The Actuarial Profession
making financial sense of the future

Life conference and exhibition 2010
Rajeev Shah and Dee McIntosh

Counterparty risks within groups

7-9 November 2010

Counterparty risks within groups

Agenda

- How are intra-group counterparty risks different?
- Working part terms of reference
- Working Party's thinking to date
- Entities subject to counterparty risk
- Assessing intra-group counterparty risks

Working party members

- Andrew Chamberlain, Alexis Iglauer, Dee McIntosh, Rajeev Shah, Paul Simmons, James Tuley (chair)

Definitions

Counterparty risk (attaching to any transaction)

Risk that the amounts recoverable by an insurance undertaking will be reduced due to the default of the counterparty

- Quantification of risk based on:
  - Probability of default
  - Loss arising from default
  - Take account of mitigating factors such as collateral arrangements

How are intra-group counterparty risks different?

- Different governance approach?
- Less likely to have own separate credit rating?
- Less likely to have process to manage counterparty risks e.g. collateral arrangements
- Knowledge about the counterparty?
  - Non-public information
- Control over the counterparty?
  - Ability to stop/influence the counterparty from taking actions that increase risk

Working party terms of reference

- Appropriate allowance in technical provisions and capital assessment for risks arising from membership of a group
- Appropriate issues an actuary should address in viewing the impact of intra-group transactions

In scope	Out of scope
Solo company	Parent/Group balance sheet
Direct impact on solo balance sheet arising from failure of another company in the group to fulfil their obligations	Indirect consequences (e.g. Impact of tarnished brands)
Intra-group transactions	Softer issues (e.g. general management constraints imposed by group/parent)

Working party's work so far

Thinking to date

- The types of entities that can be subject to counterparty risk within groups
- Thinking from solo-entity's point of view
  - Differences against counterparty risks from unrelated entities
  - Capital requirements

Yet to be done

- Issues specific to Pillar 1 and 2 under Solvency I
- Issues specific to Solvency 2
- Technical provisions

Entities subject to counterparty risk within groups

- Solo entities
  - Range those with a strong sense of their own entity to captives
- Mutual as well as Proprietary entities
  - Mutuals may outsource services to “sister” mutual entities
- Branches
  - Structures that cross jurisdictions (e.g. EU)
  - Localisation of asset requirements
- Groups
  - Concentration/dispersal of risks across its subsidiaries

Definitions

Intra-group transaction

Any legally enforceable transaction, whether or not contractual and whether or not for payment, by which an insurance undertaking relies, directly or indirectly, on other undertakings within the same group or natural/legal person linked to undertakings within that group

- Arise from moving “risk to capital” (e.g. reinsurance) or “capital to risk” (e.g. contingent loans)

Knowledge

- Additional information shared privately by the counterparty
- Solo must understand the information provided and how the counterparty:
  - interprets it
  - would react to changes in the information

Control

Directive control

- Ability to:
  - stop the counterparty taking action that increases the risk of it failing to meet its obligations
  - require the counterparty to take action that reduces the risk of it failing to meet its obligations

Mitigatory control

- Ability to take action to mitigate impact of actions by the counterparty

Allowance for intra-group counterparty risks

Starting point

- Treat the counterparty as if it is outside the group
- High requirements for non-rated counterparty
- Scale of reduction between 0% to 100%

Requirements for any reduced allowance

- Standard of documentation and governance at least as good as used with unrelated counterparty
- Non-public knowledge
- Control

The ends of the scale for reduced allowance for counterparty risk

100% reduction – fully owned captive

- Full knowledge and control
  - No operational distinction
  - Legal separation only for regulatory and/or tax reasons
  - Key roles performed by same staff at parent and captive
- Capital requirement calculations consolidate the captive

0% reduction – sister company in another jurisdiction

- Limited contact
- Relationship similar to that with an unrelated counterparty
- No knowledge or control

Middle of the scale - assess the level of knowledge and control

Knowledge

- Areas covered by available information relevant to the counterparty's creditworthiness
- Frequency and quality of analysis
- Ability to drive the nature of the information and to clarify it
- Sharing of the information within own entity

Controls (especially in times of distress)

- Control without relevant knowledge is of no value
- Effectiveness of controls
- Ability to exercise controls in time (especially in
- Range of controls
- Negative consequences of exercising control

Summary

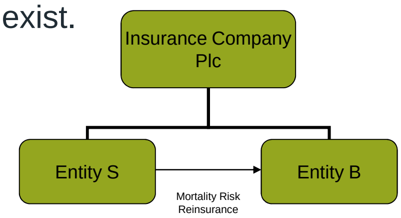
- Initial capital requirement assuming transaction with third party outside the group
- Reductions in capital requirement only possible if documentation and transaction standards at least as good as with third parties
- Both (private) knowledge and control necessary for reductions in capital requirement
- Reductions to capital requirement reflect level of knowledge and control

Practical Example

Practical Example

Insurance Company Plc

- Solo Entity S and Entity B
- Both Entities transact UK business (same jurisdiction)
- Internal Reinsurance arrangement between Entity S and Entity B in place to spread risk more evenly across the Group.
  - Mortality risk is passed from Entity S to Entity B.
- No other intra Group arrangements exist.



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Typical Current Practice

Entity S

- Capital Requirement reduces by £Xm to reflect risk passed across to Entity B.
- Little or no allowance is made by Entity S to reflect any additional risk associated with this intra group transaction.

Entity B

- Capital Requirement increases by c. £Xm to reflect the increased risk transferred in from Entity S.

Insurance Company Plc

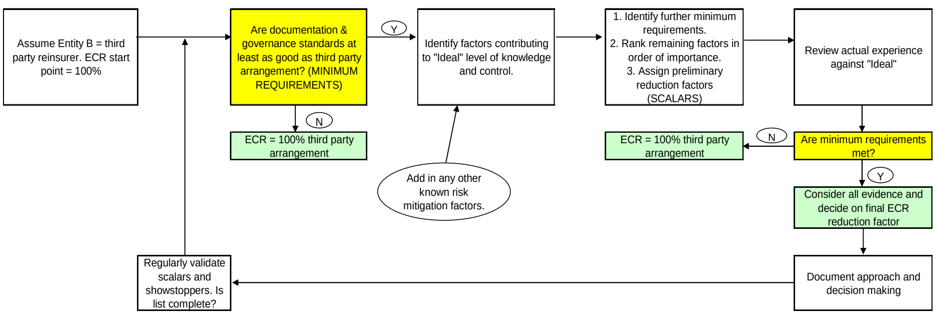
- Gross/net Capital Requirement is relatively unchanged (ignoring diversification benefit)

Potential Issue

- Due consideration may not have been given to the counterparty risk associated with Entity B. Capital Requirements within Entity S & at Group level may, therefore, be understated. (Extra Capital Requirement may be needed.)

Proposed Approach (cycle) for Entity S

Estimating Extra Capital Requirement (ECR) Reduction



"Ideal" In More Detail
Knowledge & Control (NB: List is not exhaustive)

- To achieve an "Ideal" level of knowledge, points to consider in order of importance may be;
  - Do you have access to Entity B latest own capital assessment **(and balance sheet)**? (MINIMUM REQUIREMENT)
  - Is the information up to date?
  - Has the regulator applied any capital additions suggesting Entity B do not understand their risk profile?
  - Does the capital assessment suggest a counterparty risk may exist?
  - Does the capital assessment appropriately take into account future business plans and strategy?
  - Do you have access to regular risk and solvency monitoring activities? Is this in place?
  - Does this show that material risks are not highlighted in the capital assessment?
  - Does the process for identification of new risks feed back into the capital assessment appropriately?
  - How is actual experience considered relative to the capital assessment to ensure material risks are captured e.g. ORSA?
  - Do the management team use the capital assessment when significant decisions are being made?

- To achieve an "Ideal" level of control, points to consider in order of importance may be;
  - Does the legal documentation allow for a sufficient level of control over the counterparty risk e.g. any collateral agreement in place or pre defined re-capture terms?
  - Are these controls understood and allowed for within Entity B capital assessment? (OVERLAP)
  - Do management team within Entity S have any authority over Entity B e.g. same management team members?
  - Do the management team effectively control risk exposure and capital resources?

Preliminary Scaling Factors
Provide High Level Framework for ECR Reduction

- ECR reduction scaling factor between 0 – 100%
- Minimum requirement to have access to Entity B latest capital assessment & balance sheet
- Understanding capital assessment (points 1-5) can lead to an ECR reduction of up to e.g. [40%]

Example Actual Experience Vs. "Ideal" One Factor - Understanding Capital Assessment

Review

- Entity S has access to the capital assessment of Entity B.
- Capital assessment clearly highlights risks and exposure levels.
- Capital assessment and resulting balance sheet does not suggest any solvency issues exist.
- The regulator has applied a small capital add on.
- Entity B did not experience any material risks not captured by the capital assessment.
- **There is no documented process in place for linking the capital assessment to the business plans or strategy of the company.**

Result

- The full 40% reduction available should not be applied in light of the issue around link to business planning & strategy.
- An action plan is put in place to address this issue.
- Actual ECR….?

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Summary

- Assume Extra Capital Requirement (ECR) for all intra group counterparty risks are 100% third party arrangement as a starting point.
- If documentation & governance around transaction is at least as good as third party arrangement, there may be scope to lower the ECR.
- Identify further minimum requirements that should be met before ECR for this specific transaction can be lowered.
- Identify "ideal" level of knowledge and control around this transaction and devise preliminary scaling factors for use with lowering ECR.
- Review risks against actual experience and decide on final scaling factors that should be used to reduce ECR.
- Final minimum requirements, scalars and ECR reduction factors should be documented and validated on an ongoing basis against experience.
- Final decision should be documented with justification for this decision and actions resulting from the review should be fed back to the business.

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Discussion - Questions and comments

- Is it only possible to achieve a 100% reduction in counterparty risk if you score "full marks" in all categories?
- What are the possible scoring criteria for transactions that fall in the middle of the scale?

Contact Details

- If you have any feed back for our working party you can contact us on the following email addresses;

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