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# Developments in Solvency II – A global practitioners view

Lehman Brothers, London,  
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Allianz 

## Allianz supports currently launched Solvency II Framework Directive (FD)

- Follows a principle and risk based approach
- Focus on risk based capital calculation (internal models)
- Applies market consistent valuation
- Goes one step further concerning Group Supervision (not only supplementary)
- Allows for diversification effects
- Aims for convergence across Europe
- Leads to more transparency for policyholders/stakeholders
- Supports Level Playing Field



In general Allianz welcomes risk and principle based Solvency II FD - Implementing measures have to support these principles (e.g. diversification effects, group supervision.)

## Allianz is prepared for the upcoming changes due to Solvency II

- ✓ Group wide risk governance in place
- ✓ Internal risk capital model rolled out
- ✓ Risk capital used for internal performance assessment and target setting
- ✓ Quarterly monitoring of risk profile (including stress tests)
- ✓ Available economic capital calculated
- ✓ Consistent approach for all segments
- ✓ Disclosure of risk information

▶ Allianz will benefit from the alignment of internal steering and external regulatory requirements

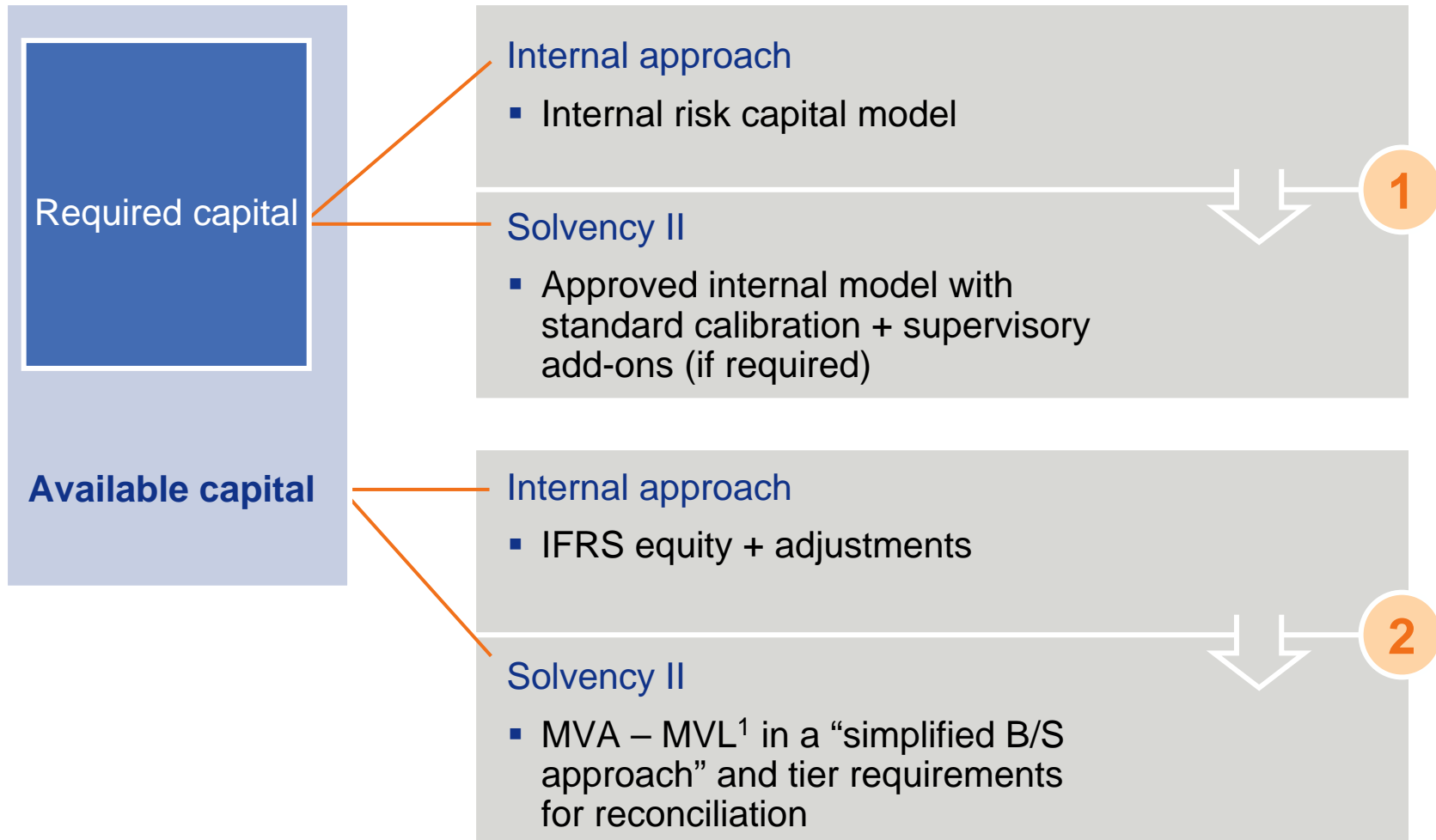
## Allianz internal risk capital model is in line with the expected requirements

	Internal risk capital	Envisaged S II requirements (QIS3*)
Level	Controlling unit	Legal entity
Perspective	Economic ruin of company	Economic ruin of company
Time horizon	1 year	1 year
Risk measure	VaR (Value at Risk)	VaR
Confidence level	99.93%	99.5%
Approach	Based on stochastic simulations and analytical approaches	Either based on approved internal risk model with adjusted confidence level or standard approach

\*QIS ... Quantitative Impact Study

 We expect to use the internal risk capital model for Solvency II purposes

# Transition from the current internal approach to the envisaged Solvency II framework



1) MVA = Market value assets  
MVL = Market value liabilities

**1** The internal risk capital model has to be based on a more conservative calibration than the Solvency Capital Requirement (SCR)

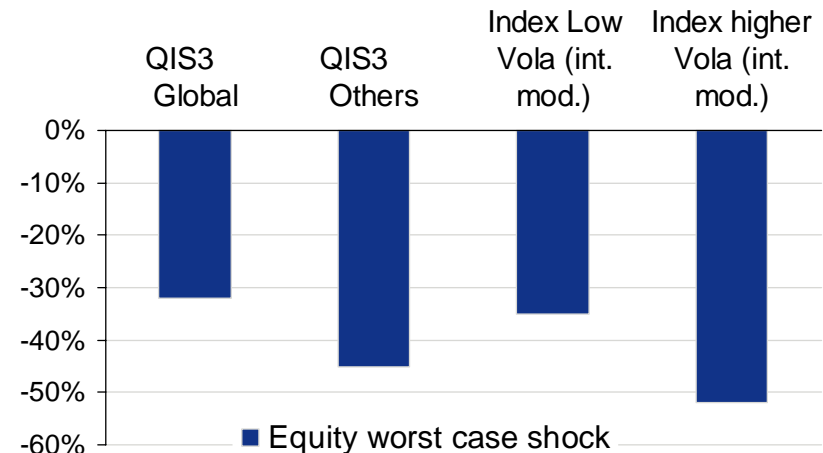
A breach of the SCR would already trigger supervisory action

- Requirement to produce a restoration plan
- Ongoing breach will lead to close monitoring by the supervisor

Since approval of the internal model not yet started it is unclear whether capital add-ons might be required and would be the most appropriate tool

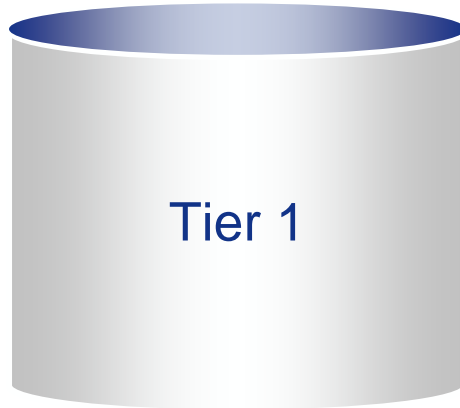
Comparison to the QIS 3 standard model

- Equity shock now differentiates between global and other equity exposure – but still in line with risk based 1year VaR frame – no application of duration approach



▶ Allianz participates in expert groups like the CRO-Forum and the International Financial Risk Institute (IFRI) to support reasonable approaches

## 2 Proposal for Eligible capital for Solvency II is driven by Basel II



- Tier 1 e.g. :
  - common S/H equity
  - positive difference in valuation (between accounting and solvency valuation)



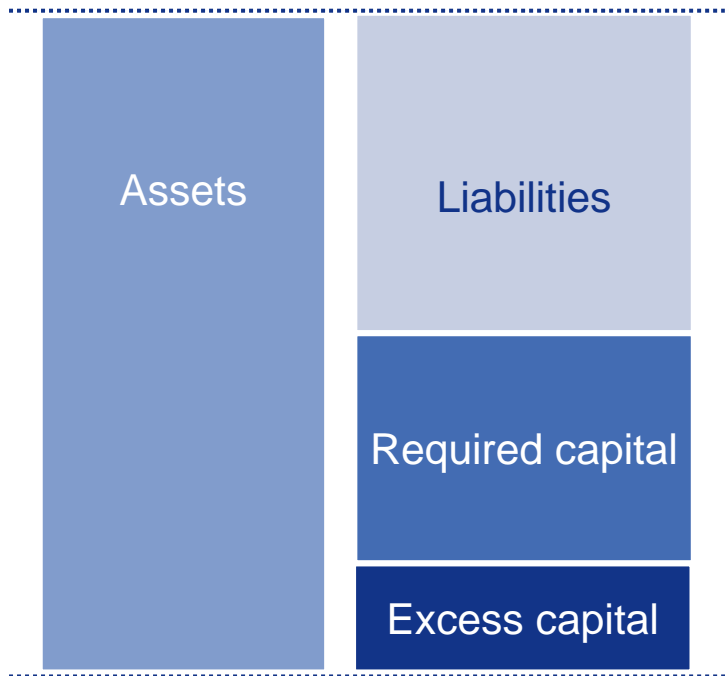
- Tier 2 e.g. :
  - perpetual subordinated debt,
  - dated hybrid capital



- Tier 3 : e. g. contingent capital

▶ The tier structure and the rules for eligibility are not finally defined and should not add extra complexity – Limits are not necessary within a risk-based approach

## The disposability of economic excess capital depends on . . .



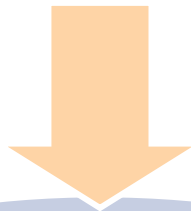
- ... local regulatory purposes (solo solvency)
- ... rating agencies' requirements
- ... local accounting requirements (e.g. equalization reserve, admissible assets)

▶ Issue: The definition of assets and liabilities is different in each dimension

# Impact assessment: Solvency II will help to avoid surprises

## Situation today

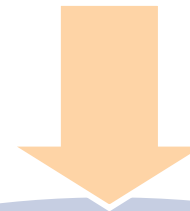
- Solvency I not risk based
- Accounting mismatch due to different treatment of assets and liabilities



Regulatory framework gives wrong incentives (e.g. risk mitigation not reflected)

## Solvency II

- Capital requirement risk sensitive
- Available capital reflecting true economic situation



Makes sensitivities of economic value depending on risk factors transparent and rewards appropriate steering

# Going forward Solvency II will impact the whole value chain of insurance companies (1/4)

Market view	Allianz perspective
Defined risk strategy crucial	
<ul style="list-style-type: none"> <li>▪ Capital requirements <b>risk sensitive</b></li> <li>▪ Investment strategy based on <b>liability structure</b></li> </ul>	<ul style="list-style-type: none"> <li>✓ Risk capital based on internal model already <b>embedded into performance measurement</b></li> <li>✓ <b>Stress tests</b> on regular basis and operating entities to provide contingency plans if required to avoid adverse risk situation</li> <li>✓ Investment strategy based on <b>risk bearing capacity</b> – taking risk sharing with P/H into account</li> </ul>

## Going forward Solvency II will impact the whole value chain of insurance companies (2/4)

Market view	Allianz perspective
Use of capital more efficient	
<ul style="list-style-type: none"> <li>▪ <b>Allocation</b> in line with economic requirements</li> <li>▪ Economic <b>excess capital might increase</b> but significant part will be locked (e.g. rating)</li> </ul>	<ul style="list-style-type: none"> <li>✓ Risk capital is <b>single currency</b> between entities and segments</li> <li>✓ <b>RoRAC</b> calculations per LoB (Line of Business) to make performance transparent</li> </ul>

## Going forward Solvency II will impact the whole value chain of insurance companies (3/4)

Market view	Allianz perspective
Higher transparency concerning economic capitalization	
<ul style="list-style-type: none"> <li>▪ Book value replaced by economic valuation will force weaker undertakings to act</li> <li>▪ <b>Diversification effects</b> will have a positive impact on capital requirements for well diversified undertakings</li> <li>▪ <b>Consolidation fostered</b></li> </ul>	<ul style="list-style-type: none"> <li>✓ Due to strong financial position and diversified portfolio <b>high risk bearing capacity</b> of Allianz to fund growth</li> <li>✓ Effect of risk mitigation activities (e.g. hedging) valued <b>in line with financial markets</b></li> <li>✓ As Integrated Financial Service Provider peak risks can be diversified across segments</li> </ul>

# Going forward Solvency II will impact the whole value chain of insurance companies (4/4)

## Market view

## Allianz perspective

Product design, pricing and underwriting focused on balance between risk transfer and reward

- Peak risks will not be taken by weaker players anymore thus fostering **consolidation**
- **Pricing impact** of financial guarantees and low frequency/high severity risks
- Incentives of sales force will reflect risk/return profile of product
- **Increased competition** if market price exceeds significantly risk adequate price

- ✓ **Portfolio effects** are analyzed during underwriting process
- ✓ **Capital charge used for pricing** reflects already diversification benefits

## QIS 3 – Showed still some shortcomings

### **MCR (Minimum Capital Requirement) calculation:** focus on consistent framework

- QIS3 led to negative MCRs – calculation not in line with SCR
- MCR should be a percentage of SCR (eg: 33%) to leave enough room for supervisory intervention

### **Diversification effect:** focus on real economic risk

- Diversification of other segments and Non-EEA\* was not taken into account
- No disadvantages for financial conglomerates and globally diversified groups should exist

### **Cost of capital margin:** market consistent valued technical provisions

QIS 3 supports market valuation of technical provisions and aims for MVM via cost of capital approach (to discuss: Cost of capital rate; diversified or undiversified SCR etc..)

\*EEA..European Economic Area

 QIS 3 showed on average lower Solvency ratios than Solvency I

## Outlook: Challenges still lie ahead of us

Solvency II rules **not yet defined in detail – Draft of SII framework Directive one good step in the right direction**

- E.g. lead supervisor concept – clear cut between duties of group and solo supervisor has to be made
- Treatment of Integrated Financial Service Providers (e.g. diversification effects between segments and Non-EEA)

Standard risk model for Solvency II **final calibration within QIS4?**

- Has to reflect mechanics of internal model
- Need to give an incentive to move to internal models

Extent of influence of internal models and Solvency II on **rating agencies' standard models** under discussion

**Approval of internal models** by the supervisory bodies outstanding

- Efficient production of risk capital figures required
- Enhancement of data quality and processes

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