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Panel discussion:

"SOLVENCY II AND THE INDUSTRY: NATURAL FRIENDS OR FOES?"

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The answer to the question *"Solvency II and the industry: natural friends or foes?"* cannot be but one: being a supervised and responsible industry we will duly abide by the new regulation once it comes into force. Meanwhile, we hope the outcome of the ongoing consultation process will be a set of rules capable of helping the industry to control itself increasingly better.

Beyond this simple answer – surely it hasn't surprised you, has it? –, and prior to dealing specifically with some of the topics that are currently at the centre of the debate, I would like to make some general considerations on this project.

- Surely insurance must be provided within a framework that protects policyholders and ensures their good faith is not betrayed by reckless companies unable to meet their contractual obligations. In our view, such a framework would have the following main features:

    - A homogeneous regulation that allows all companies to compete on an equal footing across Europe.

- ➢ A reasonable level of capital requirements that should not discourage those investors who wish to risk their money in our business.

- ➢ At least from the point of view of those countries with a Latin culture, a regulation that does not limit itself to defining a few principles: it is necessary to lay out a limited set of positive rules in order to keep implementation uncertainties to a minimum.

- In our opinion, the control over the industry reaches its maximum effectiveness when the supervisory authorities are staffed by competent professionals, who can acquire an informed and true view of the companies under their control by means of a sufficiently in-depth knowledge. In this respect, we view positively the proposals to have a lead supervisor for those European players with subsidiaries in several markets. We also support the proposal of a lead supervisor and of an effective exchange of information among the supervisors of the various countries without the need of separate filings for sub-groups. We await further details on the so-called Pillar II, which covers the supervision of risk management systems and, more specifically, the validation of internal capital models. We look forward to having a frequent technical dialogue with supervisors that would allow the authorities to form a valid opinion of those processes that are tightly linked with management, such as risk control.

- The main concept that underpins the new regulation is a specific analysis of the risk profile of each company, based either on the application of fixed factors or, even better, on an own internal model. At least from a theoretical standpoint, capital requirements will match risk profiles, thus allowing for a more accurate measurement of profitability and a rational justification for solvency levels, as opposed to the never entirely fulfilled return expectations of equity investors. The new regulations may also spur the industry into adopting appropriate rate setting policies that reflect the actual risk embedded into each cover. Subject to a sufficient degree of public awareness, this would support market discipline, thus preventing rates from under- or over-shooting. All of this is contingent on the approach followed to define Pillar III concerning transparency and market information.

- On a separate, albeit related, note I cannot avoid mentioning the present inconsistency in financial reporting: only listed groups – two out of over 150 in my country – must prepare their accounts under IFRSs, while all other market participants may report under local GAAP. Generally speaking, Insurance continues to be at a disadvantage compared to other industries by having to report under a provisional IFRS. Surely, this situation does not contribute to the transparency that is being aimed for, thus raising the cost of capital for listed insurers. It is desirable that the entire industry report as soon as possible under IFRSs and that rapid progress be made towards the so-called Phase II of IFRS 4, in order to ensure that European insurers provide homogeneous and comparable financial information to the markets. In this respect, Europe's leading insurers have already made public their proposal for Phase II of IFRS 4 (to be more precise, I am making reference to the Elaborated Principles of the CFO Forum, which I hope are supported by the entire European industry). In more general terms, the proliferation of similar yet different regulations in several countries in which we operate – regarding solvency as well as accounting standards or internal control rules – is creating problems and increasing expenses for multinational groups and represents a significant obstacle for our own initiatives aimed at establishing a homogeneous internal control framework.

- Another rather general thought: as far as listed companies are concerned, I am convinced that in the long run "market consensus" reflects a sufficiently accurate assessment of the specific situation of each company and of the quality of its management. The equity market's "rewards" or "punishments" may take their time, but ultimately its judgment tends to be correct. Our success in competing for capital will first and foremost depend, as it has so far, on the quality of results and on the industry's growth perspectives. Capital models by themselves will not entail a change in underwriting controls and in technical results. Although past experience may be analysed in an increasingly more sophisticated fashion and probabilities may be extrapolated on the basis of hundreds of scenarios, that will never provide a guarantee against underwriting mistakes. Our price on the equity markets and our competitiveness will continue to depend on the opinion of investors, which will retain its distinctively global and, at least partially, intuitive nature. Put otherwise, it will depend primarily on good management. The same can be stated about solvency: there is no better guarantee for policyholders than good results, that is, than good management over time. In this respect, I consider that it would be wise to limit the expectations about the new solvency regulations, as far as investor communication is concerned.

- I must now go back to the specific issue of Pillar I: "minimum" and "solvency" capital requirements. As highly qualified industry representatives have already warned, it would be dangerous to impose a solvency regulation that is tougher than the present one across the board. Although, as we saw previously, the opinion of the equity markets reflects solvency requirements only to some extent, if such requirements were made uniformly stricter we would find ourselves at a disadvantage in attracting capital compared to other industries or to insurers operating in different economic areas. The results of the QIS2 process that are known to date are – at least in our country – too inconsistent to be conclusive and therefore require a revision of the approach proposed so far.

My own personal feeling is that a group like ours, with an underwriting policy consistently aiming for an underwriting profit and a conservative investment philosophy, will ultimately end up with capital requirements under Solvency II that are not too far away from present ones. The question would then be: was it really worth it to go for such a sophisticated approach to end up with a regulation that does not really imply a meaningful change in economic terms? Maybe the need for it arose in markets that are more advanced than those of South Western Europe and are characterised by insurance and non-insurance risks that we have not taken so far. If so, would it be possible to simplify the regulation for those cases to which part of the requirements are not applicable?

Anyway, and despite any legitimate doubts, I wish to stress that at MAPFRE we seriously mean to develop a systematic risk management methodology and we are making rapid progress towards it. In addition to allowing us to develop our own internal capital model, this methodology will also become a management tool that will require us to formalise a series of intuitive risk management rules that we have been applying so far. And I must recognise that perhaps we would not have taken this step had we not been forced to do it by SOLVENCY II.

At present, we have attained the following degree of preparation:

- **Internal capital models**

  The implementation was completed in the Reinsurance Operating Unit and is underway in the Commercial and Motor Insurance Operating Units. All units operating in the EU will have their own internal capital model by 2008. We are using software applications that have been developed in part internally, with the help of separate teams of external consultants for the Life and Non-life businesses.

- **Standard factors models**

  Implemented in all Operating Units, adapting factors used in rating agencies' capital models. Calculation is performed on a half-yearly basis and, beginning in 2007, will be used to assign capital and to define dividend policies across the Group; they will be replaced by internal capital models after 2008.

- Between now and 2008 we need to integrate our own internal capital models (Operating Units based in the EU) and standard capital models (other countries) into a single own capital model for the group.

- We have created a Risk Management Area for the Group and have appointed risk management coordinators in each Operating Unit.

- At the end of my presentation, I will comment on our system to assess operational risk.

I would now like to cover a few issues that are being discussed at present, with respect to which I will try to explain our position in the present phase of the debate.

1. Measurement of technical reserves and risk margins.

The measurement of technical reserves should be identical under both Solvency II and under Phase II of IFRS 4, that is, consistent with the market value of insurance liabilities. Non-hedgeable liabilities, as are most Non-life technical reserves, should include an additional prudential margin (the market value margin). Among the measurement alternatives for this margin we favour the cost of capital method for its simplicity and for the objectivity of its calculation, against the more rigid and bureaucratic percentile method.

The coexistence of two methodologies for the calculation of technical reserves (that is, Solvency II and IFRSs) would confuse the users of the information and would burden companies with an additional administrative workload. The intermediate solution of reconciling the calculation of technical reserves under the two methodologies would not solve the issue completely.

2. Diversification benefits in groups of mono-line companies.

A group's legal structure should not be a defining element in risk assessment at the consolidated level, nor at the individual level. Under present proposals, those groups that are structured around mono-line companies would be imposed an additional capital requirement at the level of their subsidiaries, as these would not benefit from the diversification credit which, if applicable, would only arise in the group's consolidation process. This does not appear to be a logical approach.

3. Models and capital requirements for countries outside the EU.

It should be possible for the standard formula and the own internal model for capital assessment to coexist within the same group of companies. The standard formula could continue to be used as a capital assessment tool in those countries in which, either because of the little relevance of their business, or because of the lack of comparability between their business lines and those of the group they belong to, it would be advisable to adopt a simple solution.

In the case of our group, which has large operations in Latin America, it would be appropriate to adopt an internal capital model in the European businesses, which would be complemented by a standard formula assessment of the capital requirements in our Latin American subsidiaries, without excluding the possibility of implementing an internal capital model in those subsidiaries which may require it due to their volume or to legal requirements of their respective countries.

4. Goodwill as an "eligible" investment.

As previously mentioned, I believe we need specific rules for those aspects which principles may cover in too generic terms; thus a clear definition of eligible assets would be most useful, especially in the case of intangible assets. In our view, goodwill arising from both the acquisition of a portfolio of policies and the consolidation of subsidiaries should be an eligible asset under Solvency II, to be valued following the same criteria applied under IFRSs.

5. Assessment of operational risks

The assessment of operational risks is tightly linked to the internal control systems. In our case, we have opted for establishing decision processes based on an appropriate separation of functions, and we are investing in the development and formal identification of internal controls associated with business processes; and we believe this will give us a competitive advantage on companies which have chosen not to follow this approach. Put otherwise, companies that do not apply these principles should be imposed additional capital requirements. For this reason, pure accounting figures such as direct insurance premiums or total assets, or other data like the number of employees must not be used to estimate operational risks.

In 2000, MAPFRE began to define the methodology to be followed in the definition of "Operational Risk Maps". We now have our own software, "Riskm@p", which identifies the operational risks associated with the basic business processes of an insurance company (Underwriting/Issuance, Claims, Reinsurance/Coinsurance, Fees, Product Development, Human Resources, Customer Care, Sales Activities, Technical Reserves, IT Systems and Investments). Nearly 200 Operational Risk Maps were identified in MAPFRE and over 1,500 professionals or heads of business processes/sub-processes participated in the latest round of evaluation of operational risks.

Likewise, Riskm@p has a module that allows to identify and assess internal controls, be they automatic or manual, preventive or for detection purposes, associated with business processes and their respective risk factors, following the recommendations of COSO (*Committee of Sponsoring Organizations of the Treadway*

Commission) concerning the elements needed for an Internal Control System.

Although Basle II has already defined the treatment of this issue (operational risk falls under Pillar I), the insurance industry should ask itself whether operational risk should fall under Pillar I or II. The difference is not inconsequential: in practice, a satisfactory quantification of this type of risks is actually difficult due to several reasons, the most relevant of which probably is the absence of data bases on the losses caused by operational risks, which makes it virtually impossible to define accurate probability distributions that are adjusted to this type of risks.

We therefore support the inclusion of this issue under Pillar II, which will encourage companies to improve their internal controls and contribute at the same time to mitigating operational risks. Our preference goes for including Operational Risks under Pillar II, within a well-structured qualitative framework that will ensure a homogeneous application by supervisors.