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ASHK Newsletter

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New Challenges Ahead!

EDITORIAL

Dear Readers,

Welcome to the first newsletter for 2011!

Over the last several weeks, the world has been watching the aftermath of the earthquake, tsunami and nuclear accidents in Japan. The earthquake did not seem to cause significant direct damage but the tsunami that occurred only a few minutes later had caused tens of thousands of people dead, injured or missing. Furthermore the leakage of radiation from the damaged nuclear power plants could have a much longer term implications on the health of the inhabitants in the surrounding areas.

About two years ago, the global financial world also suffered from its own version of tsunami and ensuing crisis. Since then, significant developments have occurred in solvency regulations and financial reporting requirements. One of these is the Solvency II requirement for insurers across Europe. This has been chosen as the theme of this newsletter and several articles from insurance and reinsurance companies, as well as leading consulting firms will provide you with thought-provoking views on Solvency II.

Happy Reading…

Dr. Louis Ng
EDITOR

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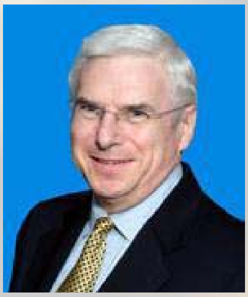

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The world needs actuaries

The recent global economic crisis has left all of us who work in finance with a great many lessons to learn. Liquidity problems, CDOs (Collateralised Debt Obligations), mis-hedging and, in the instance of Enron, fraud, all contributed to the downfall of firms which had previously thought themselves to be safe.

In the UK, Northern Rock's problems were triggered by a lack of access to the money markets which dried up, leaving it unable to access short term finance. This lack of liquidity triggered a run on the bank, leading to Northern Rock having to be saved by the Government. It's interesting to note, though, that at the point where there was a run on the bank, Northern Rock was solvent, although this was not the case a few weeks down the line.

AIG (like Lehman Brothers and Merill Lynch) were destroyed by US mortgages , particularly those that had been parcelled up and sold on in the wholesale markets. When the American housing market fell so dramatically, it had to pay up. It also has to post capital to guarantee some of its other financial exposures. The problem is that it no longer had enough cash to meet its obligations.

Mitchells and Butlers were involved a deal to sell and lease back some of the bars and pubs they owned. The banks financing the deal included Barclays, RBS and Citi, and these banks insisted that M&B protect themselves from interest rate and inflation risk that the deal would pose to venture. Furthermore, the hedges had to be set in place two weeks prior to the deal going through.

Two weeks later, the credit markets shifted and the banks went back on their offer to finance the deal. M&B were left with a set of naked hedges which instead of protecting them from interest rate and inflation movements, exposed them to movements in these.

M&B waited for liquidity to return as the banks advised them to, assuming that the property deal would still, eventually go ahead, but it never materialised. They finally closed-off the hedges crystallising a loss reported to be in the region of £500m.

What each of these failures has in common is a lack of fully understanding the risks these companies were exposing themselves to. To put it bluntly, they should have thought more deeply about their risks and how they should be managed, mitigated and, in some case, avoided.

Actuaries do not possess magic wands but they do possess skills and attributes which can make a difference.

Governance frameworks are being increasingly adopted by firms so as to avoid the mistakes of the past. Actuaries have an important role to play in designing, implementing and maintaining these frameworks. But in order for actuaries to rise to meet this challenge, it is important that we understand risk holistically and not merely in individual practice areas like pensions and life insurance.

Looking at the technical skills actuaries can bring to risk management, I believe we can offer both quantitative and qualitative skills

Long term thinking: Actuaries are trained to consider the long term, and this is in our nature – companies may find this helpful in resisting pressure to think only of short term outcomes.

True understanding of both the power and the limitations of data, and that of modelling. Yes we can create and understand complex models. But we also understand that models should be something put together to inform decisions, not to make them for us. The imperfections of models combined with a blind faith in their predictive power lay at the heart of several of the recent financial failures.

Problem solving: We can cope with complex, multi faceted problems. But we can see the whole picture too, understand all the components and how they fit together – ensuring a holistic view of risk.

Measurement and management: We understand the difference between them and the dangers with simply measuring and acting on the back of those results.

Coupled with actuaries' technical skills is our sense of professionalism and ethics. Yes we have an actuaries' code, which sets high standards – higher indeed than most other UK professions. But it isn't this code that drives actuaries to do things "correctly". Actuaries are characterised as those who want to do the right thing, and are not afraid to speak out when they think things are wrong. This "professional backbone" leads in no small part to the success actuaries have had in becoming "trusted advisors".

As valuable and crucial as these skill sets are, we also need softer skills too. Our communication and business awareness skills need to improve if we are to sit at the heart of corporate governance. The next generation of actuaries must be a generation of business leaders.

I'm fully aware, though, that the Actuarial Profession needs to help equip our members with these skills, both technical and soft, in order to help them push into this sphere. Our Chartered Enterprise Risk Actuary (CERA) qualification is an important step in that process.

Available to both students and Associates and Fellows, the CERA qualification covers areas such as:

- Concept and framework
- Process
- Risk categories and classification
- Risk modelling
- Risk measurement
- Risk management tools and techniques
- Economic capital

CERA is a global accreditation and was the result of a treaty signed in 2009. The CERA risk management credential is now supported by 13 actuarial associations around the World, covering geographical areas as wide ranging as Europe, the USA, South Africa, Japan and Australia.

The UK profession is, itself, global. 40% of the UK actuarial profession's members work overseas – and of these 75% work outside of Europe. The world is increasingly globalised. And the development of this global CERA credential presents our members, including our 192 members here in Hong Kong, and future members with a wonderful opportunity worldwide.

Ronnie Bowie
President of the Institute and Faculty of Actuaries

Solvency II

There has been much discussion and debate on Solvency II. Documents and consultation papers have been published and reviewed. Calculations and re-calculations have been done through the various Quantitative Impact Studies (QIS). So, how equipped are insurance companies in complying with the new capital rules? The answer appears to be far from certain.

What has happened?

Despite being pushed back a number of times, it is now fairly clear that European insurance companies, and companies whose parents domicile in Europe, are required to comply with the new capital regime by January 1, 2013[1].

More detailed guidance on compliance, so-called Level 3 Guidelines, is being debated and published by the European regulators.

Through the fifth Quantitative Impact Study (QIS5), most insurance companies now have a fairly clear view on where it stands, i.e. how solvent they are, when the new capital rules become effective. Fewer major changes are introduced in the latest QIS' with perhaps the exception of allowing illiquidity premium in discounting liabilities.

To the dismay of senior executives, Solvency II cannot be let to only actuaries. In fact, to be successfully implemented, Solvency II involves a major cultural change in life insurance companies and spans across nearly all disciplines in an insurance companies - actuaries, asset managers, risk officers, CFOs, to name but a few. This is evidenced by the need to incorporate disciplined risk management throughout the company, or Pillar 2 requirement of Solvency II. Companies, in particular Asian insurance companies, have embarked on a soul-searching journey to define its risk appetite and capacity. Discussions are overheard in board meetings and on the executive floor about "*what Solvency II considerations do I need to bring into this project?*" and "*how does this new product fare under Solvency II?*"

CROs and risk actuaries positions are created and filled. Seminars are held with Solvency II or Enterprise Risk Management as their theme. Is this reminiscent of the variable annuities craze we faced a couple of years ago (before the global financial crisis)? I still remember the days when the mere inclusion of variable annuities or hedging in the subject of a seminar or workshop will naturally attract hundreds, if not thousands, of enthusiastic actuaries.

[1] Omnibus II Directive

Challenges

Asian insurance companies are normally characterized by regular premium products. For young companies, the future premiums, or more precisely the profits thereof, can be quite significant. The European regulators appear to be uncomfortable in treating these profits as Tier 1 capital and it is not exactly clear the final decision of that discussion. Failing to treat this as Tier 1 capital will have adverse impact on Asian companies balance sheet.

Another key feature of Asian insurance products is the ability to increase premium rates. This is especially so for the profitable accident and health business, e.g. critical illness and hospital income benefit. Certain unit-linked contracts are also allowed to increase their COIs and policy administration charges. The current Solvency II rule says that where such increases are not capped, all these contracts can only be valued up to the boundary where the company has rights to increase the rates. In practice, this can be as short as one month, if a company needs only notify policyholders with one month's notice. Imposing this boundary removes sizeable future profits/value in the Solvency II balance sheet.

In addition to valuing a policy liability on a best estimate basis, one has to allow for risk margin. This is briefly the cost of holding the capital related to non-hedgeable risks in that policy. For non-investment contracts and whole life contracts which extend far beyond the existing available yield curve, that cost of capital is by no means trivial. I am certainly interested in the extent this cost is factored into the purchase price of recent M&A deals.

Practical difficulties

For actuaries actively involved in modeling, the key difficulty is likely to be the need to monitor the company solvency on a continuous basis. [2] As we all know, it can take the most efficient valuation and finance teams weeks, if not months, to complete embedded value computation and reconciliation. The need for stochastic valuation and to calibrate to market prices only serves to increase the complexity of insurance liabilities valuation. Companies are actively finding ways to both speed up the valuation process or tools to approximate their balance sheets, e.g. replicating portfolios, in order to reduce the need to do frequent actuarial runs.

With Solvency II, we are now drawn to focus on the tail distribution. This means that a simple change from normal to log-normal distribution may turn a "well-capitalized" company insolvent overnight. Gone are the days that valuation actuaries need only feel comfortable about the best estimate. Variability in experience becomes just as important as the best estimate. Asian insurance companies, not usually blessed with massive historical statistics, may find this especially challenging. More questions are being asked of "*how bad does my mortality experience have to deteriorate within x*

[2] Article 44 of Level 1 Directive

standard deviations?" The more interesting questions are *"what is the probability that an extreme fall in equity in Singapore happens together with an interest rate increase in Hong Kong?"* Some of you that are close to modeling may already know that the Solvency II required capital is, sadly, rather sensitive to answers to these questions. The time it takes to collect sufficient statistics to close this feedback loop is also much longer than one for the best estimate.

Modeling aside, there is a need to live and breathe the "Internal Model" (or so-called use-test) if an insurance company decides to use its own risk assessment / measurement system instead of following a standard (prescriptive) model. Product decisions, reinsurance decisions, M&A decisions and other major business decisions need to consider Solvency II capital and the associated return on that capital. A decent return on local statutory capital is no longer sufficient to launch a new product. This has profound implications on high guarantee products like universal life and return of premium.

How does it affect Asian companies?

There is no doubt Solvency II is likely to change the way insurance companies operate. This is especially so for companies with European base.

Solvency II is likely to lead management to look at economic benefits (and costs) of insurance business. A weak local solvency regime, which may benefit local companies, is likely to cause problem to multinationals as they actually have to hold a much higher capital elsewhere in the world.

Companies writing with-profits business are particularly interesting. In countries such as Singapore and Malaysia, insurance companies are required to distribute most of its asset share to policyholders. In other words, the best estimate liability in a with-profit fund is close to its asset, leaving only an estate to cover the required capital and risk margin. If shareholders are not willing to provide the capital, this re-invites the question on strengthening the estate in those countries and obviously policyholder's reasonable expectation (PRE) crops in. In most cases, bonuses were illustrated without an allowance for contribution to such strengthening in the past.

My colleagues once asked me whether Solvency II is the panacea to capital mismanagement. As much as I would love to agree, I still believe that a system can only be as good as its practitioners. I urge you, being key practitioners in the new paradigm, to take up this challenge!

Alan Tan
Regional Director, Financial Risk Management
Prudential Corporation Asia Ltd

A Perspective from the AXA Hong Kong Solvency 2 Program

Hong Kong is a long way away from Europe and at times that distance can be felt in the difference in culture and business practice. However, for those firms falling under the scope of the upcoming European-wide Solvency 2 regulation, this gap will inevitably narrow as firms get to grips with effectively implementing and refining enterprise wide risk-management programs.

For AXA Asia (ex Japan), the Hong Kong business will be the only one in scope for Solvency 2 initially when it comes in to force on the 1 January 2013, and so it has made sense to run the dedicated project from the local office. This is an arrangement that has worked well as it's ensured a close working relationship with the local teams which is essential to help build a sense of local ownership of the framework being put in place and to ensure that the work done is tailored appropriately to the local business.

More than just the numbers

Solvency 2 is an overhaul of the insurance regulation with the overall aim of improving policyholder protection by aligning the amount of assets a company needs to hold (capital) with the economic risks that the company is running. In a Solvency 2 world companies writing less risky business, or those who risk manage their business in a sound way will get the benefits of needing to hold less capital relative to firms writing more risky business or those who are less active in managing their risks.

Under Solvency 2 firms will be able to calculate their capital requirements using one of two approaches:

1) *Standard formula.* Firms can use a set of rules as laid out by the regulator to calculate their capital. Iterations of the standard formula have been assessed in the Quantitative Impact Studies (QIS), the latest of which was QIS5 which took place towards the end of last year. This is a simpler approach than the alternative, but may not be a very close reflection of the actual risks a business is running as it is not tailored to the specific business. Even still, this is not to say that the standard formula isn't turning out to be a reasonably sophisticated model in its own right.

2) *Internal model approach.* Firms can build and use their own internal model to calculate and report their capital. This is typically a considerable undertaking, but the potential benefits are also considerable in terms of more closely aligning capital requirements with the actual risks being run. In this scenario firms will have the additional burden of demonstrating that the same model used to report their capital requirements is also used to run the business at the most Senior levels. This, in Solvency 2 speak, is the 'Use Test'.

At the heart of any Solvency 2 program with internal model ambitions will be a sophisticated Economic Capital model. This is certainly the case with AXA, who have stated their intentions to go down the route of internal model approval globally with AXA, who have stated their intentions to go down the route of internal model approval globally and have already been reporting internal economic capital for a number of years based on group-wide methodology. This is one of the benefits of being part of a global insurance group renowned for its strength of governance and risk management practice. However, Solvency 2 is much more than just the numbers, and while these have naturally been the focus of the Solvency 2 project initially, other aspects of the program are now gaining prominence, for example:

- **Internal model governance:** Overall risk management is a cornerstone of the Solvency 2 framework and forms part of the 'second pillar'. This is where it becomes clear that the Solvency 2 program is not just an actuarial program, but indeed an enterprise wide program that will require an overhaul of the governance, working practices and even mindsets of staff at all levels across the organisation. For example, take the ambition of establishing a culture of risk awareness in which each process owner takes responsibility for identifying risks to the business and reports and manages them appropriately – it will require a range of activities to be performed throughout the business to foster such a risk aware culture.

- **Use Test:** Some aspects of the use test will be easier to meet and evidence, while others will pose significant challenges. For example, it is reasonably straight-forward to put in place the mechanisms to ensure business performance and senior management compensation is monitored and evaluated on metrics from the internal model. However, some of the less prescriptive requirements cannot be so simply achieved. An example of this is the requirement that the Board & Senior management must have a good understanding of the methodology, assumptions, short-comings and results from the internal model. This will involve more than running a few Solvency 2 workshops and will require significant investment from the most senior members of the company and the Solvency 2 team.

- **Data Quality**: The model will only produce results as good as the information going in to it. As the old saying goes "rubbish in – rubbish out". Hence, ensuring data is accurate, complete and appropriate is a key aspect and a significant work stream in its own right, as it will likely be for many companies in scope for Solvency 2.

And the list could go on and on. But the aim is not to run through all the work areas under the S2 program, but merely to help dispel the myth that Solvency 2 is just about the numbers, it's not. To be successful it will need to run across the business and fundamentally change the way risks are identified, monitored and managed.

Non-European Economic Area Program

Here in Hong Kong as a Non-European Economic Area (EEA) country our requirements will be slightly less than those of our EEA counterparts. In Hong Kong, the main area of relief from being a non-EEA country is in the reduced disclosure requirements to the local regulator. For AXA the reporting will only be done on a consolidated basis to the headquarters in Paris. However, not having a local regular for Solvency 2 means there is no external party to negotiate with on contentious issues or to verify approaches to achieving regulatory compliance. It also means the business will be run on two bases – the risk sensitive Solvency 2 basis, but also the risk-insensitive local basis, which will make the business of running the business that bit more challenging.

The Program

A Solvency 2 team based at AXA headquarters in Paris is driving the Solvency 2 project. At a local level, besides the Hong Kong office, the regional office have a role in those aspects where they support the local office, but also in keeping a view across Asia to help ensure the portability of solutions across the region. This forward looking approach aims to help maximise synergies across the region as and when other business units come in to scope for Solvency 2 in future.

Given the breadth of the scope of the project it has been split in to five work streams, three of which mimic the three Pillars of Solvency 2, the other two as transversal work streams covering data and documentation. However, it is being run as a single project, ultimately reporting to a Steering Committee of the most Senior Management in the company. To help ensure the successful delivery of the Solvency 2 program a dedicated team of specialists have been committed to the project combined with business owners as much as possible. Ultimately it will be the business owners who will take ownership of the Solvency 2 framework, so getting their early buy-in will be an important part of embedding the new framework in the business operations. This in-house team is also supported by external vendors who can bring specialist knowledge to the project and provide short-term relief when there are peaks of demand for resources from the project and business as usual activities. This combined approach should help ensure the smooth delivery of the project with minimal impact on running the business.

There are certainly challenges ahead for the Solvency 2 program and it will continue to require significant investment in people, processes and systems. While there is no choice on compliance with the Solvency 2 regulations there is, however, a choice on how the program can be viewed: An expensive compliance exercise or a great opportunity to leverage best practice risk management from our European counterparts to help implement a truly enterprise-wide risk management framework. I prefer to think of it as the latter.

Delme Pritchard
Solvency 2 Program Director
AXA China Region Insurance Company Limited

The Evolution of Reinsurance in the Era of Solvency II

Solvency II's extensive impact on the insurance industry will include changes in reinsurance needs and practices. This article explores this anticipated area of change, with a special focus on reinsurance that is motivated by capital or financial reasons.

Insurers buy reinsurance for many reasons. For the purposes of this exploration, we group these into three areas:

- To receive product development, underwriting or other services,
- To transfer risks and thereby to limit volatility in <u>future</u> income results or capital needs, or
- To reduce <u>current</u> capital needs or to improve returns on <u>current</u> capital

Reinsurance for Services

Of the three categories noted above, this is the one that will undergo the least change with the advent of Solvency II. The need for these services will not reduce, and they will in fact increase in at least two areas.

Solvency II will cause insurers to need to develop new products or, at least, to modify old ones. One reason for this is that under Solvency II some existing products will turn out to be too expensive for the insurer, due to the high amount of capital that they require. Another reason is that companies will be motivated to write a broader range of risks, in order to take advantage of Solvency II's implicit credit for diversification. Designing and selling new products will be one of the ways to achieve this diversification.

New needs that will arise under Solvency II include the formal demonstration that (i) the insurer's actuarial assumptions are based on relevant credible data or expert opinion and (ii) that risk management processes are fully integrated into the insurer's overall management processes. Reinsurers and reinsurance will be able to play key roles in each of these.

Limiting Future Volatility

The need or role for reinsurance in this area will only increase. First, many of the measures whose volatility is presently a concern will continue to exist (e.g. IFRS net income, embedded values, taxes) and concerns about their volatility will also persist and need to be addressed. Second, Solvency II will be a much more volatile measure than the Solvency I system that it is replacing, so desires to mitigate this future volatility will increase.

One of Solvency II's foundations is that of "market consistency". This means, among other things, that the derivation of the Solvency II balance sheet and the required capital ("Solvency Capital Requirement" = SCR) will use live market inputs (e.g. government bond yields, bond credit spreads, equity prices) and constantly updated actuarial best estimates (e.g. mortality, lapse, and disability rates). This will have the result that a company's solvency position under Solvency II will be much more volatile than under Solvency I and other current systems.

As well as increasing the need or desire to mitigate future capital positions, Solvency II will make the mitigation itself more complicated and, perhaps, more costly.

Managing Current Capital

This area of reinsurance has always been difficult to describe succinctly and it goes by many names (e.g. financial reinsurance or capital motivated reinsurance). Such reinsurance may be accompanied by services and it definitely includes normal risk transfer, but the driver behind doing the reinsurance for the insurer is to reduce the amount of equity capital it needs to hold and/or to improve its return on that capital. Two simple examples, one from each end of the spectrum of capital motivated reinsurance, help to define this class of reinsurance.

A company may be unable to raise new equity in order to match its growth in new business, but may also be unwilling to accept the repercussions of not

selling that new business (e.g. lower total commissions paid to sales agents, need to lay off administrative staff, etc). By selling the new business and reinsuring it onwards, the insurer can satisfy both its constraints. Implicit in this arrangement is that the insurer is ceding to the reinsurer the future margins in that business required to service the capital needed to support it, but it is nonetheless keeping the expense, administrative and other margins and charges, which it can use to pay its agents and employees.

A company may be unhappy with the return on capital that it is able to achieve, given competitive pressures and regulatory requirements. If it can identify an element of the required capital that it can reduce via reinsurance, and for which it can pay the reinsurer a price with proportionately lower margins than its total margins, then it can increase its return on capital. If, for example, an insurer can cede the risk which generates ½ of its capital requirement to a reinsurer for a price which has a percentage margin of ½ of the insurer's total product margin, then it will retain ¾ of its total absolute margin but will only need to service ½ of its original capital. This will clearly increase the insurer's return on capital.

Under Solvency II the need or opportunity for these two cases, and for capital motivated reinsurance in general, will evolve. For the first case (i.e. reinsurance as an alternative to raising normal capital), the basic issue will continue to exist. It may even get worse if investors are unsettled or uncertain about Solvency II and its impact on the profitability of their capital deployment. For the second case (i.e. reinsurance to improve return on capital) the situation gets much more interesting.

This latter category can be characterized as arbitrage, in that the reinsurer is able to hold capital (and thereby charge a price) which better reflects the risks and rewards than the capital requirement of the insurer. To the extent that Solvency II's key foundation principle of market consistency is carried through to implementation, the opportunities for pure arbitrage will be greatly reduced. On the other hand, Solvency II's reflection of diversification effects will introduce a new driver for differential capital and pricing between different companies, and this will become a new basis for "economic arbitrage".

Conclusions

Under Solvency II, insurance companies' needs will evolve in many areas, and so will the corresponding reinsurance solutions. The mere fact that Solvency II's quantitative requirements are directly and "sensitively" tied to risks, means that reinsurance – which is all about risk – can only take on a more central role than it already plays in capital, financial, and risk management.

Paul Sauvé
Senior Vice President Business Development
Global Financial Solutions
RGA International Reinsurance Company Limited

Solvency II : Definitely challenging, but also a catalyst for change

In this article we share some insights into Solvency II - while there are significant challenges, our view is that the industry will benefit in the long term. However, there is a danger that Solvency II (and similar exercises world-wide) is viewed merely as a technical black-box. To ensure that this does not happen, we, as actuaries, need to grasp the opportunity to go beyond the numbers and demonstrate the value it can add to the business. This is an obligation on each and every one of us in the actuarial profession.

Currently scheduled for 2013, Solvency II will introduce a risk-based regulatory framework and new disclosure requirements for insurers across Europe.

There has been a steady stream of developments over the past 18 to 24 months: the high level principles in the Solvency II Framework Directive (Level 1) have been agreed; consultations have taken place on Level 2 implementing measures; and progress is being made towards the final specification of the standard approach through the Quantitative Impact Study (QIS) exercises.

However, there is still much work to be done to finalise the framework. The Level 2 measures have to be published and ratified, Level 3 guidance needs to be drafted and communicated, and the potentially wide range of transitional measures introduced in the Omnibus II Directive need to be refined.

The Solvency II framework is therefore unlikely to be finalised until 2012, introducing a significant level of uncertainty for insurers. They are not, however, sitting on their hands – significant progress is being made with implementation. In this article we examine some of the challenges and opportunities facing insurers, and the actuaries who work for them, as they forge ahead with implementation.

And for those companies that feel Solvency II will have no direct impact on them – understanding your competitors is core to business success. As Solvency II will directly affect players in all markets in Asia Pacific, every company should be aware of the impact it is having.

Some key observations include:

- The current desperate shortage of actuarial talent in Asia Pacific is being exacerbated as European companies are actively targeting actuaries from the region to become part of their Solvency II armies in Europe.

- The results of QIS 5 provide an estimate of the solvency capital requirements of the European insurance industry, some €547 billion compared to available capital of €902 billion. However, the industry results mask significant variation in solvency positions by company. QIS 5 also sheds light on the largest risk exposures of insurers – market risks for life business and premium and reserve risk for general insurance business.

- Directionally the markets in the Asia Pacific region are moving towards regulatory regimes that pay greater attention to risk management and economic capital. Risk based capital is a step on this journey, and is already being adopted in many of our markets.

- The models being built to support these frameworks are large and complex. As we learned from the global financial crisis, complexity and becoming slaves to models is extremely dangerous and we must not lose sight of the benefits of simplicity and the necessity of applying common sense.

- Effective communication is absolutely critical. We need to develop our expertise in how to communicate key messages relating to risk, capital and value in a compelling, powerful and understandable way for senior management and for external disclosure. And we all know that, unfortunately, actuaries are typically considered poor in this area so we must address this or risk fading further into the backwaters of insurers.

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Getting going

Progress on Solvency II implementation has, to date, been mixed. Where progress is greatest, companies have created dedicated Solvency II programmes, with significant commitment of time, money and resources. There is, however, a danger that these all encompassing programmes can get caught in planning paralysis, exacerbated by the fact that the framework is still to be finalised. Companies that break the programme into manageable pieces with a focus on targeted deliverables to be developed iteratively seem to be making the most progress – strong project and change management structures are needed to make implementation a success.

Internal model application and approval

One of the innovative Solvency II proposals is to allow companies to use their own internal model to determine regulatory capital, subject to meeting specified requirements. Companies looking to have internal models approved by the start of 2013 will face the dual challenges of developing and testing such a model, and convincing supervisors that their model is robust and meets the approval criteria.

Currently, most actuarial departments have cumbersome and complex systems and processes that have evolved over many years and typically involve a lot of manual intervention. Developing an internal model presents companies with an opportunity to rethink and radically change the way their actuarial reporting systems and processes are operated to remove extensive manual interventions and reduce operational risk – and at the same time meet the requirements for Solvency II (and other emerging regulatory developments). Industrialisation of actuarial systems and processes represents the transformation of the existing process into one that is highly streamlined, systemised and automated.

The key advantage of this approach is that it allows actuaries to relinquish the day-to-day struggle of wrestling with the desktop spaghetti of systems and spreadsheets typified in today's environment. This gives both the actuarial teams and management more time to validate and interpret results – which makes life more interesting for actuaries and is a long term benefit for company stakeholders.

Risk management

Solvency II has also provided a catalyst for insurers to invigorate and grow their risk management programmes, with its explicit requirements for how risk management should be performed and by whom. Companies may need to reorganise their governance structures, teams and risk reporting and develop new systems, e.g. to better understand how their risk and solvency position evolves over time and under different scenarios as part of the Own Risk and Solvency Assessment required by Solvency II. This includes developing, promoting and embedding a risk culture throughout the organisation – without this insurers will not be able to demonstrate that risk management systems are core to their decision making.

Risk culture can be defined as the norms and traditions of behaviour of individuals and of groups within an organisation that determine the way in which they identify, understand, discuss and act on the risks the organisation confronts and takes[1]. Risk management is not just the responsibility of the risk management function; the focus needs to move into the wider business.

Relying on processes and controls will not be enough to give confidence that an organisation is capable of state of the art risk management - there will always be ways to circumvent the controls. It is therefore necessary for the company's leadership to encourage a strong risk culture where employees are risk aware, understand the consequences of their decisions and are confident to raise objections when necessary. Risk culture is not static and should be actively challenged to encourage continuous improvement. Some companies are planning to use regular risk culture surveys to foster this cycle of improvement by allowing management to benchmark against other organisations, track their own performance and provide results at a sufficiently granular level for remedial actions to be defined and then actioned.

[1] IIF Report Reform in the Financial Services Industry: Strengthening Practices for More Stable System. Institute of International Finance, 2009.

Increased public disclosure

One of the building blocks behind Solvency II is increased public disclosure - using market discipline to improve corporate governance and solvency ratios. Companies therefore need to have a clear strategy as to how they explain their Solvency II results in order to ensure that they are correctly interpreted and understood by shareholders, analysts, rating agencies, the media and policyholders.

A key concern for many insurers is the potential volatility of capital requirements. Michael Diekmann, the chief executive of Allianz, has been quoted as saying "Even very small changes in interest rates will lead to huge fluctuations in our theoretical capital requirement without anything having changed significantly in the … economic environment."

The QIS 5 report, published by EIOPA on 14 March 2011, highlights the need for more work in the field of valuation of technical provisions, including the application of an illiquidity premium, and other anti-cyclical mechanisms, to help address the volatility inherent in the Solvency II valuation rules.

Equivalence and its importance for Asia Pacific

The overarching principle of equivalence is that the third country supervisory regime ensures a similar level of policyholder and beneficiary protection as the one provided under Solvency II.

Guidance on equivalence is subject to the timelines set-out for Level 2 implementing measures and Level 3 guidance. The Level 3 guidance will, however, benefit from practical insights learned from the first wave of assessments (covering Bermuda, Switzerland and to some extent, Japan) which is due to take place between July and September 2011. The second and third waves of third country assessments are due to take place in 2011/12 and 2013/15 respectively - countries to be included are still to be determined.

For those companies that are part of groups that fall under the Solvency II regime, equivalence introduces further complexity – both in terms of the uncertainty relating to requirements and potentially needing to manage the business under two solvency regimes.

Competing for scarce resource

The demand for and scarcity of skilled finance, actuarial and risk management resources (especially those with Solvency II experience) is posing a further challenge to insurers. We are already seeing actuarial recruiters turn towards Asia Pacific, worsening our own shortage of such skilled individuals. This problem is likely to be exacerbated over the next two years as companies, advisors and supervisors compete for the scarce talent. Actuarial bodies will clearly need to consider this challenge when developing their study programmes in the future.

Companies should therefore be looking to enhance the skill set of their existing employees through training programmes and Solvency II project work. This will help to embed the knowledge within their organisations and provide a more concrete resource base for the future.

The strategic perspective

For affected companies and groups, Solvency II will fundamentally change how the regulatory capital they need to hold is determined. The more explicit allowance for risk and diversification effects will encourage companies to re-evaluate and change such things as corporate structures, investment strategy, hedging and reinsurance strategy in order to move to a more optimal risk-focused position.

Company management is already starting to address the strategic opportunities that might result from the new framework. Some are simplifying corporate structure to best maximise diversification effects. Reinsurance, hedging and other risk reduction strategies are being reviewed where QIS exercises have helped companies to get a better grip on the key risks to which they are exposed. Similarly, the profitability of products on a Solvency II basis is being examined, with decisions being taken around product design and pricing or indeed exiting certain products or markets.

****

Solvency II comes into force at the beginning of 2013, and both insurers and supervisors must address considerable challenges to be ready in time. But, within these challenges lie opportunities, not only to improve business efficiency and identification of strategic priorities, but also to make the actuary's role more value-add. It's important that we, as actuaries, grasp the opportunity not only to extend ourselves technically, but also to expand our role within a more risk aware culture.

Mark Saunders
Managing Director, Towers Watson

Penny Fosker
Senior Consulting Actuary, Towers Watson

Solvency II – Changing the Actuarial IT Landscape

As insurance companies increasingly focus on the systems challenges required to ensure that their actuarial models meet Solvency II requirements, they are appreciating that the actuarial IT landscape is fundamentally changing and becoming more challenging and expensive to implement and maintain. No longer can the actuarial systems be thought of as anything other than mainstream corporate systems that require the same executive attention and IT disciplines as those applied to administration and accounting technology within the firm. This strategic, operational and IT shift applies equally to large insurers seeking to gain internal model approval and to smaller insurers with more modest standard model aspirations.

Many insurers have undertaken analytic gap analyses to determine if and how their existing actuarial models can be extended to perform Solvency II Pillar 1 analytics. However, less attention has been given to the Pillar II and III auditablity and transparency requirements to move from a fundamentally desktop model development, data management, run execution and reporting world to an enterprise environment.

As per Figure 1, changes in the systems requirements as a result of external pressure for more complex models which are used for more purposes, more frequently with shorter reporting cycles, and with demonstrable audit, control and reproducibility can be summarised as:

- **Enhanced ALM Analytics** which will further stretch the boundaries of models and systems initially intended and built for policy-by-policy embedded value type projections. Increased asset types with advanced investment and disinvestment strategies are just some of the required enhancements.

- **Model and data version, audit and control** with centralised code and assumption management rather than a decentralised desktop Excel-like usage paradigm. Data warehouses, usage rights, transaction logs, roll-back, regression testing and web-based access are some of the new technologies being considered.

- **Production automation and monitoring** within a separate environment to that of model development. This requires standard production schedules, automated data feeds and results aggregation, ability to rerun jobs and results version control.

- **Dynamic processing capacity** to replace or supplement fixed internal capacity to meet peak usage periods. Both the size of runs (numbers of model points and scenarios) and number of runs (stress tests, alternative strategies, analysis of change etc) are increasing the demands on processing capacity.

- **Frequency and timeliness of reporting** is increasing both the operational and processing demands placed on the actuarial resources at a time of increased pressure to reduce costs.

- **“Real Time” risk management** with daily solvency monitoring, active hedging programs and risk dashboards to provide the information to make decisions to actively manage the risk positions of the organisation that is consistent with and complements the production cycle actuarial reporting analytics.

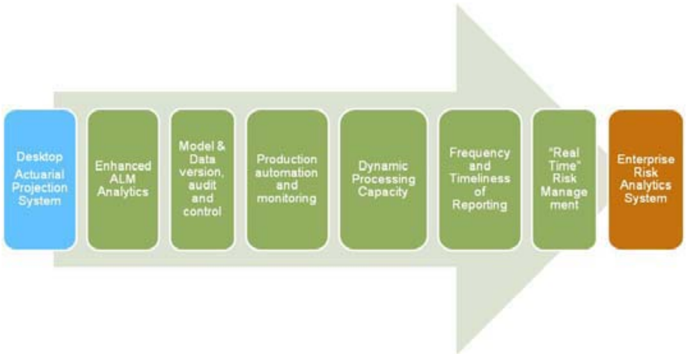

Figure 1: Desktop to Enterprise Risk Analytics

These requirements collectively impact on the historic silo'ed and self-managed actuarial modelling system. To meet these requirements, organisations should review their entire actuarial IT landscape in order to implement a holistic and integrated modelling solution that is aligned with the transformed reporting process. Figure 2 outlines what a future Solvency II IT Solution landscape might consist of:

Infrastructure: At the base level is the data warehouse, processing and business intelligence technology infrastructure within a centralised internal or hosted data centre. This is fundamentally different and orders of magnitude more sophisticated technology than currently adopted by actuarial departments to store data and run projections. This requires active involvement and management by the corporate IT department.

Software Platform: Sitting on top of the infrastructure is the production environment software platform which provides the data and processing management, version and audit control as well as risk dashboard reporting tools. This will typically be a web-based interface in order to facilitate wide spread internal local and global access.

The Analytics Layer provides all the tools used to produce the Pillar I analytics. It is important to recognise that the scope of the analytics used stretches beyond the “hard core” actuarial projection and daily solvency monitoring systems to include other (often Excel based) calibration, input preparation and output reporting tools.

Resources, both internal and external, providing traditional actuarial, risk management and actuarial system implementation functions, as well as wider organisational process transformation and system integration expertise.

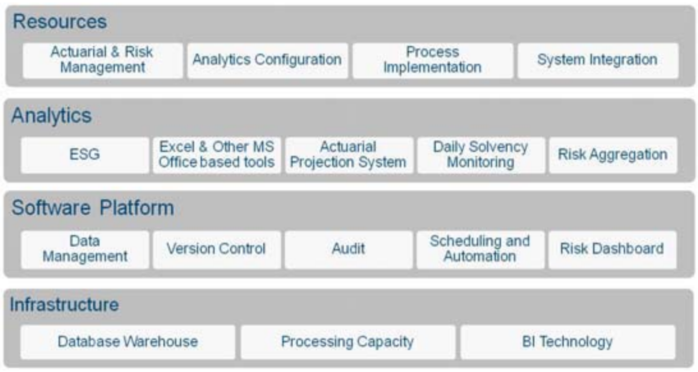

Figure 2: Solvency II Actuarial IT Solution Landscape

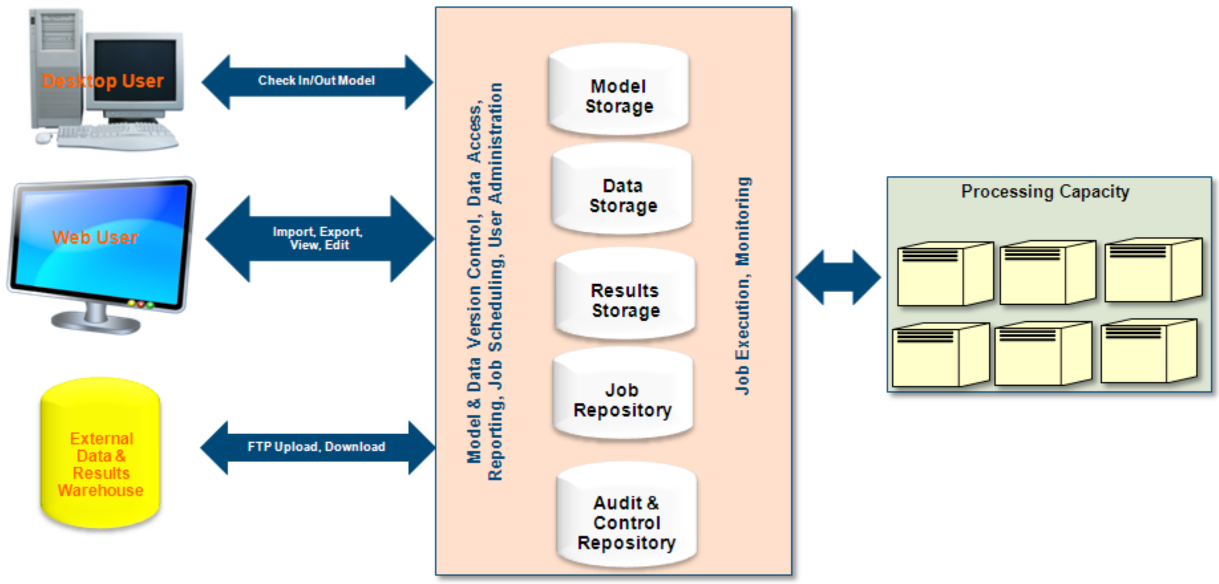

Figure 3: Possible Solvency II IT Solution

How can the current actuarial modelling function evolve to meet this future landscape? Figure 3 sets out a conceptual framework of the future actuarial IT solution in which actuarial modellers continue to use their desktop actuarial modelling tools to develop the model code but store, for version control purposes, the model in a central model storage warehouse. Models are checked in and out in a paradigm consistent with other IT version control best practices. Production users interface to the model, manage data, schedule runs and view output through a web user interface which provides global but controlled user access and data management. Model point data, ESG scenarios, market information and other external data is fed to the system and output results potentially returned to feed into wider corporate MI systems. Jobs are executed on an internal grid or external cloud processing capacity.

The interesting aspect is that the requirements and implementation solution are largely independent of the size of the firm. All organisations are seeking better systems and processes with fewer resources and need these capabilities to varying degrees. The only difference is the scale and the capacity of the organisation to implement it internally or through external support, to use existing actuarial systems/models or to implement new solutions, and whether to host the solution internally or seek to outsource the infrastructure and/or operation of the models using cloud computing resources.


Written by Martin Sher and Pat Renzi, Consulting actuaries in Milliman

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Darwin Rhodes is the leading global specialist in Actuarial Recruitment. Since establishing our office in Hong Kong in 2001 we have developed an enviable reputation for providing a first class service to our clients and candidates. From a candidate perspective we have managed to identify opportunities where, in some cases, they have felt they were seeking the unobtainable and as a result assist them with accelerating their careers exponentially. For our clients we have provided innovative resourcing and compensation strategies enabling them to build and grow their teams and businesses.

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News in the Circle

Daisy Ning (RGA) would like to share her happiness with you for the birth of her son, Zachary Fung, who was born on Aug 5, 2010.

Members' Update

ASHK By-Laws on Due Process and CPD

Members are advised that following the general membership consultations conducted last June on the ASHK By-Laws regarding Due Process for the Development of Professional Standards and Guidance Notes and regarding Continuing Professional Development, the ASHK Council has formally approved both By-Laws on 17 January 2011.

Please click here to access the summary of the questions and comments received, the Professional Matters Committee's response and the final By-Law on Due Process.

Please click here to access the summary of the questions and comments received, the Professional Matters Committee's response and the final By-Law on CPD. This By-Law will supercede AGN6 on CPD.

Withdrawal of AGN8

Following a review by the Life Insurance Committee, and a decision by Council on 21 Feb 2011, AGN 8 (Process for Determining Liabilities under the Guidance Note on Reserving Standards for Investment Guarantees as issued by the Office of the Commissioner of Insurance) has been withdrawn.

MEMBERSHIP UPDATE & ACTUARIES ON THE MOVE

New Members

Fellow

Albert Ko-Pan CHU	AIA, FSA (2009)
Angela Man-Wa CHUI	AXA China Insurance, FSA (1999), MAAA (1995)
Yungui HU	Deloitte, FSA (2008), MAAA (2008)
Brian Wing-Yeung LEUNG	AIA, FSA (2009)
Li QIU	ING Asia/Pacific, FSA (2005), MAAA (2005), EA (2005)
Mark O'REILLY	Deloitte, FIA (1978), ASA (1986), MAAA (2006)
Kris Lai-Mei WAN	AIA, FSA (2008)

Associate

Eric Chi-Kin CHEUNG	University of Hong Kong, ASA (2009)
Tommy Yiu-Sing CHING	HSBC Insurance, ASA (2009)
Douglas Chun-Tak LAM	KPMG , ASA (2008)
Daniel SHUN	AXA Asia Pacific, AIAA (2010)
Jason Ka-Shing TO	AXA Asia Pacific, ASA (2009)
Sam Shun YEUNG	Munich Re, ASA (2010)

Student

Aaron Kai-Chung CHAN	Deloitte, SOA Student
Mandy Wai-Man CHAN	Towers Watson, SOA Student
Ricky Wa-Fat CHAN	AXA Asia Pacific, SOA Student
Yun CHEN	Willis, SOA Student
Mikey Wai-Leong HO	Manulife, SOA Student
Amanda Man-Chi KAN	Deloitte, SOA Student
Shailesh KARANDIKAR	Deloitte, IoA Student
Arthur Kwan-Kuen KWOK	Towers Watson, SOA Student
Frankie Chun Ho LAU	Manulife, SOA Student
Sam Sik-Hung LAU	Manulife, SOA Student
Mickey Sing-Chiu LAW	AXA Asia Pacific, SOA Student
Kelvin LO	Alliance Bernstein, I&FoA Student
Alex Pak-Kin WAN	Manulife, SOA Student
Camille Ping-Ping YEUNG	PricewaterhouseCoopers, SOA Student
Olivia Ling-Xian YEUNG	RGA, SOA Student
Simon Hoi-Chon YUEN	Manulife, SOA Student
Chi-Hang WONG	Willis, CAS Student
Jonathan Ho-Wang WONG	SOA Student
Tsz-Kit WONG	Willis, CAS Student

Membership Upgrade

Fellow

Henry Ka-Fai CHAN	Manulife, FSA (2010)
Candy Hiu-Yan CHIU	Manulife, FSA (2009)
Ivy Tak-Yee CHIU	New York Life, FSA (2009)
Ken CHOW	AXA, FIAA (2010)
Christie Lai-Yin LEE	Guy Carpenter, FCAS(2011)
Mandy Hoi-Man LEE	Manulife Financial, FSA (2010)
Vivian Yuan-Kwan SZE	AIA, FSA (2003)
Soo-Hwee TAN	AXA Asia Pacific, FSA (2010)
Minnie Jing YU	Deloitte, FIA (2009)

Associate

Ian Tat-Pong CHENG	Manulife, ASA (2010)
Issac Kwok-Man KWAN	Ageas, ASA (2010)
Gary Ka-Wai LEUNG	HSBC Insurance, ASA (2010)
Kelvin Hei-Man LI	CIGNA, ASA (2010)
Antony Kin-Leung LOK	Prudential, ASA (2010)
Cheryl Cheuk-Yee SIN	HSBC Insurance, ASA (2010)
Jianbo XIANG	Gen Re, ASA (2009)

Reinstated Members

Fellow

Tom Ho-Lun CHAN	AIA, FSA (2009)
Victor Kit-Chung CHAN	AIA, FSA (2009)
George Wai-To CHAU	AIA, FSA (2007)
Brian Hung-Ying CHIU	CIGNA, FSA (1995), MAAA (1995)
Zita Sze-Dar CHUNG	Mercer, FIAA (2006)
Michael Lik-Yeung FUNG	Willis, FIA (2007)
Lisa LAU	AIA, FSA (1999)
Thomas Hung-Tak LEE	MetLife, FSA (1997)
Ricky Hiu-Fung LEUNG	AIA, FSA (2008)
Shirley Shut-Ling LEUNG	AIA, FSA (2004)
Alvin Wai-Shing SIU	AIA, FSA (2006)
Issac Chun-Yam TONG	AIA, FSA (2007)
Rejoice Cho-Yi WAI	AIA, FSA (2004)

Associate

Peggy Hau-Chui CHAN	Manulife Financial, ASA (2008)
Thomas Kwok-Ming TANG	PricewaterhouseCoopers, ASA (1995)
Joanne Hung-Yan YIU	PricewaterhouseCoopers, ASA (2007)

Actuaries on the Move

Fellow

Paul CARRETT
Simon Chi Sum CHAN
Jeff CHENG
August CHOW
David HUGHES
Mario LAI
Jeff LAU
Dominic LEE
Charles YUEN

Associate

Kahhoa KHOR
Ivan LEUNG

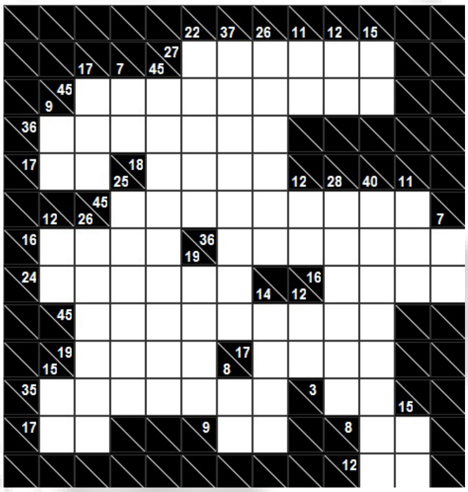
Student

Kelvin LO

The Actuarial Society of Hong Kong, 2202 Tower Two, Lippo Centre, 89 Queensway, Hong Kong
Tel (852) 2147 9420 Fax (852) 2147 2497 Website: www.actuaries.org.hk

PRIZE TO GIVE AWAY!

A prize will be presented to the member who submits the first correct entry of **the Kakuro**. Join the game and submit your entry to ASHK Office by email: actuaries@biznetvigator.com **NOW** !!!



How to play:

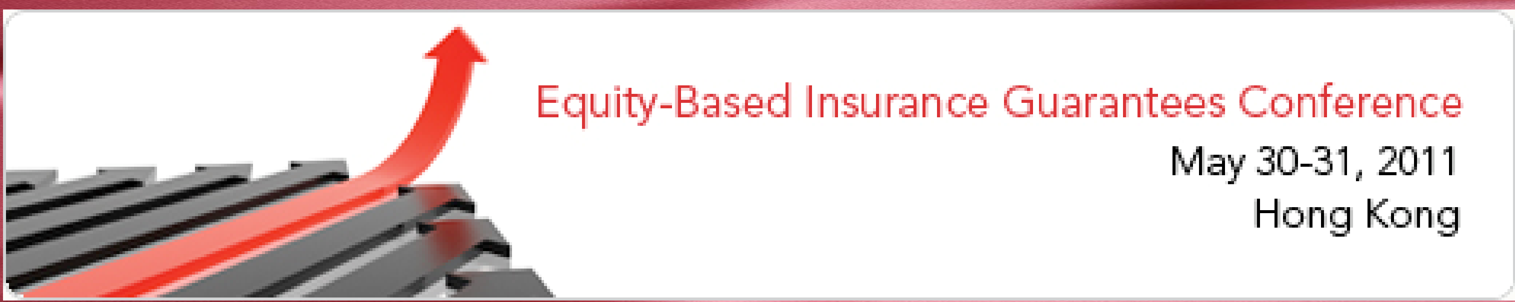
- Place the digits 1 to 9 into a grid of squares so that each horizontal or vertical run of white squares adds up to the clue printed either to the left of or above the run.
- Numbers below a diagonal line give the total of the white squares below; numbers to the right of a diagonal line give the total of the white squares to the right.
- **No digit can be repeated** within any single run. Runs end when you reach a non-white square.

Suggested solution for Dec 2010

AND…
the winner of the last issue is **Mr. Brian Lai**!

UPCOMING EVENTS

Fri, 8 Apr	SOA APC, Beijing
Mon, 11 Apr	SOA APC, Hong Kong
Wed-Thu, 13-14 Apr	ASHK Soft Skills Course – Leadership
Tue, 19 Apr	ASHK Investment & Risk Management Symposium
Mon - Wed, 16-18 May	ERM Techniques and Practices (Nexus, Risk Training, ASHK & SOA), Hong Kong
Tue-Thu, 24-26 May	5th Asian CFO Insurance Summit
Mon - Tue, 30-31 May	SOA EBIG, Hong Kong
Thu-Fri, 2-3 Jun	SAS 3rd General Insurance Conference, Singapore
Wed, 8 Jun	ASHK Evening Talk
Tue – Fri, 19-29 Jul	Joint Regional Seminar in Asia
Mon – Wed, 29-31 Aug	SOA IFRS and US GAAP, Hong Kong
Early Sep (tbc)	SOA IFRS and US GAAP, Taipei
Mon – Thu, 10 – 13 Oct	16th East Asian Actuarial Conference (EAAC), Kuala Lumpur, Malaysia
Oct (tbc)	SOA APC, Shanghai
Fri, 28 Oct	SOA APC, Hong Kong
Tue, 1 Nov	SOA APC, Singapore
Wed – Fri, 2-4 Nov	SOA FAC, Singapore
Mon, 7 Nov	ASHK Annual Dinner
Tue, 8 Nov	ASHK Appointed Actuaries Symposium
Thu, 10 Nov	SOA CRC Senior Life Actuaries Forum, China
Oct or Nov	Society of Actuaries of Thailand Non-Life Forum, Bangkok
Dec	ASHK AGM



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Following our successful launch in late 2009, The Emerald Group's Hong Kong branch has gone from strength to strength in the actuarial recruitment market in Asia.

By exporting our first class actuarial recruitment brand from the UK & Europe over to Asia, we are also now ideally positioned in this market to advise on a wide range of opportunities both locally in Hong Kong as well as through Singapore, Japan, China and across the regions. It has been evident that the Insurance market in Hong Kong was very much in need of a fresh, high quality, actuarial specialist recruitment firm to assist with growing business needs. Our proven ability to consistently meet this demand with the supply of high quality actuarial professionals in all disciplines has therefore enabled us to build relationships with clients that will hopefully develop into long-standing and successful partnerships.

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Whilst our Hong Kong branch typically focuses on Asia-Pacific vacancies, we also are perfectly positioned to introduce you to our colleagues, opportunities and networks in the UK & Europe if your career aspirations or recruitment needs dictate.

Therefore, if you are looking to recruit high caliber candidates from either the local region or further afield, or you are merely considering your own career at this stage and would be interested in hearing about local or global opportunities, we would be delighted to speak further with you. And, whilst our core business is very much focused on the Actuarial Profession, we also offer opportunities to many non-actuarial insurance professionals in areas of underwriting, catastrophe modeling, claims management and risk engineering so please do not hesitate to contact a consultant if we can provide further information.

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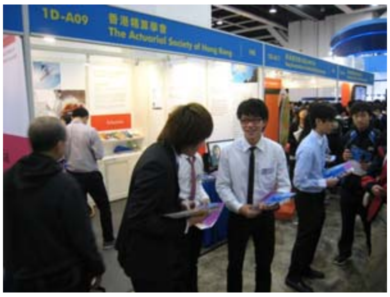
EVENTS' HIGHLIGHTS

Education & Career Expo 2011 (17-20 Feb 2011)










IAAust Presidential Dinner (3 Mar 2011)


Mr. Barry Rafe, IAAust President





EVENTS' HIGHLIGHTS

ASHK Luncheon Meeting (4 Mar 2011)

Speaker : Mr. Barry Rafe
IAAust President

ASHK Luncheon Meeting (15 Mar 2011)

Speaker : Mr. Gregory W. Heidrich
Executive Director, SOA

Speaker : Mr. Ken Guthrie
Managing Director of Education, SOA

ASHK & HKRSA Joint Luncheon Meeting (23 Mar 2011)

Speaker : Mr. Ronnie Bowie
I & FoA President

ASHK
NEWSLETTER

Volume 01/2011

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Contributions to the ASHK Newsletter

We welcome members' contribution to the following sections of the ASHK Newsletter: Feature Article, Actuaries on the Move and Puzzle Corner.

Send correspondence to the ASHK Office at the address below. When sending in correspondence which has been created in a word processing program, when possible, email a copy of the file to either the editor's or the coordinators' e-mail address. Publication of contributions will be at editor's discretion.

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