IN CONVERSATION: TOM WILSON

Tom Wilson is acting Chief Risk Officer with Allianz, one of the leading global services providers in insurance and asset management. In this issue's conversation, Tom shares his thoughts on Solvency II, the importance of internal models, and what to expect from the next phase of the credit crisis.

THINK: Let's start with Solvency II. What are its most positive aspects?

TW: As a regulatory framework, Solvency II is a tremendous step forward for the insurance industry, predominantly because it takes a risk-based perspective as opposed to a more traditional accounting or key measure-based approach. Solvency II also allows for the use of internal models, giving firms an incentive to become better at risk management. In terms of the next steps for Solvency II, as well as for Basel II, coming up with additional modifications or rules that incorporate the experiences of the recent past will be very important, whether they be judgmental, programmatic or calculation-based.

THINK: Are there elements of Solvency II you are concerned about?

TW: I do think it is unfortunate that the group support provision of Solvency II was not passed. Group support was a provision that would have allowed large diversified insurance groups to recognize some of the diversification and to support some of their local operating entities' minimum solvency capital requirements through a letter of comfort or a limited guarantee. It will be reconsidered in 2015, but in the meantime, as a large diversified insurance group that manages its

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capital base across many legal entities with the objective of supporting those legal entities, we would have strongly preferred group support. This provision would have enabled Allianz to make sure that we don't have tied capital, which makes our policies more expensive to our policyholders.

THINK: Why do you think the group support provision was rejected?

TW: It was rejected because local regulators, especially those without a large, international group within their jurisdiction, were potentially concerned about whether or not capital would ever flow into their jurisdiction following a negative event. You'd rather have the cash capital locally than a promise; a bird in the hand is worth two in the bush, so to speak.

THINK: Is there a great distinction between the direction of modeling and analysis required to support Solvency II and the type of work you would otherwise be doing at Allianz?

TW: Most of the international insurance groups in Europe are already operating an internal model, which is based significantly on the same market value balance sheet approach of Solvency II. Allianz has been operating on that basis since 2003–2004. In my previous position it was a similar approach. So our industry has had many years' experience working on internal models and refining them based on a market value balance sheet approach. As a consequence, we already have been going down this path, and find it very useful to understand what we consider to be the economics of our business.

In many accounting and statutory capital regimes, interest rate movements do not impact either one side of the balance sheet or both sides of the balance sheet. For example, under certain accounting regimes such as IFRS, if your assets are available for sale or in the trading book, their values will move with interest rates although your liabilities will not. So you have a tremendous amount of accounting mismatch being illustrated, although if you are hedging your best estimate cash flows you're not exposed from an economic perspective. So we have found that an economic perspective provides better management insight in terms of the risk/returns on an economic basis, which leads to better decisions.

That's why basically the industry and specifically the large international firms within the European industry have already moved down this path substantially.

THINK: Are there areas where the interests of the industry and the regulators are moving in different directions?

TW: One area where we will have to have an open and constructive dialog with regulators will be in the area of what I'll call process-driven controls and model validation routines. I anticipate that there will be a significant amount of effort put into documentation, including documentation of processes, of controls and of control effectiveness. You have to accept that there may be a higher quotient of validation and documentation required to gain regulatory approval for internal models. It's up to us to prove, based on materiality-based rules, that the processes and the documentation that we do have in place are sufficient for the purpose of the models. And that's going to be a give and take process with the regulators.

THINK: You mentioned internal models in a positive light, but not everyone has had a constructive experience using them.

TW: The current market crisis has clearly indicated that internal models, by themselves, are not the end all and be all. This has been especially proven for the banking industry, which had neglected the potential impacts of leverage as well as market liquidity. I still think that a risk-based, market value approach is very important. I guess the message should be that because of their incentives and their risk-based approach, internal models are definitely the way to go forward. We just need to make sure that we are updating our internal models as well as the regulatory frameworks to be in alignment with recent developments.

THINK: Looking back at the experience of the banking industry, what should firms consider before relying on internal models?

TW: The use of internal models does provide a firm with greater insight. Just the action or activities needed to put together an internal model requires a greater understanding of your book of business, of the factors that impact your book of business, and of the pricing/valuation functions that translate those factors into value changes. Without an internal model, there's not as much of an incentive to get to that level of understanding of any given book.

The downside of internal models is that they may be created by technically competent people without much common sense with regard to the overall industry, or the system within which assets are traded. There may also be an overreliance on their conclusions. I think in this particular case, there was an assumption made by many individuals and firms in the banking industry that assets were liquid and therefore that the time horizon one was exposed to the risk of a particular asset was very short. The assumptions were that liquidity was basically for free and always available. This was the justification for the increasing leveraging ratios that you saw in banks, which were getting higher and higher. Of course, now we have a different assumption altogether about the cost and availability of funding.

Models themselves can provide tremendous insight, but they also can be, if not necessarily misused, certainly misunderstood. People can lose track of the fact that just because your model says you don't have any risk, and you are running a very large balance sheet with a tremendous amount of leverage, it doesn't necessarily mean that you should feel comforted. Internal models really need to be augmented by strong risk management capabilities, by individuals with experience who won't just take models for granted, but actually take a look and see very large numbers and regardless of what the market is doing just ask the question: Does it make sense?

THINK: Where does the industry stand relative to the financial crisis?

TW: I'll use the analogy of a windstorm. We've gone through the first leg, in the sense that the financial crisis as it manifested itself in Q4 2008 was all about the banks. Every single weekend during Q4, it was a question of which bank was going to go south, and whether we were positioned on a Sunday evening to activate notices of default in Tokyo to start the process for Monday morning. It was a very chaotic time, but it was all about the banks. We're in a relatively calm period, or in the eye of the storm.

THINK: What will the next stage look like?

TW: I think the next wave of the storm is going to hit corporate borrowers and corporate debt issuers in terms of potential for impairment, defaults, and impairments on corporate debt. I can see that's going to come through beginning Q2 or Q3 2009, and probably last a year. It's going to come with a lag because funding, and in particular financing of inventories, financing of production, as well as financing for the consumer demand side, has been greatly reduced, and it's just taken a while for it to work through the corporate balance sheet.

Looking forward to the back half of 2009, I anticipate a qualitatively different, but equally interesting period where we're not faced with financial institution bankruptcies per se, but rather more on the corporate side. I also anticipate that we are in one of the most interesting strategic asset allocation periods ever faced. I think there is a strong suspicion that in the near term, loose monetary policies plus aggressive purchases of US treasuries and gilts by the Fed and Bank of England respectively are going to keep interest rates low but, at some point in time, those monetary activities are not going to be sufficient to keep people feeling good about US treasuries and gilts, so rates are going to spike. And they are going to jump up dramatically. Now, will it happen in 6 months, 9 months or 12 months? I don't know. But there is a strong suspicion that at some point rates will spike.

This leads to a very interesting question for those people who are in charge of strategic asset allocation today: Should we lock in and hedge rates at artificially low levels under the expectation that in 6, 12, or 24 months rates are going to spike? Looking forward, those are going to be the two critical areas for financial market risk. Associated with those spiking rates are going to be some interesting developments in terms of the foreign exchange rates. So that's what I am concerned about in a market-based area.

THINK: What about from a corporate perspective?

TW: From a corporate perspective I want to continue with a conservative credit strategy to make sure that we continue to be well capitalized and understand the risks to our capitalization ratios. I also want to minimize those risks because the ability for financial institutions to raise money is not as optimal as it could be, relative to other times. One of the value points for Allianz is that we are strongly capitalized.

THINK: Are there particular challenges adapting a global framework for a business like insurance that is so locally driven?

TW: We have the standard complexities being an international firm, but we're not that complex in the sense that most market risk and most credit risk is pretty much the same wherever you are, and therefore we can implement globally consistent modeling approaches. For the liability side, where we are very unique in each jurisdiction, we do need that extra step because we rely on the OEs [operating entities] to develop the models to cover the unique aspects of their local markets within our policies and guidelines, but we nevertheless validate the models and make sure they are suitable for our purposes.

There are also certain benefits in terms of the implementation costs. In certain implementations of enterprise risk solutions, we have only needed to implement a single instance of each model using globally consistent parameters, for example, for market and credit risk. That means all we need to do is make sure that the OEs have the appropriate input data for market and credit risk.

THINK: You've utilized Algorithmics solutions to help construct enterprise risk frameworks at more than one organization.

TW: I think it is fair to say, having used Algorithmics as one of the core components of an ERM system once, I liked it so much that I did it twice.