Risk Appetite for a General Insurance Undertaking

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GIRO 2011
Risk Appetite Working Party
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Format

1. Risk Appetite within ERM  
   George Orros

2. Risk Appetite Concepts  
   Michael Garner

3. Risk Aversion, RA Articulation & Effectiveness  
   Paul Kaye

4. Risk Appetite Characteristics and Disclosure  
   Martin Burke
Risk Appetite within ERM

Accountability
- to the company
- to owners
- to regulators
- to legislators
- to other stakeholders

Policy Formulation
- creating the vision
- creating values
- developing culture
- monitoring the environment

Supervisory Management
- oversight management
- monitoring budgetary control
- ensuring business capability

Strategic Thinking
- positioning in the changing markets
- setting corporate direction
- reviewing and deciding key resources
- deciding the implementation process

Internal
- Operations review cycle

External
- Governance review cycle
- Strategy review cycle
- Policy review cycle

Risk and Opportunity Management
- to other stakeholders
- monitoring the environment

Very likely
Low  Medium  High  High
High  High  Medium  Low

Likely
Low  Medium  High  High
High  High  Medium  Low

Unlikely
Low  Medium  Medium  Medium
Medium  Medium  Medium  Low

Very unlikely
Low  Low  Low  Low
Low  Low  Low  Low

Negligible  Minor  Significant  Major
Major  Significant  Minor  Negligible

Probability
Consequence
Risk
Opportunity
Benefit

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## Risk Appetite within ERM

### Table: Risk vs. Opportunity

<table>
<thead>
<tr>
<th>Probability</th>
<th>Risk</th>
<th>Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very likely</td>
<td>Low</td>
<td>High Medium</td>
</tr>
<tr>
<td>Likely</td>
<td>Low</td>
<td>Medium High</td>
</tr>
<tr>
<td>Unlikely</td>
<td>Low Medium</td>
<td>Medium Medium</td>
</tr>
<tr>
<td>Very unlikely</td>
<td>Low Low Low Low</td>
<td>Low Low Low Low</td>
</tr>
</tbody>
</table>

### Diagram: Risk vs. Opportunity

- **ROM Line**
- **Probability**
- **Risk**: Very likely, Likely, Unlikely, Very unlikely
- **Opportunity**: Very likely, Likely, Unlikely, Very unlikely
- **Consequence**: Negligible, Minor, Significant, Major
- **Benefit**: Negligible, Minor, Significant, Major
Risk Appetite within ERM

Risk Heat Map Matrix

Risk Appetite Boundary Line

Risk ‘R1’ exceeds the risk tolerance, so terminate / avoided / transfer out to another enterprise.
Risk ‘R2’ in moderate danger zone; validate risk positioning and consider terminate / avoid / transfer out.
Risk ‘R5’ within acceptable zone, so acceptable balance to the enterprise between risk and reward.
Risk ‘R6’ is too simple for enterprise, so transfer out to another corporate ‘parent’ that can add more value.
Risk Appetite versus Risk Tolerance

- Likelihood Impact
- Risk Appetite Line
- R1, R2, R3, R4, R5, R6
- Risk Tolerance

Risk Appetite Boundaries

- Low, Medium, High
- Within Risk Appetite
- Exceeding Risk Appetite

Return
- Capital at Risk
- Current State
- Target State
- Global Protection
- High Excess Personal
- Low Excess Personal
- Corporate
- Individual
- Surgical
- Health Cash
- Hospital Cash Plan
- Individual
What is the Risk Appetite of an enterprise?

“There is no single value that can be used to determine a firm’s risk appetite. If it were, then stochastic dominance could be used to decide which risks to accept and which to avoid. Risk appetite must consider the income statement for measuring the effect of a risk on earnings, the balance sheet for determining the impact of risk on key financial ratios, and even off balance sheet items that could affect an organisation’s financial position. Thus, risk appetite has multiple dimensions that are based on multiple data sets of financial data.”
Risk Appetite Concepts

Capacity
Ultimate ability to assume and absorb risk

Tolerance
Undesirable risk that is tolerated

Appetite
Desirable risk, subject to the reward being adequate

Risk Limits
Silo-based criteria to help guide transactional risk-taking
Drivers of Risk Aversion, Risk Appetite Articulation and Effectiveness

Paul Kaye

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Risk appetite drivers

- Capital
  - Survivability
  - Sustainability

- Earnings
  - Size of hit
  - Cause: market or private
  - Cause: core or non-core

Appetite

- Market size
  - Post event upside?

- Risk Confidence
**Risk Appetite Articulation and Effectiveness**

- Not possible to be prescriptive over best practice
- But ten criteria proposed to assess Risk Appetite statements and their use

**Articulation**
- an assessment of six theoretical aspects covering scope, coherence and usefulness

**Effectiveness**
- an assessment of four practical aspects covering the implementation within the organisation

<table>
<thead>
<tr>
<th>Vertical Coherence</th>
<th>Horizontal Coherence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stakeholder Coherence</td>
<td>Analytical Balance</td>
</tr>
<tr>
<td>Decision Support</td>
<td>Governance</td>
</tr>
<tr>
<td>Awareness</td>
<td>Usability</td>
</tr>
<tr>
<td>Influence</td>
<td>Credibility</td>
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</table>

**Articulation: the Coherence criteria**

**Vertical Coherence**
- Statement includes more granular risk appetite guidance
- Consistent and connected with corporate objectives
- No consistency or connection between corporate objectives and detailed risk guidance and limits
- No detailed risk guidance and limits
Articulation: the Coherence criteria

**Horizontal Coherence**

- Appetite consistent across risk types (does not imply the same)
- Appetite consistent across business units / portfolios
- Apparent how appetite sits in the context of business strategy
- Variations in appetite without reason or consideration

**Stakeholder Coherence**

- Consideration and reconciliation of all different risk perspectives
- External reconciliation: investors, policyholders, regulators, rating agencies
- Internal reconciliation: group and local management
- Potential stakeholder conflicts not recognised or addressed in a meaningful way
Articulation: Analytical Balance

Analytical Balance

- Appropriate use of quantitative measures and qualitative considerations
- Over reliance on quantitative measures: confused or poor decision making (or “rules” being partly ignored)
- Over reliance on qualitative considerations: limited practical guidance

Articulation: Decision Support

Decision Support

- Full range of risk related decision support: underwriting, portfolio management, capital management, reinsurance, asset allocation, etc...
- Risk appetite focus on risk control only
**Articulation: Governance**

**Governance**
- Clear responsibilities for assessing, measuring and monitoring actual risk vs. risk appetite
- Escalation procedures where potential risk appetite breaches
- Escalation procedures where limitations in decision support

- Focus on defining risk appetite without a view of its administration

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**Effectiveness: Awareness**

**Awareness**
- Established what each role / level of responsibility should know about the risk appetite policy
- All individuals know relevant parts of risk appetite policy

- Little or no knowledge of risk appetite policy beyond board and risk management roles
Effectiveness: Usability

Usability

- Risk appetite consequences understood
- Authority requests escalated in accordance with risk appetite governance
- Practical implications of risk appetite not understood
- Limitations in decision support

Effectiveness: Influence

Influence

- Decisions informed by risk appetite
- Organisation operates within stated risk appetite
- Risk appetite statement seen as compliance requirement
Effectiveness: Credibility

Credibility

✓ Trusted by stakeholders
✓ Actual event outcomes in line with disclosed appetite

✗ Limited evidence of risk appetite being used to inform decisions
✗ Regular adaptations of risk appetite
Risk Appetite Characteristics

Size of General Insurance Undertaking

<table>
<thead>
<tr>
<th>Small</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pros</strong></td>
<td><strong>Pros</strong></td>
</tr>
<tr>
<td>Nimble</td>
<td>More stable business</td>
</tr>
<tr>
<td>Less complex politics</td>
<td>More influential</td>
</tr>
<tr>
<td>Risks closer to surface</td>
<td>Genuine peer review</td>
</tr>
<tr>
<td>Geographic proximity</td>
<td>Critical mass</td>
</tr>
<tr>
<td><strong>Cons</strong></td>
<td><strong>Cons</strong></td>
</tr>
<tr>
<td>Expertise / Expense?</td>
<td>Overly complex / confused</td>
</tr>
<tr>
<td>Growing pains</td>
<td>Longer change cycle</td>
</tr>
<tr>
<td>Formal processes observed?</td>
<td>Communication more challenging</td>
</tr>
<tr>
<td>Large firm concepts?</td>
<td>May be more widely spread</td>
</tr>
</tbody>
</table>

Risk Appetite Characteristics

- Tail
- Maturity
- Diversity
  - Business lines
  - Geography
- Profile
- Structure
  - Ownership
  - Platforms
- Market
- Stakeholder point of view
Risk Appetite Disclosure

- Consistency
  - Lack of accepted definition
  - Quantitative & Qualitative
  - Interchangeable terms
  - Strategic or Tactical focus

- Part of a wider framework

- Considerable detail in Appendix to paper

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

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