

# Risk capital management in Asia in partnership with Quest Group

## Maximising underwriting capital for profit

With the EAIC in Bali this week, it is timely to consider risk-based capital changes in Asia. By **SEAN MCDERMOTT** and **GRAHAM COMBES**



THE MAXIMISATION of shareholder returns is a core objective of the board of directors of every underwriting business. Success in this is a function of the capital tied up in a business and the profits generated per unit of capital. Globally, regulatory authorities are enhancing regulatory frameworks and placing a much greater emphasis on overall enterprise risk, typically increasing the capital required to reflect the wider assessment of risk.

In a risk-based capital framework the amount of capital required to support any insurance business reflects the risk inherent in each core component of the business.

Assuming lines of business are equally profitable, the limiting factor for profit generation is the maximum premium that can be underwritten. It is therefore imperative as much of the insurer's capital as possible is applied to underwriting activities rather than allocated to other business risks.

Sean McDermott of Quest Group commented: "We closely monitor risk and capital charges,

which has enabled us to enhance capital efficiency in our Singapore insurer, as well as develop solutions to assist our clients in the wider Asian region."

Figure 1 provides a simplified illustration of the benefits. Assuming all underwriting is equally profitable (eg, produces a return on capital employed of 20% per the diagram) then the greater proportion of the capital applied to underwriting/premium risk the greater the profit for the same total capital.

### Maximisation of underwriting capital

Minimising the amount of capital allocated to the non-underwriting risks increases the capital that is free to support the core underwriting function. Some key ways in which capital can be freed up include:

**a) Reducing claims/reserving risk:** a significant capital charge applies claims reserves for discontinued lines of business. Selling such discontinued business immediately reduces the balance sheet claims reserves, eliminating the capital charge. Provided the discontinued busi-

ness is well reserved, a sale can be achieved at or close to book value, enabling an entity to free up capital to increase underwriting activity. An additional direct benefit is the future cost savings associated with administering the legacy business.

Furthermore, under some regulatory regimes in Asia there is a requirement to carry a margin of prudence over and above the best-estimate claims reserve. For example, in Australia and Singapore it is a regulatory requirement there is a provision for adverse deterioration up to a 75% actuarial confidence level. This is a double hit in that extra capital is required to cover the margin as well as an increased capital charge to cover the additional claims reserves.

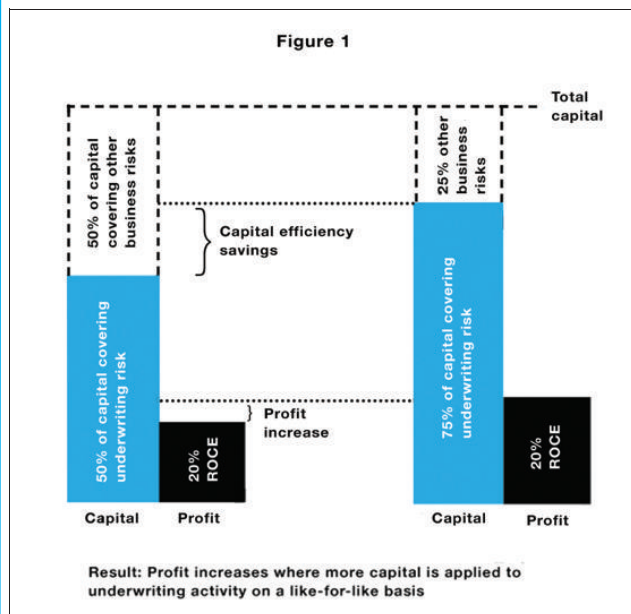
**b) Market risk/investment risk/exchange risk:** the risk profile of the investment portfolio attracts a capital charge. Generally, the investment guidelines should seek to minimise capital charges without sacrificing returns (as far as that is possible). Similarly, currency matching of assets and liabilities minimises the exchange risk

thereby reducing or eliminating the associated capital charge.

**c) Concentration/counterparty risk:** on the asset side of the balance sheet, credit default is a key risk. A capital charge is levied where there is a material proportion of assets, be that reinsurance recoveries or invested assets, which are exposed to a single counterparty. Tools including proactive reinsurance collection and commutation strategies can be effective in managing this risk and minimising capital charges.

Overall, the emphasis globally is on a more holistic view of risk and with that comes a greater appreciation of the impact of non-underwriting risks. Graham Combes of Quest Group observed: "Insurance groups, together with their advisers such as Quest Group, have been investing in this area and restructuring their businesses to ensure non-underwriting risk is minimised as capital efficiency is prioritised."

**Sean McDermott BA, BAI, FCA, and Graham Combes FCA, ACII, both of Quest Group London**



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