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# The role of the Risk Function in the context of Solvency II and what are the features of an “effective" Risk Function

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## The role of the Risk Function in the context of Solvency II and what are the features of an “effective" Risk Function

- **Background – SII Regulatory requirements**
- **Risk Management & System of Governance**
- **Risk Function effectiveness – How & What?**
- **Risk Communication**
- **Closing Remarks**

21 September 2017

# Regulatory Requirements

### *Article 272 Actuarial function*

**Ultimate Responsibility:**

**coordination of the calculation of technical provisions.**

**In coordinating the calculation of the technical provisions, the actuarial function shall include all of the following tasks:**

- (a) apply methodologies and procedures to assess the sufficiency of technical provisions and to ensure that their calculation is consistent with the requirements set out in Articles 75 to 86 of Directive 2009/138/EC;
- (b) assess the uncertainty associated with the estimates made in the calculation of technical provisions;
- (c) ensure that any limitations of data used to calculate technical provisions are properly dealt with; 17.1.2015 L 12/169 Official Journal of the European Union EN
- (d) ensure that the most appropriate approximations for the purposes of calculating the best estimate are used in cases referred to in Article 82 of Directive 2009/138/EC;
- (e) ensure that homogeneous risk groups of insurance and reinsurance obligations are identified for an appropriate assessment of the underlying risks;
- (f) consider relevant information provided by financial markets and generally available data on underwriting risks and ensure that it is integrated into the assessment of technical provisions;
- (g) compare and justify any material differences in the calculation of technical provisions from year to year;
- (h) ensure that an appropriate assessment is provided of options and guarantees included in insurance and reinsurance contracts.

**Tasks:**

(a) **provides an opinion on the reinsurance policy and the reinsurance program;**

(b) **provides an opinion on the underwriting policy;**

(c) **contribute to the effective implementation of the risk-management system, in particular with respect to the risk modelling underlying the calculation of the capital requirements.**

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# Regulatory Requirements

### *Article 269 Risk management function*

**Ultimate Responsibility:**

**ensuring the effectiveness of the risk management system, setting the undertaking's risk appetite and overall risk tolerance limits, as well as approving the main risk management strategies and policies.**

**Tasks:**

(a) **assisting the administrative, management or supervisory body and other functions in the effective operation of the risk management system;**

(b) **monitoring the risk management system;**

(c) **monitoring the general risk profile of the undertaking as a whole;**

(d) **detailed reporting on risk exposures and advising the administrative, management or supervisory body on risk management matters, including in relation to strategic affairs;**

(e) **identifying and assessing emerging risks.**

**The risk management function shall co-operate closely with the actuarial function.**

***References***

- *Commission Delegated Regulation (EU) 2015/35*
- *EIOPA Guidelines on System of Governance*

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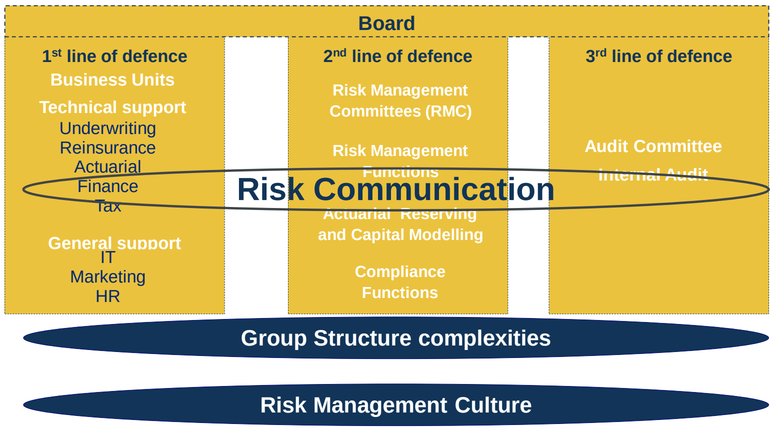
# Governance Model: Three lines of defence as a framework

**Most firms have implemented a three lines of defence system of governance as part of their SII implementation model. It provides sound principles for a risk management framework, although not an explicit regulatory requirement**

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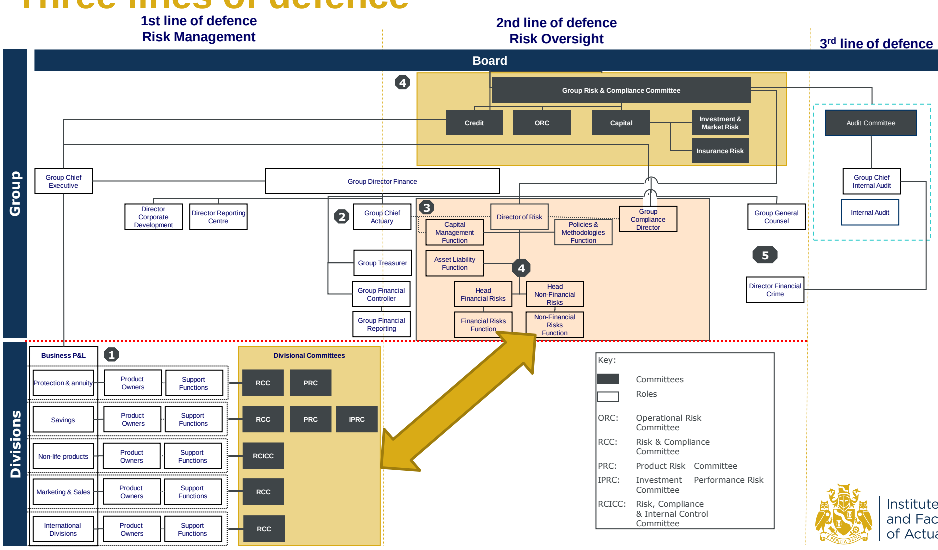
# Group Complexities: Three lines of defence

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# Risk culture?

- "Risk culture is a term describing the values, beliefs, knowledge and understanding about risk shared by a group of people with a common purpose, in particular the employees of an organisation or of teams or groups within an organisation" *
- Culture arises from repeated behaviours shaped by underlying attitudes *

"The way we do things around here".

- Integral to firm personality and identity
- Something people can relate to – staff and customers
- How to get along within the organisation

*Risk culture is not a set of prescribed standards, regulations or practices*

* Institute of Risk Management, 2012

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# Risk culture is fundamental to an effective risk management framework

- What is 'good' risk culture?
  - ✓ Consistent and clear tone from the top
  - ✓ Commitment to ethical principles whilst balancing commercial pressures
  - ✓ Clear risk accountabilities and acceptance of the importance of risk management in BAU and change activity
  - ✓ Visible and consistent role modelling by senior and middle management
  - ✓ Constructive communication and challenge across all staff levels
  - ✓ Mechanism and process for challenging the status quo
  - ✓ Good information sharing upwards and downwards within the organisation
  - ✓ Transparent and effective escalation of risk management activities and of issues and loss events
  - ✓ Organisational sharing and learning from failures
  - ✓ Rewards for appropriate behaviour

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# Some Indicators of a good risk culture

| | |
|---|---|
| Tone from the top | • Risk leadership and clarity of direction<br>• Attitude and response to bad news<br>• Consistent messaging and role modelling |
| Policies and procedures | • Values statement<br>• Escalation processes and whistleblowing<br>• Formality of remediation activity<br>• Formal implementation of policy framework |
| Risk management framework and governance | • Clear accountabilities<br>• Transparent and timely risk reporting and MI<br>• Status, resources and empowerment of second line of defence<br>• Customer complaint handling (and reporting) processes |
| Employee engagement | • Training programme<br>• 360 feedback process<br>• Open, honest communication |
| HR processes | • Management information<br>• Recruitment, induction and training<br>• Performance/ talent management<br>• Remuneration |





# Key attributes of Risk management function

| Area | Key attributes |
|---|---|
| Effective System Governance<br>• Responsibilities<br>• Accountabilities<br>• Consulted<br>• Informed | • Clear accountabilities which present expected behaviours and state that the individual is held accountable to behave in line with expectations<br>• Accountability for managing risks clearly aligned to an individual<br>• Accountable for identifying, managing and escalating emerging and unexpected risk issues<br>• Self-assessment risk and issues and reporting upwards (proportion of risk issues raised by management rather than by internal audit)<br>• Clear accountabilities for change activity – individual and committee decision making and risk assessments |
| Transparent and timely risk reporting and MI | • Management raising of risk issues on a timely basis, along with remediation plans<br>• Defined measurement criteria for risk culture<br>• MI to support effective assessment of prevailing risk culture<br>• MI that encourages lessons to be learned and a forward thinking approach |
| Status, resources and empowerment of second line of defence | • CRO is the ultimate champion of challenge to the risk culture, with sponsorship from the Board<br>• Control functions share the same stature as first line of defence functions, participating in Committees and proactively involved in the decision making process<br>• Openness and transparency of first line of defence and executive management in interactions with risk function and internal audit<br>• Role of Risk in oversight and challenge to change activity is clearly articulated and practiced |

## Risk & Capital Management under Solvency II

| | |
|---|---|
| SII Risk Management | Pillar 3 reporting |
| Capital Management (SF SCR, ORSA Pillar 2 capital, IM capital) | Solvency II Data |

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## Risk & Capital Management under Solvency II

| | | | |
|---|---|---|---|
| **SII Pillar 2**<br>Effectiveness of risk management<br>Emerging risk | **Capital Management** | **Solvency II Disclosure** | **SII Data Governance Framework** |
| **Pillar 2 systems of governance** | **Process & Methodology** | **Pillar 3 internal control** | **Systems and Processes** |
| **Risk Framework**<br>Change in risk profile | **Risk coverage and capital modelling** | **Reporting Governance** | **Quality Control** |
| **ORSA**<br>Process and decision making | **Internal model**<br>CRO's role in validation | **Alignment of internal reporting with ORSA** | **Data Policy and Directory** |
| **Benchmarking**<br>Insight into industry approaches | **Risk Appetite**<br>Business strategy alignment | **SFCR and RSR**<br>Managing reputation risk | **Data Consistency**<br>Data limitations |

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## Risk function effectiveness – How & What?

- Risk strategy is adopted by all departments or BU's. Risk strategy is applied and understood for all risk classes.
- There are clear metrics to demonstrate ROI/ROE and some linkage to performance measurement.
- Strategy and objectives are developed dynamically in conjunction with business strategy.
- Risk policies and procedures are clearly stated and in line with risk strategy and regularly updated
- Risk appetite and tolerance form an integral part of strategy and are regularly reviewed.
- Limits and standards are calculated frequently and is adequately sensitive to underlying risks and model output.
- Limits and standards are frequently communicated and the usage is embedded in the firm's policies and decision making.
- Risk appetite and tolerance are reviewed actively based on 'real life' events.

- Full and regular certification of compliance with the framework combined with ongoing oversight and monitoring by risk functions
- Senior management fully engaged in performing stress tests of qualitative and quantitative factors to assess the future validity of the risk management framework.
- There is a complementary and integrated suite of tools to cover each aspect of the process (e.g. identification, assessment, early warning etc.). The process is dynamically updated. Appropriate balance of active and robust controls (entity- vs. process-level, preventive vs. detective, manual vs. automated etc.).
- There is a cost vs. benefit analysis of controls (to mitigate risk) carried out on key material risks

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## Risk function effectiveness – How & What?

- Internal loss data as well as policy and experience data are fully reconcilable. Processes enable scaling of loss data and appropriate interpretation of external data.
- Data handled processes are efficient. Fully implemented and operational procedures for the retention of records and results relating to risk identification, measurement and monitoring, actions taken to control risks and exposures against risk appetite.
- Ability to understand impact of underwriting and reinsurance on extreme events exposure.
- Extreme event management process is regularly performed. The process is a decidedly non-routine, 'blue sky' thinking whilst in touch with events shaping the future of the world.
- Extreme event management includes a process of early warnings that allow the organisation to anticipate the disasters.
- There is an effective robust Emerging risk management framework
- Continuous aggregate risk monitoring against abroad spectrum of disaster scenarios is employed

- All risk and issues associated with the change are visible to relevant senior management. This allows challenge at the appropriate level and timely resolution
- Regular updates on the risk profile of the change initiative is a priority for relevant committee(s) to approve and necessary action plan is set in motion and there is 'buy-in across all impacted departments

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## Risk function effectiveness – How & What?

- Reporting is embedded in the business's day to day activity and is integrated across risk classes.
- Defined procedures for action and remedial steps according to information being communicated
- Reporting of losses or near misses is part of the day to day process, hence more efficient than a separate scheduled exercise.
- Reporting linked into trigger and escalation levels e.g. KRIs

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## Risk communication

Example: Risk Dashboard Reporting

# Executive Summary - Example

**Overall Appetite Statement:** *'The firm wishes to write business with the expectation of a cross-cycle return on capital employed of 10.5%, while not exposing capital (SCR) to potential losses of more than 16% from any risk source (or combination of risk sources) more often than once every 5 years.'*
The 1 in 5 year Net Profit Before Tax (Ultimate), shows a loss of £30m (ultimate) that is 14% of SCR. This is a reduction in the previously reported breach of 19% of SCR based on the Year end 2016 that was reviewed by the RCC in XX 2017.

| Risk Appetite | Status (previous year end submission) | Status (current) |
|---|---|---|
| Overall | | |
| Underwriting | | |
| Cyber | | |
| Reserving | | |
| Market | | |
| Credit | | |
| Liquidity | | |
| Operational | | |

| Negative Movements | | | |
|---|---|---|---|
| Tolerance | Prior Status | | Current Status |
| | Jul-17 | Aug-17 | Sep-17 |
| Ceded income variance more than 25% against plan (Underwriting Risk) | Approved Variance | Approved Variance | Action required |
| Exposure to reinsurance recovery from a single reinsurer in respect of the top 3 CAT exposures not to exceed 30% (Credit Risk) | Monitor | Monitor Closely | Action required |
| Initial policy input should be recorded within 5 working days (Operational Risk) | Monitor Closely | Approved Variance | Monitor Closely |
| The firm does not wish to lose more than 2% of the liquidated funds due to early withdrawal before maturity (Liquidity Risk) | Monitor | Monitor | Monitor Closely |
| No tolerance for any breaches of approved procedure in relation to reinsurance placement (Credit Risk) | Approved Variance | Monitor | Approved Variance* |
| Minimal tolerance for acceptance of risks outside the approved business plan (Operational Risk) | Monitor Closely | Monitor | Monitor Closely |
| **Positive movements** | | | |
| Tolerance | Prior Status | | Current Status |
| | Jul-17 | Aug-17 | Sep-17 |
| No tolerance for not submitting staff annual Objective setting review to the HR in a timely manner (Operational) | Approved Variance | Approved Variance | Monitor |

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# Risk dashboard example – drill down

| Tolerance | Current rating | Last satisfactiry result | Description |
|---|---|---|---|
| **Underwriting Risk** | | | |
| Ceded income variance more than 25% against plan for any Line of Business (Underwriting Risk) | Action required | May-17 | Ceded income variance greater than 20% against plan:<br>− Property D&F at xx% of plan<br>− PI at 50% of plan<br>− Energy at xx% of plan<br>− Aviation at xx% of plan<br>− Miscellaneous at xx% of plan |

| Risk Monitoring Tolerances | | | | |
|---|---|---|---|---|
| **Tolerance** | **Jul-17** | **Aug-17** | **Sep-17** | **Assessment/ Comments** |
| Income variance more than +/-20% against plan for any Line of Business | | | | For 2017 UWY income<br>> variance against plan for the whole account is £xxm less than plan (-x%)<br>> At a CoB level the following breaches have been noted:<br>− Property D&F £xxm less than plan (-x%).<br>− Energy £xxm less than plan (-x%)<br>-MAT £x more than plan |
| Rating variance more than +/- 5% against plan for any Line of Business | | | | The rating variance is within the tolerance threshold |
| Probable Maximum Loss (PML) in respect of Property XL should not exceed approved loss thresholds for each territory | | | | No breaches were reported. |

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## Closing remarks

- Effective risk function requires an effective and sensible ‘fit-for purpose’ system of governance framework
- People process and systems play a huge part in effective risk management – understand and influence the risk culture!
- Risk managers must have both technical (capital modelling know-how and appreciation of strengths & weakness), operational and ‘people skills’ – don’t just read a book…. go take a walk and talk to that person taking risk (knowingly or passively) on behalf of the firm
- Getting buy-in from the decisions makers (Board and 1st line of defence executives) is critical to demonstrate value of a risk function
- Think beyond compliance and reporting deadline!

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The views expressed in this presentation are those of the presenter.

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