People

An interview with Nigel Knowles

Asia-Pacific head of risk and value management

Mark: How do you see risk and value management evolving in Asia-Pacific?

Nigel: I'm often reminded by colleagues that 'turkeys don't vote for an early Christmas'. If it weren't for regulatory drivers in the insurance and banking sectors in Europe, it is possible that some of the more complex calculations and practices might have taken longer to emerge than they did. The investment required to implement reporting systems capable of evaluating some of the stochastic quantities demanded by the regulations is significant and in the current climate such an investment will fall under scrutiny like any other major expenditure.

Mark: So there's no further change expected then?

Nigel: Far from it. Our feathered friends have plenty to worry about! Solvency II and MCEV will affect European multinational firms (MNCs); IFRS4 Phase 2 will also be implemented at a similar time to Solvency II; and residual concerns arising from the financial crisis are also driving behaviour to invest and improve systems and processes

Mark: What will Solvency II and the other drivers mean for the firms in Asia-Pacific?

Nigel: As a general rule, the major firms already practise some of what they might need to do under Solvency II and MCEV, especially in the larger business units. Investment has already been made in more modern modelling systems better suited to the more complex tasks associated with these requirements. The job is not complete, however. Smaller business units may not yet have put in place such systems, benefiting from group 'waivers' on the grounds of materiality. These subsidiaries may well find themselves having to implement newer systems too meet the demands of their head offices in the coming months.

Mark: So it's just about stochastic modelling then?

Nigel: No - even for those companies that have put new systems in place, the Internal Model requirements may well multiply current demands many-fold. The distance between a simple actuarial system that produces periodic calculations and an embedded process that traverses all aspects from governance to future decisions-making is enormous. The 'use test' alone could be quite onerous to evidence.

Mark: It all still seems too far away - 2012 for Solvency II and IFRS4 Phase 2 seems a lifetime away. Surely firms should worry about this year's P&L more than some unrealistic modelling requirements that might never be needed.

Nigel: There's more than a grain of truth in that statement. Firms should only ever put in place systems that help them run their business appropriately. Getting new business in through the front-door and controlling expenses are, and should remain, a priority for almost everybody. If you are not going to be immediately affected by any of the big developments in Europe, you may well conclude that investing time and energy in managing the investment risks in your portfolio or understanding the likely capital requirements for the firm are far more important.

Mark: Could you explain what you mean by that?

Nigel: Post Lehman Brothers, notwithstanding the collective sighs of relief owing to the bounce back in the equity and credit markets to the levels of the third quarter 2009, we're seeing an increased focus on the plain vanilla topics like risk management.

We're seeing boards of directors seeking to better understand the risks being run by the companies in their charge. That means a need for better information and more frequent information as well as education of these stakeholders. At the same time, the prospect of capital being less readily available than in the past is seeing greater emphasis being placed on risk management.

Phrases like 'better information' and 'more frequent information' should cause any of us to pause. 'Better' may well translate into richer systems whilst 'more frequent information' certainly creates an additional burden.

Having efficient processes, including for example smart modelling techniques, must be a good thing.

As for good old fashioned risk management, the starting point has to be a robust ALM platform that allows different business and investment scenarios to be tested. Firms are carefully assessing their exposure to asset risks and re-evaluating the current investment strategies.

So much change in such a short period of time is placing a burden on all firms, European MNCs and domestic champions alike. In addition to the training and development of their own actuarial teams, some of these plain vanilla risk management topics still require investment in system enhancements too.

Mark: But what about your turkeys? There's no regulatory imperative surely.

Nigel: Far from it. The region's regulators may not have (yet) embraced market consistency for evaluating liabilities, but they are encouraging firms to analyse risk and for their boards of directors to have a better understanding of the risks that firms face. For example, even where book value reserves are the norm, we are seeing firms being encouraged to investigate the effect of many interest rate scenarios on their liabilities and communicate outcomes to their board members.

MCEV (Market Consistent Embedded Value)

Reporting principles introduced by the CFO Forum in June 2008 with the goal of bringing greater consistency and improved disclosure to the European insurance industry's Embedded Value disclosures. Specifically, the MCEV Principles© were designed to bring:

- A shareholder's perspective on value, being the present value of future cash flows available to the shareholder, adjusted for the risks of those cash flows.
- A market consistent approach to financial risk.
- A greater focus on disclosing cash emerging from covered business.
- Disclosure of combined Group MCEV information.

IFRS4

The International Financial Reporting Standards issued by the IASB (International Accounting Standards Board) that applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs.

Internal Model requirements

Documentary evidence is required for all of the following items: the use test (see below), statistical quality standards, calibration standards, profit and loss attribution, validation standards and documentation standards.

The 'use test'

Insurance companies need to demonstrate that the internal model is widely used in and plays an important role in following their system of governance, in particular:

a) their risk-management system and their decision-making processes; and

b) their economic and solvency capital assessment and allocation processes.