AFM – Non-Executive Directors' Seminar

Risk and Capital Management Techniques

A presentation by Tim Bateman

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Subject matter for today

- Consider the challenges to the capital position of mutuals and friendly societies
- Look at how risk management is developing
  - Refresher on the ORSA and a reminder on Board responsibilities
  - Industry themes
- Outline a range of capital management techniques
  - Option put forward by FSA in CP12/38
  - Initiatives by Reliance Mutual and MGM
- Q&A

Definitions - Wikipedia !!

- **Risk** is the potential that a chosen action or activity (including the choice of inaction) will lead to a loss (an undesirable outcome). The notion implies that a choice having an influence on the outcome sometimes exists (or existed). Potential losses themselves may also be called "risks".

- **Economic capital** is the amount of risk capital, assessed on a realistic basis, which a firm requires to cover the risks that it is running or collecting as a going concern, such as market risk, credit risk, and operational risk. It is the amount of money which is needed to secure survival in a worst case scenario. Firms and financial services regulators should then aim to hold risk capital of an amount equal at least to economic capital.

Capital position of mutuals

Challenges

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Challenges affecting capital in the mutual sector

Mutual sector faces several challenges to its capital position:

- Sales and Distribution - the sector must find ways of selling profitable new business against the background of RDR
- Capital requirements - remain uncertain in the light of Solvency II and will affect different lines of business to different extents
- Ownership and distribution of capital – the allocation and fair distribution of surplus back to policyholders and members (Project Chrysalis)

Risk and capital management will remain high priority for the mutual sector

Risk Management

Is holding capital enough?

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Risk Management and the ORSA process

The Board's regulatory responsibilities for ORSA

Board is the ultimate owner of the ORSA

1. Responsible for regulatory compliance, e.g., sign-off ORSA documents

2. Must take an active role in the process…

- ✓ Setting risk appetite and approving any changes to it
- ✓ Developing strategy and business plans
- ✓ Reviewing appropriateness of the risk management framework
- ✓ Reviewing and approving the ORSA policy
- ✓ Reviewing and challenging the ORSA report metrics / conclusions
- ✓ Confirming acceptability of current and forecast capital position

The changing face of Risk: What are companies doing?

Capital Management

Increase capital or reduce capital requirements?

The capital management toolbox

Areas of Capital Management

Financial/ actuarial	Business management	Investment	Risk transfer	Capital solutions	Business reorganisation
Review models for prudence	Product redesign/ repricing	Asset portfolio redesign/restructure	Financial reinsurance	Equity raising	Discontinue/run-off certain lines of business
Review actuarial reserves/DAC for prudence	In-force management	Cash flow/duration matching	Longevity hedge	Debt structuring	Reorganisation of corporate structures
Accounting and tax optimisation	Ongoing business volume/mix management	Credit	Risk transfer/ external reinsurance	Contingent capital	Renegotiation of guarantees
Regulatory arbitrage	Underwriting and claims management	Derivatives/ static/dynamic hedging	Reinsurance optimisation	Private equity	Mutual capital
Inter-fund arrangements	Expense management and outsourcing	Alternative Investments	Securitisation	Other (non-reinsurance) internal transactions	Purchase/sale of business/blocks of business

Possible Capital Management Actions

Capital management – example feasibility assessment / RAG scorecard approach

Potential actions	Size of the prize	Cost & complexity to implement	Likelihood of success	Timescale to implement	Overall assessment
Review existing models, methods & assumptions	A	G	G	G	To be decided based on firms preferences
Reinsurance optimisation	G	G	G	A	
Alternative investments	A	A	G	G	
Outsourcing	G	A	G	A	
Longevity hedge	G	A	G	R	
Review product design & pricing	A	A	G	A	
Re-organisation of corporate structure	G	R	A	A	
Private equity	G	R	A	R	

Case study: Capital optimisation project

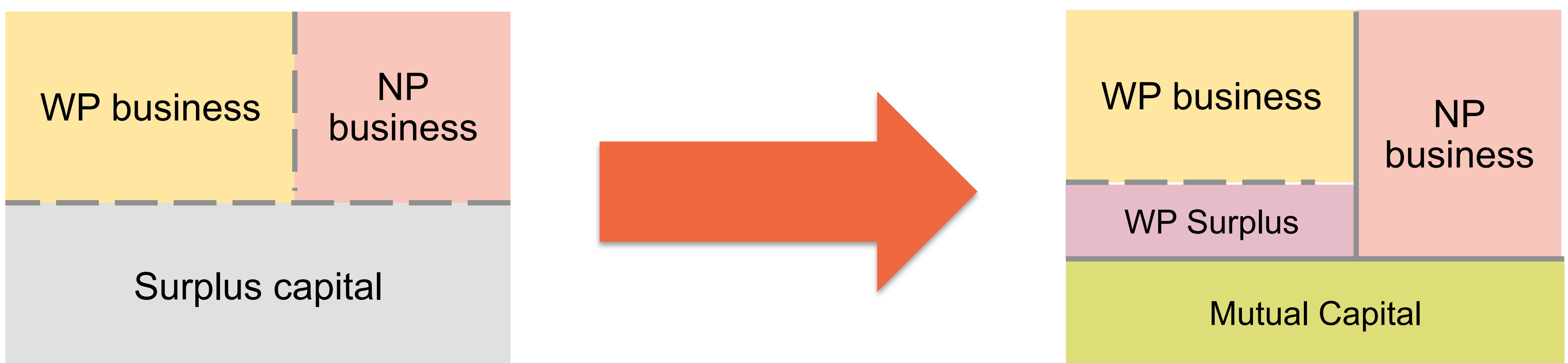
Client's challenge	**Board wanted to review the risk profile and to optimise the capital position under Solvency II**
Objectives	• Ensure calculations robust and based on true "best estimates" • Identify opportunities including risk transfer, capital raising and strategic actions • Consider how current capital policy would need to change for Solvency II
Approach	• Review of assumptions, methodology & models to identify areas of material prudence and suggestions for changes to approaches • Develop framework for categorising and assessing different optimisation options • Review current risk appetite and how current risk limits apply under Solvency II • Consider p/h expectations and potential management actions
Result	• A number of options which will help to optimise capital • Methodology & results externally reviewed and fit for regulator scrutiny • Reduced capital requirements under Solvency II

Restructuring with-profits mutuals – CP12/38

Mutual Capital

- Identify capital required for WP policyholders
- Identify 'Mutual Capital' to fund the on-going (non-profit) business

- CP12/38 contains draft regulation to govern the process
- Mutual can remain as an on-going entity selling non-profit business



Resolves the issue of ownership of capital?

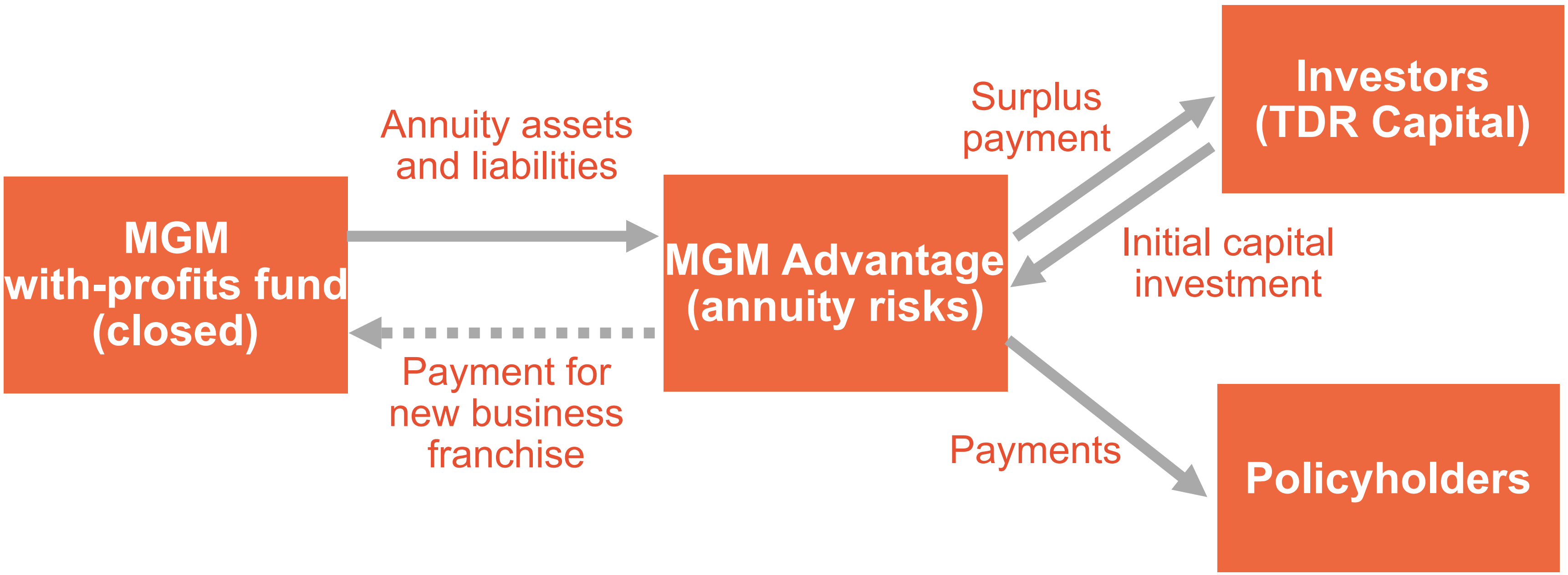
CP12/38 – comments and alternatives

- CP12/38 does not change overall capital or overall risks of company, rather clarifies membership rights and benefit expectations
- May leave some uncertainty given no legal or member approval process
- May have some capital and solvency implications under current draft proposals for ring-fencing of with-profits funds.

Alternative structures will continue to be considered for example:

- Reliance Mutual now has a structure with 6 separate with-profits sub-funds and an Ordinary Business Fund
- Others have suggested the establishment of members accounts for all new policyholders

Case Study: MGM and TDR Capital



MGM Advantage (a new Life Company owned by TDR Capital) transfers ring-fenced assets and liabilities off MGM balance sheet in return for payment for franchise value, and allows capital injection from external investors (TDR Capital)

Q&A

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