Podcast Transcript

ERM: Capital Management (February 2010)

Moderator: Capital management plays a central part in the enterprise risk management process. A company's capital position determines its ability to assume risks and to expand its business.
To properly embed capital management in the overall ERM process, it is important to understand the role of capital management in an insurance company and how it adds value for shareholders.

With us to discuss capital management for insurers is Wolfgang Hoffmann, Towers Watson Senior Consultant.

Wolfgang, can you outline the main roles performed by the capital management function?

Hoffmann: Within an insurer the capital function will take the lead in some activities and play a supporting role in others. The capital function will lead on determining, monitoring and reporting the company's capital position, allocating capital to business units and identifying a suitable mix of capital and finding cost effective ways to raise it.

On the supporting side, the capital function will support M&A and corporate restructuring activity, investor communication and analyzing past performance and setting future targets for business units.

In addition to these roles, the capital function will play an important role in setting the company's capital management policy, which will determine the way the capital function sees its role. Generally however, the responsibility for the capital management policy lies with the board of a company.

Moderator: Solvency II is currently on the minds of many people. What impact do you think it might have on capital management?

Hoffmann: Solvency II is a big step for the insurance sector in Europe and beyond, as it moves regulation from largely using simplistic, formula-driven approaches to setting capital requirements on a risk-sensitive and economic basis. This will allow the capital management and risk management functions to work much closer together than in the past.

To illustrate this point: The regulatory capital requirement under Solvency I, the current regulatory regime, and indeed, many regulatory regimes around the world, do not always reflect the riskiness of an insurer's business. This means that the capital function must manage to a capital standard that does not reflect the insurer's position. The risk function, on the other hand, will often concentrate on the insurer's real risk position. The management of risk and capital under two different, and sometimes conflicting, metrics creates substantial friction, extra work and costs.

Solvency II will align the activities of the two functions much more closely because capital requirements under Solvency II will be both the regulatory basis, and a reflection of the insurer's true risks and capital needs.

In addition, rating agencies are moving toward an economic view — some agencies are already willing to make some allowance for the results of companies' internal capital models in assessing capital requirements.

And although Solvency II is specific to the EU, many other countries are observing the developments carefully, and it could potentially provide a blueprint for a coherent global regulatory framework.

Moderator: Where do you see areas where capital management can add value for an insurer?

Hoffmann: We have seen, over the last years, that companies have more and more looked at making their corporate and legal structures more capital efficient: Recent examples are Swiss Re, which now operates in the EU out of two Luxembourg-based companies — one for life business and one for non-life. Reinsurers made use of this sort of thinking and corporate structure first, but we are also seeing primary insurers set themselves up this way, for example, ZFS, with the establishment of their Dublin-based Pan-European General Insurance carrier. While, of course, a complex and costly exercise, such restructuring can save hundreds of millions of euros in capital alone, in addition to improving operational efficiencies. I would expect more companies to carefully examine their legal structure and seek to enhance capital efficiency.

Another more operational aspect is to increase the capital efficiency of the business written. Capital efficiency has two parts to it — the amount of capital used and the profit per dollar of capital. The capital function will help with both parts.

Moderator: What are some efforts companies can undertake to increase their capital efficiency?

Hoffmann: The amount of capital used can be improved through a number of means. Options include use of reinsurance or hedging strategies and securitizations or other fund-raising actions. Analysis of which of these options requires the least capital will allow the insurer to improve its capital efficiency over time. It is helpful to conduct scenario- and business-planning analysis of the options in order to gauge whether there are some scenarios in which a particular capital structure will lead to a lack of flexibility for the insurer or a lack of capital in future.

As part of the capital management process, the capital management function can help to raise the profit per dollar of capital by allocating capital to those business units and lines of business that are expected to generate the best risk-adjusted returns per unit of capital. In doing this, the capital function needs to have good management information on business unit performance. The business units must set financial targets and have remuneration of the business unit management tied to hitting this target.

So capital management links in closely not just with risk, but also with wider elements of ERM. Successful capital management requires a holistic view of the business.

Moderator: Wolfgang, thank you for discussing capital management within an ERM framework.