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Embedding Risk Management

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Agenda

- Embedding Risk Management – what do we mean
- FSA Expectations
- Operational Risk
- Examples
- Solvency 2

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What is ICA/Embedding Risk Management?

- Balancing risk and available capital within an economic framework (e.g. ICA)
- Use of risk based capital, including the ICA, within the operational and risk management processes of the firm
- Informs business & strategic decisions
- Senior management understanding and ownership of risks
- All of the above encompass "Use Test"

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FSA ICA Practice to Date

- Primary focus of first round reviews of ICA submissions on quantitative robustness
- Concerns on inadequacy of 'use test' – generally dealt with as qualitative feedback
- Results of "use test" scrutiny encouraging for some firms, only developing/variable for others.

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FSA second round reviews……..

- Alignment of ICA and Arrow reviews - often at same time (or close together)
- Is there senior management ownership?
- Is there integration between the risk management framework and capital management?
- Is there evidence that the use of risk based economic capital is being used as an input to business decisions?

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What FSA expects from firms…...

Board/senior management ownership:

- Management embracing risk based ICAS disciplines and being able to evidence this
- Board members provided with training sufficient to enable them to provide informed and robust challenge
- Training for new Board members
- Ongoing education on developments, topical issues

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What we expect from firms….. (2)

Integration between risk management and capital management systems:

- Responsibility of Board & senior management to define risk appetite for firm
- Risk management policies & practices in place to measure & monitor risk within business units
- Output from risk management system feeds into ICA (e.g. measuring Op Risk)
- If running business at higher confidence level, how does this relate to ICA?

What we expect from firms….. (3)

Use of ICA embedded in :

- Strategy & business planning
- Asset mix, investment allocation & hedging
- Capital allocation processes
- business sold/written
- Product design & pricing decisions
- Quantitative management information

Examples of Embedding

- Investment decisions – e.g. Firm Y decides that, based on ICA results, that market risk is too high so may reduce equity backing ratio (EBR)
- Better understanding of profit & loss drivers in the business (e.g. impact of lapses)
- ICA informs investigations into selling more of a particular type of product - believes Risk X diversifies well against other risks in its portfolio and perceives competitive advantage over peers.

Examples of Embedding (2)

- Teach-in sessions before board meetings targeting specific topics e.g. risk management & economic capital methodologies.
- Firms offering board members one-to-one training e.g. by AFH or valuation actuary
- Inclusion of ICA risks in MI – requires more frequent estimation of ICA / economic capital – some firms perform ¼thly (approx basis)

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Examples of Embedding (3)

- ICA used to highlight firm's most material risks
- Reinsurance – optimal level of cover and how reinsurance is best structured
- Reinsurance – spread of exposure among reinsurers (credit risk), extent of reliance on individual reinsurers, etc.

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Operational Risk

- Firms have expanded risk management functions and are introducing more advanced systems for identifying and quantifying operational risk
- Limited internal operational risk loss data remains a challenge, though industry moves to collect and share loss data
- Operational risk is now a higher priority for insurance firms - leading to cultural and behavioural benefits

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Operational Risk (2)

- Workshops approach to identify threats and mitigants often used
- Estimating loss event severity and frequency still a challenge
- Information can be modelled stochastically – to arrive at a capital charge for a specified risk appetite
- Does your Board understand the approach being taken?

Towards Solvency 2

- From Solv 2 draft Directive, ICA directionally consistent with S2 – both economic, risk-based solvency regimes
- Also likely to be consistent with direction of IAIS thinking
- Recital 11 of S2 Framework Directive emphasises the need for robust risk mgmt disciplines and being embedded into a firm's business
- For S2 purposes, using internal model results as an input into business / strategic decisions (i.e. "use test") is a pre-requisite for internal model approval

Towards Solvency 2 (continued)

- Under ICAS, we sometimes took a sanguine view on "use test" for first round ICA reviews – this discretion will be lost for Solvency 2 internal model approval purposes
- Firms may opt to deal with specific risks using a partial internal model (e.g. Operational Risk)
- Development of group ICG – group diversification credit expected to require group-wide integrated risk and capital management capability

Questions?

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