

China boardroom update

Insurer risk assessment regulatory developments

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ADVISORY

Assessment of insurer asset management requirements

In brief

The CIRC has issued a circular dated 20 August 2008 regarding the risk assessment of insurer asset management (关于开展 2008 年保险资产管理现场检查工作的通知). This issue of China boardroom update discusses the newly released circular and its possible implications on future risk management requirements for Chinese insurers.

Relevant regulation discussed in this issue:

Circular issued by the CIRC under Baojianzijin [2008] No.1079 dated 20 August 2008 regarding the risk assessment of insurer asset management.

Background

In contrast to record profits for Chinese insurers in 2007, the downturn in international and Mainland stock exchanges in the first half of 2008 has led to significant investment setbacks for major Chinese insurers that have subsequently dragged down their net profits and called into question their risk management controls over investment portfolios. While the China Insurance Regulatory Commission (CIRC) already has in place quite stringent limitations on insurers' equity investments, they have now gone a step further and issued a circular on the risk assessment of insurer asset management (关于开展 2008 年保险资产管理现场检查工作的通知) to all insurance companies and insurance asset management firms, dated 20 August 2008. This issue of China boardroom update discusses the newly released circular and its possible implications on future risk management requirements for Chinese insurers.

Insurers are required to submit a report on quantitative risk analyses, including a calculation of risk metrics and stress testing, by 25 August 2008. They are also required to submit a report detailing a qualitative self-assessment of operational procedures by 31 August 2008. In addition, the circular requires insurers to prepare for a walkthrough of their asset management process, which is to be conducted by the CIRC between August and November 2008.



Details of the new requirements

The circular outlines its objectives to enhance corporate governance, standardise operating procedures and improve risk controls in relation to investment management. The regulation aims to assist insurance companies to manage the potential risks they face and to protect policyholders from insolvency of insurers.

In particular, the circular sets out the following self-assessments which should be performed in relation to asset management, and includes in-house assets in addition to externally-managed assets.

Quantitative risk analysis entails the following:

- Assessing the risks inherent in investment portfolios, including market risk, credit risk and operational risk
- Disclosing details of investment holdings
- Calculating risk metrics such as Value at Risk (VaR) for different risk exposures and comparing the metrics with their corresponding risk limits
- Performing stress testing on different risks in accordance with the scenarios prescribed in the circular
- Explaining the possible actions to be taken when the risk limits are exceeded.

Qualitative assessment entails the following:

- Assessing the company's corporate governance structure in relation to investment management
- Analysing the process of formulating asset allocation strategies
- Evaluating settlement risk control
- Assessing the asset management process.

Insurance companies were required to submit a quantitative risk analysis report by 25 August 2008 and a further qualitative self-assessment report by 31 August 2008.

Implications for Chinese insurers

The circular will have a direct impact on Chinese insurers. The requirements contained within the circular are in line with a general trend towards the enhancement of operating procedures and controls within the insurance industry in China, with a view to companies being better able to understand and manage the risks inherent in their business operations.

While sensitivity tests are not new to the Chinese insurance industry (dynamic solvency test requirements being one example), it is expected that the regulator-driven focus on both wider risk management considerations and scenario-specific stress tests will be further enhanced in the future. In recent months, *The Basic Standard for Enterprise Internal Control* was jointly issued by the CIRC, and requires all listed companies (and encourages other companies) to

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establish, evaluate and assess the effectiveness of their internal controls. State-owned enterprises are also required to establish a risk management commission, under the State-owned Assets Supervision and Administration Commission (SASAC) requirement dated 2006. These requirements reflect the push to enhance insurers' risk management frameworks, and are potential stepping stones to the wider concept of Enterprise Risk Management.

Furthermore, looking forwards to the proposed Solvency II regulations in Europe for example, there is a direct link between scenario-driven stress tests by risk category and the calculation of solvency capital. The concept of risk-based solvency capital is yet to be introduced for Chinese insurers.

We set out below certain action points for management consideration:

- Consider carrying out a diagnostic review of the qualitative risk management framework surrounding the asset and investment controls while rectifying significant/material weaknesses.
- Consider the implications on resources and expertise, particularly surrounding the technical VaR calculation basis, and whether or not to appoint external advisors to assist with the transfer of knowledge and/or to assist with the calculations themselves in the future.
- Consider the benefit of extending the prescribed scenario tests to the management of solvency capital within the company on an on-going basis.
- Prepare for a CIRC walkthrough of the asset management process.

It is expected that the CIRC will issue further guidelines and requirements in the arena of insurer risk management in the future. Any further developments will be communicated in due course.

Reference

Details of the relevant regulations can be obtained from the following source:

- Assessment of insurer asset management requirements
http://www.circ.gov.cn/Portal0/InfoModule_7267/80079.htm

By Risk Advisory Services, KPMG China

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