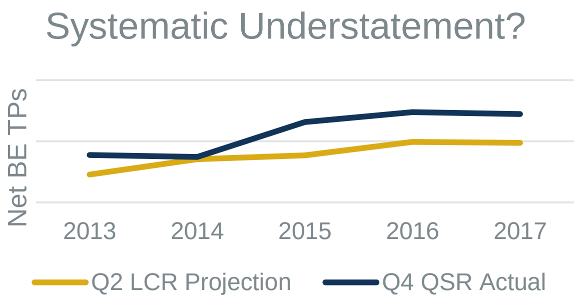
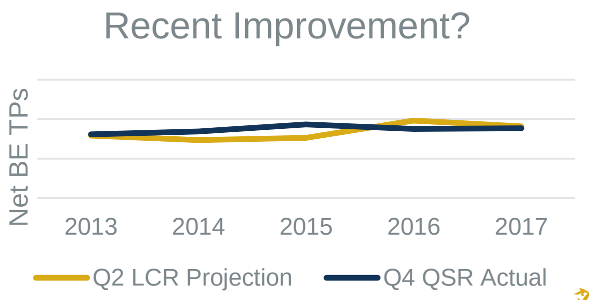
Q2 to Q4 Best Estimate Roll Forward

•Lloyd's review

- Projected Q4 balance sheet is the starting point for the 2019 SCR
- Has this position been an accurate estimate over time
- Focus on systematic understatement of reserve position
- Improvements to process should be validated, eg backtesting





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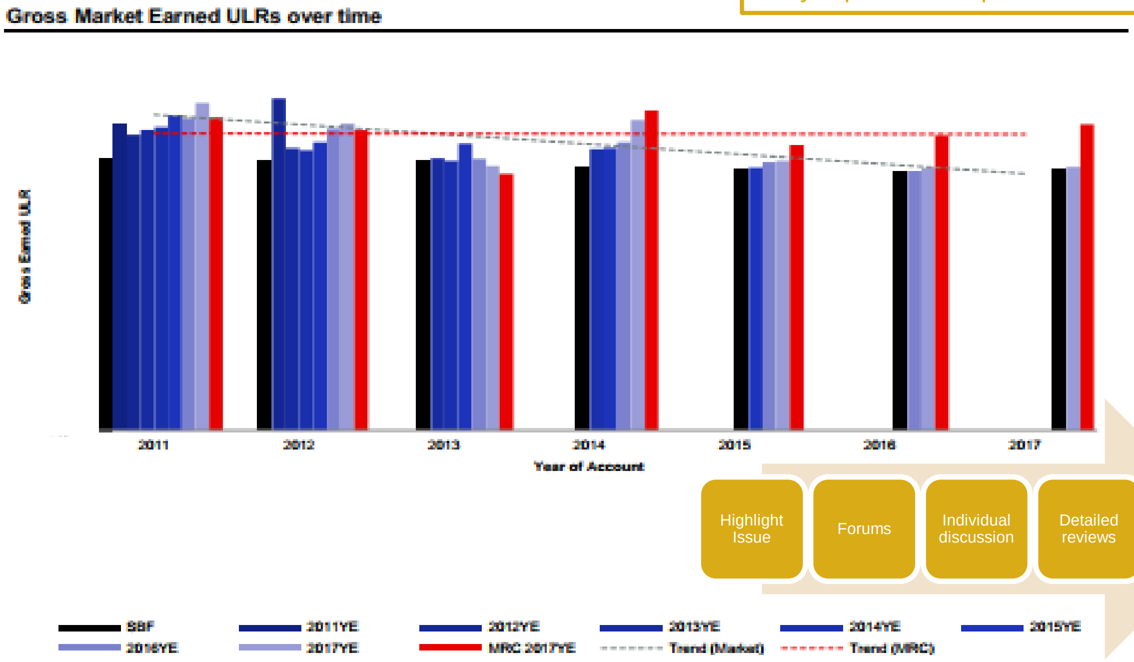
Best Estimate Reserves

- In practice

Casualty FinPro (as per Syndicate TPD submissions over various years):

Why is plan now expected to be sufficient?



Highlight Issue → Forums → Individual discussion → Detailed reviews → ?

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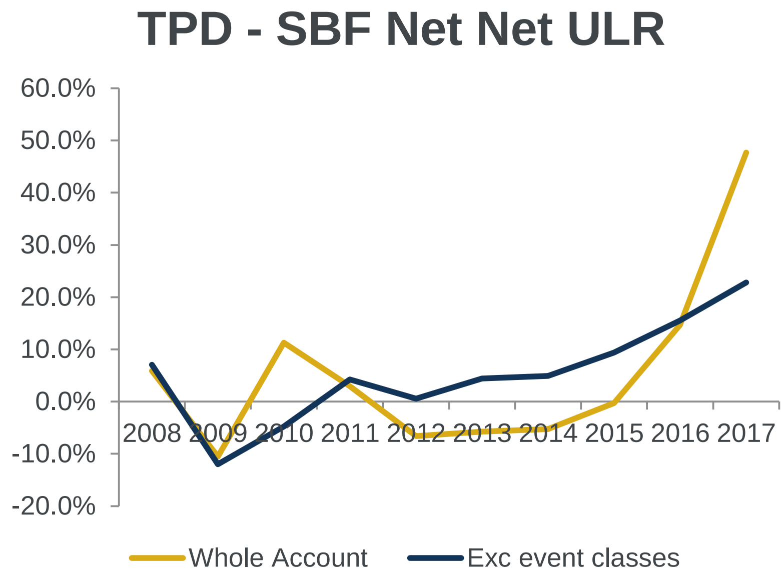
Planning vs Actual Loss Ratios

- Lloyd's has observed adverse performance in the market's actual experience compared to plan in recent years.
- Submission requirements required explicit consideration, reporting and validation of the prospective loss ratios used for capital setting.
- These loss ratios should not take account of improvements without a clear track record of these being delivered.
- Consistently not meeting plan suggests optimism or some other deficiency in the planning process.
- Expect modelled ULRs to include an uplift to reflect this.



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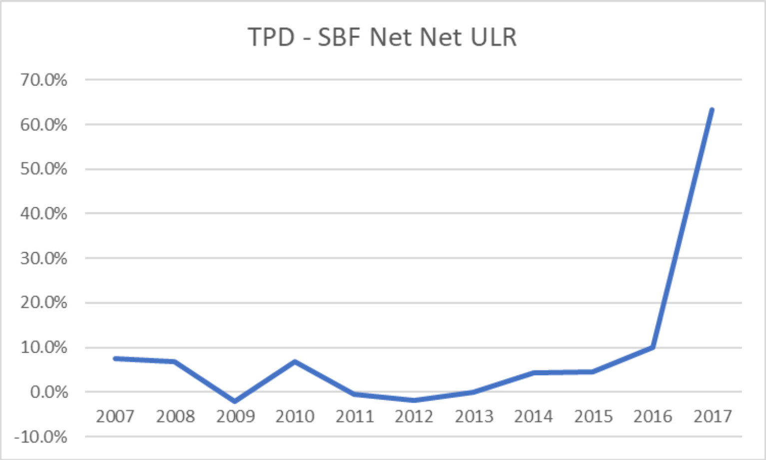
Planning vs Actual Loss Ratios

• MI – Typical Planning Optimism

Lloyd's	Trend
Class 1	
Class 2	
Class 3	
Class 4	
Class 5	
Class 6	
Class 7	
Class 8	
Class 9	
Class 10	



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Capital Loadings

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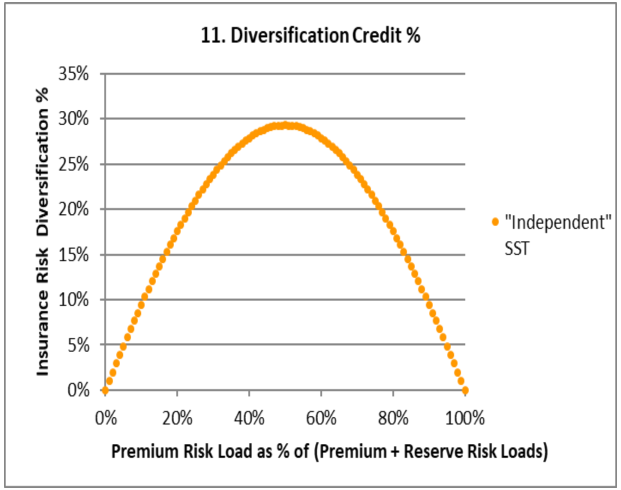
2019 Focus Areas

- There's no such thing as a (risk) free lunch
  - We accept that diversification between risk types can be material
  - We do not accept that risk can be added and remove capital – even if this risk "diversifies well" (e.g. writing a new class)
  - Negative contribution to capital of market risk → investigation by market risk working group



- Oversight focus is that risks are contributing enough to capital
- Capital set on 99.5th VaR, preference is for tests measuring this contribution
- All statistical tests of dependency have some limitations
- SST considered to be an appropriate test in this context and we don't expect agents to sit outside it → investigation by diversification working group into alternative tests

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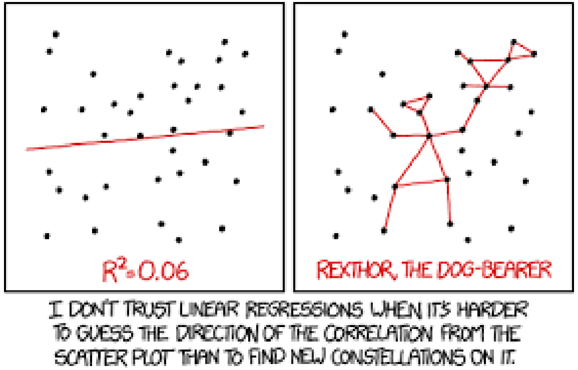
2019 Focus Areas

•Change should be considered in terms of risk profile

- **Under Solvency II, an internal model output should not change in the absence of a risk profile change**
- Top-down view key for sniff test, stability and SII compliance
- We expect the external environment and business context to be key considerations
- Updates for data should not ignore risk profile
  - A year of good experience doesn't tell you that the risk is reduced
- Changes should not be accepted by virtue of being the consequence of input updates → You should be comfortable that you are submitting a valid representation of your risk profile and articulating what has changed



- Stress tests should focus on your business and key risks: Avoid self-fulfilling cycle!
- Focus on demonstrating appropriateness, a few examples of what not to say:
  - "This moves the capital by 50% but it is not a useful test."
  - "This test produces a fail but the parameterisation is accepted."
  - "This change did not have the expected level/direction of impact but it's been accepted."
  - "Capital has gone up so the load should be removed."

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The Capital Paradox – nobody likes to get loaded…

Some amateur psychology, just in case the numbers are not enough to deal with

- Please have a deep-seated, carefully considered and genuine belief that the hard work of your capital teams in producing, documenting, presenting and explaining numbers is the best and most appropriate representation you can make of your business…
- …And also don’t be offended/upset/angry/confused when we ask fundamental/challenging/basic questions on it

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Hindsight is 2020

• How could the process difficulties have been reduced?

- By Lloyd's
  - Review process timescales for both capital and planning
  - Transparency on nature of review
  - Move away from benchmarks for discussion, require more accessible validation information to facilitate this
  - Communication of expectations and requirements – market messages presentation
- By the Market
  - Input into the reviews of modelling and processes
  - Take market messages on board – be clear they have been considered
  - Keep in touch with us on model changes – be clear on the drivers for these
  - Articulate the need for, prioritisation of and nature of change

2020 CPG process focus

- Market messages plus responses to submission features

  - Actual vs expected reserves
    - Historically reconciliation of the projected and actual balance sheet is poor – also at 2018YE
    - Feedback loop missing in the majority of syndicates
    - Understated Exposure = Understated Capital
  - Class sizes vs volatility
    - Reductions in volume but not line size may require upward adjustment to CVs
    - Much of the poorly performing business was not driving volatility
  - Diversification, negative contribution of risk, nature of model change
    - Aim to address in collaboration with the market, 2020 Plan

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Getting Set for 2020

- Three main (linked) themes: Market working groups, market communications, market guidance

Q1

- Market working groups kick off
- CPG process review kick off
- Limited validation information request due 1st March
- Capital briefing (28th February)
- Exposure management Catastrophe model completeness LMA working group kick off
- IMO returns (18th March)

Q2

- Feedback on March market information provided
- Market testing data collection (due 1st of May)
- Syndicates selected for phase two of market versus central view deep dives
- Validation briefing (2nd May)
- Capital Market messages (10th June): Setting out expectation of market movements
- Exposure management model completeness return
- Draft SCR and model change guidance and requirements circulated for comment (including working group outcomes)

Q3

- Finalisation of guidance (July)
- Feedback on May market testing data collection
- Outcome of phase two deep dives
- NED Forum (4th Sept)
- LCR submissions – including additional validation information “template”

Questions

Comments

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