Actuaries Institute

PANDEMIC BRIEFING

ICAAP Considerations

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Objective

This note aims to assist actuaries advising entities on the capital implications of the COVID-19 pandemic.

Scope

Although this note specifically covers life insurance, general insurance and banking, parts of it may also be applicable to health insurers.

The Board is responsible for ensuring that their regulated institution holds capital commensurate with its risk profile, and that the institution has a Board approved Internal Capital Adequacy Assessment Process (ICAAP). ICAAP involves an integrated approach to risk management and capital management.

COVID-19 has materially impacted the operating environment of regulated institutions. In these uncertain times, Boards will need to review their business objectives, risk profile, risk appetite and associated capital requirements.

Companies will turn to their existing ICAAP to help them manage this crisis. This provides an opportunity to “road test” their ICAAP to determine which parts work and which parts need to be improved.

This note considers high level ICAAP considerations. It does not consider the derivation of individual components of the capital calculation (e.g. determining capital risk margins).

An important element of an entity's risk management framework is the management of the relationship between its existing risk profile, its prospective risk profile and the Board's stated risk appetite. Where the risk profile of an entity is outside its risk appetite the Board needs to be informed and decide how it wishes to proceed. Various potential options are available including:

a) Acknowledge the situation, provide a temporary Board approved adjustment to risk appetite, approve actions designed to return the entity to within its current risk appetite over a specified period, and increase the depth and frequency of monitoring;

b) Alter its risk appetite to acknowledge the market, customer behaviours and stakeholder expectations have fundamentally altered.

A Board's direction to management is critical in evolving situations such as Covid-19 and the associated economic environment.

APRA’s Requirements

Entities will want to consider APRA’s requirements when determining their business response to the pandemic. These include:

“The Board of a regulated institution must ensure that the regulated institution has capital that is adequate for the scale, nature and complexity of its business and its risk profile, such that it is able to meet its obligations under a wide range of circumstances.” [GPS 110 6]

APRA wrote to authorised deposit taking institutions (ADIs) and insurers on 7 April with the following guidance:

APRA expects ADIs and insurers to limit discretionary capital distributions in the months ahead, to ensure that they instead use buffers and maintain capacity to continue to lend and underwrite insurance.

During at least the next couple of months, APRA expects that all ADIs and insurers will:

- *Take a forward -looking view on the need to conserve capital and use capacity to support the economy;*
- *Use stress testing to inform these views, and give due consideration to plausible downside scenarios (periodically refreshed and updated as conditions evolve); and*
- *Initiate prudent capital management actions in response, on a pre-emptive basis, to ensure they maintain the confidence and capacity to continue to lend and support their customers.*

During this period, APRA expects that ADIs and insurers will seriously consider deferring decisions on the appropriate level of dividends until the outlook is clearer.

ICAAP Considerations

This note first considers the process by which an actuary may approach the ICAAP in this situation and then provides checklists split into the following five categories:

- Business Objectives & Risk Profile
- Current Capital Position
- Capital Forecast
- Capital Targets, Buffers and Target Surplus
- ICAAP self-assessment

Elements of the checklist would be applied in each scenario whilst others are marked as macro considerations which are relevant to the process as a whole.

Process

Many companies are adopting a dynamic scenario approach to determine the suitability of its business management processes, of which the ICAAP is a critical part.

Commonly this involves setting out a series of plausible scenarios ranging from severely adverse to optimistic outcomes of the pandemic and the associated economic environment. This could include different phases of the pandemic, different government responses and different medical discoveries (e.g. vaccines).

In addition to running internal scenarios, companies may also be running scenarios initiated by the regulator or other external bodies (e.g. credit rating agencies).

Key considerations such a process include:

- Governance
    - Who builds, issues and approves the range of scenarios, including the assumptions?
    - What is the purpose of the scenario?
    - Who will use it and how will it be used?
    - What is the granularity of these scenarios?
    - What is the frequency of updating the scenarios?
    - What is the frequency of updating the insights from each scenario?
    - What monitoring is being performed to test the like emergence of each scenario?
    - Who translates the scenarios into impacts on the insurer’s portfolio of business and financial position?
    - Who approves the methodology used to quantify the impacts?
    - Who approves the scenario results?
- Culture
    - How agile is the organisation to reacting to changes?

- Does its business management respond sufficiently?
    - Does the organisational culture manage ambiguity well?
- Communication
    - How well understood by the various stakeholders are the scenarios in terms of both the likelihood and the implications of each scenario
    - How will the company migrate operations between scenarios should emerging experience indicate changing likelihoods

An important feature of the use of scenarios is to include reverse stress tests, which document those conditions or assumptions that may lead to an entity's failure, or near failure, and the need to enact the company's Resolution Plan or Recovery Plan, where they exist.

Entities may wish to produce high level business management plans for each scenario. These will generally be less specific than produced in a more stable environment and may anticipate management actions that differ to those defined in the existing ICAAP.

The ICAAP defines a series of trigger points and potential management or Board responses should these triggers be breached. By its nature the ICAAP is intended to respond to a wide range of potential scenarios that may place the entity under financial stress, but it cannot anticipate every possible scenario. Where an ICAAP defines trigger points it would be expected that the Board may have a range of actions available and would select the most appropriate in the current and projected circumstances.

It is plausible this may lead to different actions to those described in the ICAAP. External factors in particular may differ from those implicit in the documented ICAAP actions; for example:

- Government or regulator intervention at a macro or industry level
- Community expectations
- Impacts on future business volumes and future capital requirements
- Impacts on expected claims costs and how these differ across product lines or benefit types
- Investment market impacts
- Access, and cost, of different sources of capital

In this regard, the ICAAP is not a static playbook and the effectiveness of proposed actions should still be assessed against the unique set of circumstances.

Advice around the ICAAP should apply the included considerations under each of the scenarios. A particular focus might include areas where management actions need significant pivots as emerging experience indicates a greater likelihood of a particular scenario emerging.

Advice should also acknowledge that greater uncertainty exists in many elements of the balance sheet such as Asset Values, Liability Values, Risk Margins, Required Regulatory Solvency Calculations as well in the future business plans.

A critical feature of the management in this environment is the communication with various stakeholders and how their expectations would be satisfied under each of the scenarios and with the current position.

Business Objectives & Risk Profile

Under each scenario an ICAAP advisor might consider

- Would the company's strategy change?
- What are the business objectives - short, medium and long term?
- Will the competitive environment change?
- What is the institution's risk profile?
- How reliable is this risk assessment (what is known and what is unknown)?
- Do the current risk metrics and reporting provide management and the board with sufficient and appropriate oversight of current risks and exposure?
- Is the risk assessment within risk appetite?
- Does the risk appetite need to change, either permanently or for an agreed period?
- Does the level of risk need to be reduced?

Overarching considerations regarding an Institutions ICAAP

- Did planned risk mitigation provide expected relief in each scenario?
- Is the Risk Management Framework fit for purpose?

Current Capital Position

Starting point for all Scenario considerations

- What is the current capital position relative to target capital levels and minimum requirements across the different capital metrics (CET1, Tier 1, Tier 2 and Level 1, 2 & 3)?
- What are the main areas of uncertainty in the capital calculation (e.g. valuation of unlisted assets, derivation of capital risk margins, liability valuation etc.)?
- How sensitive are the outcomes to the underlying assumptions?
- Is the business below its capital target/target surplus?
- What current or potential management actions does ICAAP recommended?
- What management actions are currently being applied and are they having the expected outcomes?

- Are there any external pressures (e.g. regulators, media etc.)?

Under each scenario an ICAAP advisor might consider

- What additional management actions are proposed and how effective are they anticipated?
- Are trigger points for management actions still appropriate?
- Are there additional risks not covered by the capital assessment and how are they managed?
- Is the frequency and reliability of the capital monitoring and reporting suitable?
- Are additional metrics required and do some metrics need to be reported more frequently?
- What is the impact of a parent or subsidiary (can capital be moved around the Group in the current environment)?
- Is capital likely to be stronger or weaker than peers and what are the consequences?
- Does liquidity impact capital (or vice versa)?
- Are there potential company's credit rating considerations and what is the expected impact?
- Are there counterparty credit rating impacts to be considered (e.g. external reinsurer with significant exposure to overseas affected markets)?
- What communication would be required with stakeholders?

Capital Forecast

Under each scenario the actuary might consider

- What is the company's capital forecast?
- What key assumptions in this forecast pose significant risk? (uncertainty and materiality)?
- What is a likely range of possible outcomes (optimistic to pessimistic)?
- If capital is below target levels, when does it return to target levels?
- What alternative actions are available (capital raisings, expense reductions etc.)?
- What level of stress can the company withstand from this point (with and without mitigants)?
- How will the effectiveness of the response plan be monitored?
- What are the alternative outcomes and actions if the risks to the forecast materialise?

Overarching considerations regarding an Institutions ICAAP

- Which management actions considered in the scenarios were included in the pre-Pandemic ICAAP recovery plan?

- Were pre Covid-19 assumptions about potential environments and hence suitability of management actions valid?
- Was the pre Covid-19 recovery plan robust, credible and within a sensible timeframe (particularly if the impact perseveres for many years)?

For further information on running scenarios and stress testing, including taking mitigating actions, refer to Scenario and Stress Testing Considerations – COVID 19.

Capital Targets, Buffers and Target Surplus

Under each scenario an ICAAP advisor might consider

- Do capital buffers and target surplus need to change?
- How have best estimate assumptions and risk margins been adjusted to reflect the scenario?
- Do any changes to best estimate assumptions and risk margins change the company's view of an acceptable capital position relative to "hard" and "soft" floors in the immediate term?
- Are there short and long term capital targets?
- Are there any countercyclical or procyclical impacts that should be considered?

Overarching considerations regarding an Institutions ICAAP

- Would ICAAP and the company's risk appetite have anticipated a breach of trigger levels from an event like COVID-19 and was any actual breach consistent with this expectation?
- Are capital targets, trigger points, "hard" and "soft" floors working and adequate?

ICAAP Self-Assessment based on the Overarching considerations

- Is ICAAP working as expected?
- Did capital triggers work as planned?
- Did risk management work as planned – e.g. risk identification and measurement?
- Did risk and capital mitigants work as planned?
- Did governance, reporting and actions accord with ICAAP?
- Were key stakeholders (e.g. Board and regulators adequately informed throughout the process)?
- Is ICAAP fit for purpose from here, based on the current operating environment and capital levels?
- Did triggers for reviewing ICAAP work as planned?
- What changes to ICAAP are required and by when?
- What are the next steps?

References:

Pandemic Briefing - Risk Management Implications of Coronavirus (COVID-19) for Non-Executive Directors

Pandemic Briefing - Risk Management Implications of Coronavirus (COVID-19) for management

Pandemic Briefing – Scenario and Stress Testing Considerations

APRA letter on Capital Management to All Authorised Deposit-Taking Institutions and Insurers 7 April 2020

APRA Prudential Practice Guide CPG – 110 Internal Capital Adequacy Assessment Process and Supervisory Review

APRA Prudential Standard GPS 110 Capital Adequacy