Joint IFoA and IRM Response to the FRC Consultation on Risk Management, Internal Control and the Going Concern Basis of Accounting

The Institute and Faculty of Actuaries and the Institute of Risk Management are pleased to offer a joint response to the FRC's consultation on this important subject.

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives. Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

About the Institute of Risk Management

The Institute of Risk Management (IRM) is the world's leading enterprise-wide risk education Institute. We are independent, well-respected advocates of the risk profession, owned by practising risk professionals. IRM passionately believes in the importance of risk management and that investment in education and continual professional development leads to more effective risk management. We provide qualifications, short courses and events at a range of levels from introductory to expert. We support risk professionals by providing the skills and tools needed to put theory into practice in order to deal with the demands of a constantly changing, sophisticated and challenging business environment. IRM operates internationally, with over 4000 members and students in more than 100 countries, drawn from a variety of risk-related disciplines and a wide range of industries. IRM qualified member grades (MIRM, CIRM and SIRM) are recognised worldwide as the sign of a qualified risk management professional and are achieved through examination and recognition of relevant prior learning. Fellowship (FIRM) follows through accredited practical experience.

Overall

The IFoA and the IRM welcome the draft guidance issued by the FRC; it represents a major improvement in the guidance offered to Directors. There are a number of areas where we suggest the guidance could be further improved and we therefore make a number of suggestions which we would be happy to discuss with you.

In formulating this response we have summarised our main points on this page. We have also paraphrased the specific questions that we understand the FRC are asking on pages 3 to 5 and provided a summary of our response to each of the specific questions.

Finally, on pages 6 to 18 we have supplemented this with comments on each numbered paragraph to provide more detailed commentary on the points that we are raising.

Executive Summary

We congratulate the FRC on an excellent paper which has a good structure and echoes many of the themes that the risk profession would like to see more widely adopted in company reporting. Furthermore, our members look forward to making ourselves available to help companies to comply with the guidance. Our suggestions for improvement can be summarised as:

- Harmonisation of the terminology through the document.
- Expanded guidance on risk interactions, ensuring that both positive and negative uncertainties are brought to the attention of the Board, and a recommendation for more guidance on expectations for a risk framework.
- The need for Boards to review near-miss information.
- Consideration of including reference to the extended enterprise within the guidance.
- Some additional structure and context for the Board questions in Appendix D
- Development of more nuanced indicators of danger in Appendix E.
- We suggest that reassurance is offered to Board members regarding how they can be satisfied that they have accounted for all available information in considering the risks to the company.

Finally, while we are sure that the FRC has already paid much attention to the wording of the title of the paper, it seems likely that a strapline containing so many words such as “Internal Control”, “Going Concern” and “Basis of Accounting” is likely to be passed straight to the Finance team. We suggest that the emphasis could be turned round to produce, e.g.

Guidance for Directors on the Management of Risk - with implications for Going Concern Accounting

We would be happy to make ourselves available to assist the FRC with these improvements should our help be required.

Responses to the Specific Questions from the FRC {Paraphrased}
[Page numbers refer to the pages in the main body of the Consultation Paper where the question is put by the FRC in bold print.]

Question 1 (page 3) - Does the draft guidance achieve the objectives of ensuring the Board deliberations will include the following factors:

- *The nature and extent of the risks facing the company*
- *The extent and categories of risk which it regards as acceptable for the company to bear.*
- *The likelihood of the risks concerned materialising.*
- *The company ability to reduce the incidence and impact on the business of risks that do materialise*
- *The costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.*

We support that the draft revised guidance achieves the objectives set out by the FRC and we welcome the messages that are provided to companies.

We see a lot of overlaps between the work that has been undertaken by the insurance sector in the last decade and by the actuaries and risk professionals who serve that sector.

We agree that solvency and liquidity are important areas of risk that need to be actively monitored and managed. In our detailed response below we also make a case for considering reputation, which we suggest can be a primary driver of solvency and liquidity risk and is also closely related to the cultural themes that the guidance discusses.

We agree with the need for regular monitoring of the risk profile and for the Board to be proactive in setting and communicating the risk appetite for the company. We have made some comments on the need to ensure the risk appetite has flexibility to adapt to commercial realities.

We warmly welcome the introduction of likelihood estimation for the principal risks and uncertainties, particularly having seen the benefit that this can deliver for risk management in the insurance sector. We consider that there is scope for actuaries and risk professionals to assist sectors which have not traditionally used these techniques but now wish to use them to comply with this guidance.

We welcome the guidance on how the Board should ensure it is comfortable with, and review the risk management framework strategy that the company has developed to manage its risks. We also welcome the requirement for the Board to disclose that they have undertaken this review and describe how the risks are managed. We agree that this will help to focus Board attention onto risk management.

We have not explicitly commented on the costs of controls versus their benefit; however we do note that we see controls as a component of a wider risk management framework.

Question 2 (page 3) - Are the structure and level of detail in the draft guidance appropriate?

The structure and level of detail of the document as a whole is appropriate; however there are some areas where we recommend an expanded text, for example in Section 5.

In terms of the document structure, perhaps some improvement could be made by harmonising terminology throughout the document and bringing forward some of the concepts and points made in the Appendices (Appendix B and C in particular). We have made our suggestions in the detailed comments.

Question 3 (page 3) - Are sections 5 & 6 still appropriate or are more substantive changes required to the text?

Sections 5 and 6 are appropriate; we have suggested some slightly more substantive changes.

We have made some comments on Section 5 where some expansion could be made. These relate to:

- Expanded definition of what the FRC expects to see in a risk management framework, which we suggest is an important section of the guidance and allows the FRC to set out the minimum requirements.
- Ensuring that information regarding the opportunities derived from uncertainty are brought to Board attention as well as the downside uncertainty to ensure the Board are provided with a full picture of the uncertainties related to value creation.
- Risk interaction being considered over time, as well as at a single point in time, and the ways that likelihoods can change rapidly following an event, which we consider is important to ensure the discussion on likelihood better reflects the real world.

In Section 6 we also highlight that near-miss information could be a useful addition to the information that the Board receives because of its ability to forewarn of risk build up and its impact on the decision making culture of the company.

Question 4 (page 4) - In section 7 the FRC proposes making firms explain what the actions to remediate any significant failing are.

We agree that this would be a positive step and welcome the FRC suggestion. We have included a comment making the FRC aware of the difficulty Boards may have in putting some information on failings into the public domain. However, we support that in the longer term increased transparency is the only sustainable option.

Question 5 (page 4) - Are Appendices D & E of use to Directors and how might they be improved.

We support that Appendix D and Appendix E are of use to Directors but would suggest that Appendix D is currently of more benefit than Appendix E. We would recommend some more structure for Appendix D with references back to the guidance. For Appendix E we suggest that some more nuanced indicators of danger should be considered.

We would be happy to make ourselves available to assist the FRC with developing these Appendices if required.

Question 6 (page 6) - Is the approach taken in Appendix B of the draft revised guidance appropriate? If not how should it be amended and why?

We agree that Appendix B is useful. As per our earlier comments we suggest it could be useful to bring some elements of this appendix forward.

In particular, we note the following sentence “The Board should satisfy that it has sufficient information to make the assessment [of the principal solvency and liquidity risks]” could be usefully moved to the main body of the document.

We describe in our feedback how this statement could cause concerns for Board members over how they can be satisfied that they have sufficient information but suggest that it is retained and that guidance is offered to Board members regarding how this can be satisfied.

Question 7 (page 7) - Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended?

We agree with the guidance in Appendix C, but as mentioned above there could be merit in bringing some of the elements of this appendix into the main text. In particular the introduction and definition of *severe stress* and its difference to *going concern* could be usefully brought into the main text.

Question 8 (page 7) - Do you agree with the guidance to Directors of banks?
[We have elected not to respond to this as others will be better placed.]

Question 9 (page 7) - Do you agree with the draft revised guidance auditing standards? If not how should it be amended and why?
[We have elected not to respond to this as others will be better placed.]

Question 10 (page 10) – Are the additions to the C1 and C2 of the Code required and comments are sought on the detailed wording. Also should C.1.3 be removed?

We agree that the additions and deletions improve the Code and welcome the changes. We have made a suggestion over clarification of the term *robust*.

Detailed Comments

Section 1

1.5
We note that the draft revised guidance refers to *risk culture*. Later in the document reference is made to *culture* and also to *behaviours and values*. We would suggest that a single definition be used which is then used through the document. Sometime the terms appear to be used synonymously so we would suggest that a common risk language is used.

It is important to have a common risk language within an organisation, as communication and shared understanding is vital to the successful management of risk. We consider it will be important that each enterprise has a common understanding of these terms.

However, imposing definitions for all firms could prove counterproductive, so we do not recommend that the FRC defines these terms. However, we *do* recommend that the FRC mandate that these definitions are agreed within each enterprise and that these definitions are disclosed, so that there is transparency and common understanding over how the terms are being defined within each enterprise.

This would serve to focus attention of the Board on what these terms mean for their businesses, and that the disclosure will ensure that users of financial reports can assess the manner in which the enterprises are interpreting the terms. The terms that would benefit from definition are:

- Risk Culture
- Risk appetite and tolerance
- Culture
- Values
- Behaviours

We note that reference is made to the phrase *risk management and internal control system.* We are of the view that the draft revised guidance establishes a sufficiently detailed picture of how risk management should work in a business context to subsume internal controls as a component of an overall risk management framework. We have a concern that *internal control* - separately identified - could lead to a box-ticking exercise. We therefore suggest that references should be to ***risk management and assurance framework including internal control*** throughout the document. We also suggest that consideration should be given to using the wider term ***Risk Responses*** rather than *Internal Controls*.

Other elements of the risk management framework could also be made explicit, for example the draft revised guidance refers to the following elements of the risk management framework later in the text:

- contingency / business continuity plans
- crisis plans
- stress testing framework

We would suggest that the risk management framework is defined to include all the elements that the FRC would expect to find in such a system and this definition can then be used throughout the document.

The guidance uses the term *robust* – here in the case of *robust assessment*. The word *robust* seems to be a term that is widely used but open to different interpretation. Our suggestion would to be clear about how the term is being used in this context.

Our interpretation of a *robust assessment* is a *comprehensive assessment* covering all the risks in this case. However – by way of example – a *robust assessment* could be interpreted as an assessment that can operate in different environments and is robust to a changing environment. In

order to ensure that the draft revised guidance is not misunderstood we would suggest that a clarification as to the meaning of robust in this context is made.

Likelihood

We welcome the focus on the estimation of the likelihood of risks occurring and agree that an "assessment of the likelihood" (and its quantum of impact) is a good way to help Boards to assess the relative importance of the risks and uncertainties they face.

We see scope for better use of data to develop likelihood estimates in sectors / enterprises where this is not currently the case.

We see benefit to be had by using the information known to management (perhaps an expanded set of information to that currently used) in order to make likelihood estimates such that events – or combinations of events – such that they can be evaluated as plausible or not plausible.

We note that arriving at a high-quality likelihood estimate requires the ability to understand and analyse available data, develop models (where necessary) and crucially to incorporate and critically evaluate the assumptions underlying the data and the models so that their limitations are understood.

We note that the assumptions about the external environment and about the company itself are often as important as the estimate itself. We therefore welcome the text in Section 3 setting out that the assumptions and limitations of models need to be understood by the Board too.

Models of some form are frequently required to make an assessment of likelihood. We welcome the FRC guidance on exposing the likely existence of model limitations and underlying modelling assumptions.

We would like to highlight the work undertaken in the UK insurance sector to comply with the Internal Model Validation requirements arising from Insurance Regulation (in particular Solvency II) and the work that is being developed in that sector to help Boards to understand the models used for estimating the solvency and liquidity risks of their firms. The FRC may find Articles 120-126 of the Solvency II directive useful as a reference point.[1]

We would like to highlight that actuaries have been at the forefront of developing tools to help the UK, EU and Global insurance sector quantify their risks, and we have tools that could be useful to help companies outside the insurance sector quickly develop a quantitative understanding of their risks. Actuaries have also been heavily involved in estimation of natural hazard risks such as flooding and seismic events which are important for business continuity event likelihood estimation and may be of material significance to the risk profile of some businesses.

Review of Risk Profile and Appetite

We agree that the risk profile should be kept under review, but highlight that the risk appetite should be reviewed too, because the combination of the risk profile and the risk appetite will be the key inputs to the risk-based decision making that is sought.

The key is for the Board to make changes to their risk appetite consciously as a part of the strategy setting for the undertaking and that the stakeholders are aware of these changes.

We note that in Section 6 the review includes an annual assessment of the risk appetite but highlight that this suggests the review of risk appetite should be included in Section 2 too. Also, we note that the risk appetite may need to be reviewed more frequently than annually in a fast changing environment.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

Ongoing Assessment

We agree that it should be an ongoing process of assessment and management of principal risks that is undertaken.

We highlight that this assessment is very similar to the ORSA (Own Risk and Solvency Assessment) process mandated by the international insurance regulatory community (including the Bank of England) which is currently being implemented in the global insurance sector (including the UK) and that actuaries, working with risk professionals, are leading or heavily involved in the development of these assessments.

The assessments combine the stress and scenario testing approach outlined in Appendix B with the likelihood estimation described in Section 4.

1.9
We note that the guidance often refers to *principal risks* relating to liquidity and solvency. We note that later in the guidance reference is made to *other risks* which could affect the cash-flows due to the company. Reference is also made later to reputation (40).

We are of the view that reputation is a key factor that has the ability to adversely affect many business models and leads to solvency and liquidity risks. We suggest that reputation should be mentioned alongside solvency and liquidity for the purposes of this guidance.

1.10
We are of the view that the use of the term *robust* is widely used but can be open to different interpretations. In this context we interpret a *robust framework* to be resilient to the environment that it operates in. However we would suggest that the FRC makes clear how it is using the term *robust* in this context to avoid confusion.

1.11
We note that here reference is made to *culture* and *behaviour*, whereas elsewhere reference is made to *risk culture* and also to *values*. As suggested above we recommend that a consistent terminology is used throughout the draft revised guidance.

Section 2

19.
Here the guidance uses the term *identifying and evaluating the principal risks*.

We interpret the word *evaluating* as synonymous with quantification of the impact and likelihood of the risks, but we suggest that the wording might amended to ensure that this interpretation is understood.

We would highlight that the interactions between risks are often as important, and often more important, than the risks in isolation. We would suggest amending the wording to refer to “the risks and the interactions between risks”, or defining risks including the interactions between risks. We note that Section 4 does make reference to the interaction of risks so this would be consistent with 26.

The FRC might consider the use of the term *Risk Strategy* as a descriptor for *agreeing how these risks should be controlled, managed and mitigated*.

We understand that the term *principal risks and uncertainties* arise from the Companies Act 2006.

We would suggest that it could be useful for the FRC to provide clarity on how it interprets the term *principal* so that a threshold for inclusion different to that intended is not used.

We interpret the term *appropriate risk management and internal control system* as meaning that the risk management and internal control system should be capable of delivering a *risk profile* aligned to

the desired *risk appetite* for the company. The term *appropriate* could have different meanings to others so a clarification from the FRC might be helpful.

20.
It may be helpful to expand this section and highlight where the FRC sees the subset of the new responsibilities so that the additional responsibilities are clearly separated. In particular, reference could be made to Appendix C where the draft revised guidance goes into detail regarding the definition of *severe stress*.

21.
We would highlight that in addition to management establishing responsibilities at all levels for the organisation, a scheme of delegated authority also needs to be established to ensure that those with responsibility have the authority and access to resources (support) to discharge their responsibilities.

This is mentioned in 22 below but it may be helpful to put this responsibility of management in 21.

22.
We highlight that *risk culture* is used here whereas the term *culture* and *behaviour and values* are used elsewhere in the guidance. As mentioned above we suggest it would be helpful to use a common terminology.

We note that in Section 3 (24) the guidance refers to *the values and behaviours that it [the Board] wishes to instil in the company*. The text goes on to articulate the considerations necessary for achieving this. It may be helpful to pull this section out and be explicit that this framework for values and behaviours is what the FRC means by *risk culture* or *culture.*

However, we are of the view that it would be better to leave the definition of *risk culture* or *culture* to the firms and mandate that they disclose their definitions.

Section 3

24.
The values and behaviours that it wishes to instil in the company, and whether this has been achieved.

As mentioned in the narrative on Section 2, this contains a useful description of how the FRC sees risk culture. We suggest there is merit in separating out this section as a description of what the FRC means by risk culture (or culture) so the term is clearly understood.

However we repeat our suggestion that the draft revised guidance could benefit from a common terminology and that firms should be left to define and then disclose their definitions of risk culture.

How to ensure there is adequate discussion at the Board.

Mention is made of reviewing the risk profile but we would highlight that the risk appetite should form a part of these discussions too. It may be necessary to amend the risk appetite as a part of the commercial strategy, and this should be possible and done as a part of the discussions on strategy, capital and risk.

The skills and experience of the Board and management

We are of the view that all Board members should have a minimum level of understanding in regard to their responsibilities concerning risk management and have a sufficient knowledge of risk management to exercise their responsibilities.

We therefore urge the FRC to encourage Boards to ensure that members undertake a programme of training to ensure that a baseline level of risk management understanding is present for them all.

We are of the view that the requirements of this paper will (necessarily) place a good deal of responsibility on the Boards of enterprises. We note that this may raise concerns over the time that Board members have to devote to the additional responsibilities and concerns that the Board will have the specific risk management skill sets.

Boards could benefit from the addition of risk professionals to the Board of Directors to ensure that the risk management skill set is present during the decision making process. If there is a risk committee then it should include at least one person with recent and relevant experience in the management of risk.

We would like to make the FRC aware of a recent paper from EIOPA[2] (European Insurance Industry Regulator) which sets out a range of skills that it expects to see boards possess relating to their 'system of governance', which they specifically define as the awareness and understanding of the risks the undertaking is facing and the capability of managing them.

We note the first sentence from the text in the draft revised guidance seems to be missing delegated authority as a requirement that a committee would require in order to discharge its responsibilities. We would suggest that the delegation of authority to discharge delegated responsibilities is sufficiently important to warrant a separate sub-section.

As a final point, we would advocate that ensuring adequate Board diversity is a significant element of corporate risk mitigation. As such, we would encourage reporting of the Board's constitution against the best practice as well as specific industry experience.

The flow of information to and from the Board, and the quality of that information.

This is the first mention of *emerging risk* in the paper. We would suggest that it is made clear in Section 2 that the Board responsibilities include *emerging risk* as a part of the *principal risks and uncertainties* they will be considering. We would also suggest that horizon scanning is referred to as a recommended activity to address these emerging risks.

It may be worth the FRC reflecting on whether this section will ensure that bad news is not filtered out from communications to Boards. Later in our commentary we suggest that information flow could usefully include near-misses in order to acclimatise the Board to risk commentary and help address the issues of getting less positive news on the Board agenda - by virtue of its higher frequency.

The use, if any, made of Board committees

We would suggest it worth considering whether there has been sufficient delegated authority for the committees to undertake their delegated responsibilities.

What assurance the Board requires, and how this is to be obtained

We strongly support the need for Board assurance over their risk management system. However, we consider that the skill set to offer a review of the governance of an organisation is a special skill set that is not restricted to the audit profession as a consequence of their duty to audit financial statements. We therefore encourage the FRC to propose that Boards seek external review from professionals with risk management skills to undertake a governance review. A variety of risk management accreditations exist, for example, the MIRM, PRMIA exams and CERA qualification.

[2] EIOPA Final Report on the Proposal for Guidelines on the System of Governance Para 5.29

Section 4

25.
We welcome the inclusion *of actions that it would consider undertaking in advance*. The reporting of management actions has been a feature of risk management in the life insurance risk management for a number of years.

26.
We are of the view that more time should be spent on the risks and interactions that are most relevant to the company.

We would urge the FRC to encourage Boards to devote their time in proportion to the risks and interactions in proportion to their threat to the enterprise.

We welcome the inclusion in the definition of *combinations* of risks.

We noted that *emerging risks* did not get mentioned here but it may be worth considering an extra sentence that the principal risks are to include current and emerging risks.

We note that the use of the term *tolerated* appears here but in 19 of Section 2, *tolerated* was not explicitly mentioned. It may be worth considering if Section 2 should be amended to include *tolerated risks*.

This section seems a good definition of how the FRC interpret *Principal Risks and Uncertainties* as defined in the Companies Act 2006. The paragraph seems as if it would benefit from a reference to Appendix B where there is more detail on what are considered *Principal Risks and Uncertainties.*

27.
We would suggest that this would be a good part of the guidance to stress the need for a regular re-evaluation of the risk profile and risk appetite of the company as it speaks to the evolving strategy of the company with the business cycle.

28.
We welcome the inclusion of stress tests and scenario tests. We highlight the work undertaken with the insurance sector on developing stress tests and reverse stress tests as a part of their compliance with the UK regulator (Bank of England) and international regulation (ORSA).

We highlight that actuaries have been leading or involved in the development of stress testing frameworks in the insurance sector and that it is a key skill area for risk professionals.

29.
This is the first mention in the draft revised guidance of *contingency plans*. We would suggest that a well-designed risk management system includes contingency plans. We would suggest that the single term *risk management and assurance framework* is used and then defined by the FRC to include internal controls and contingency plans.

We interpret *contingency plans* as *business continuity planning*, which may be a term that is more familiar to users of the FRC guidance.

We note this is the first mention of *residual risks*. There seems overlap here with the *tolerated risks* mentioned in 26. We would suggest that the terminology is harmonised and that *tolerated / residual risks* are included in the earlier sections of the guidance e.g. Section 2.

30.
This section appends *other risks* to the solvency and liquidity risks discussed earlier in the paper. We agree that there are other risks that would have a serious impact, reputation being the most obvious to us. We suggest it could be beneficial to explicitly cite reputation risk here and elsewhere in the document, specifically 19 of Section 2 where reputation could be added to the third bullet.

We also note that reputation risk is strongly linked to the (risk) culture of the organisation. Therefore, we see a benefit in highlighting the role that values and behaviours will have on reputation and suggest that some additional wording on Section 3 (24 – first bullet) could help to reinforce this point.

The text further down in 30 could be expanded to set out what is meant by reputational risk and should include other risks that the FRC has in mind too.

Section 5

31.
As mentioned above we suggest that the risk management framework be defined as encompassing the internal control system (and the contingency planning cited in Section 4).

We note that reference is made here to *culture* rather than *risk culture.* We highlight that it may be helpful to use a consistent terminology but that companies should define and disclose the definition of this term.

32.
This section could benefit with some expansion as a definition of a risk management framework. We are of the view that it could encompass a wider set of activities than those as cited. For example:

1. Contingency Planning (to include business continuity processes)
2. Crisis Management Planning
3. Stress and Scenario Testing
4. Principal Risk Identification (to include principal risk interaction identification)
5. Risk Quantification (Impact and Likelihood)
6. Model Validation (to include limitations of assumptions and models)

It may be helpful to separate out this paragraph, as it appears to provide the FRC view on what a risk management framework should contain and could receive a disproportionate amount of focus. For this reason we suggest that it covers a wide range of activities to avoid an inadvertent narrowing of what a risk management system should contain.

We note the reference to *system of risk management and internal control* and elsewhere in the document reference being made to *framework* (e.g. 10). We have used the term *framework* but we suggest that unless the FRC sees a difference between a *risk management system* and a *risk management framework* it would be better to use a consistent terminology in the draft revised guidance.

33.
It is important that the Board is aware of the uncertainty it faces and therefore that significant deviations, regardless of their direction, are brought to the attention of management.

While the Board should be aware of the significant increases in risk exposure we would suggest that a richer source of information should be presented to the Board such that significant *falls* in risk exposure should be brought to their attention too, as these provide important information regarding the uncertainty being faced by the company. A sudden fall in a risk exposure might open the way for an increase in exposure through, for example, higher sales of a high margin product. It would be better that the Board had opportunity to challenge the fall in the risk exposure prior to the subsequent increase in sales to gain more exposure.

We would also suggest that the risk management system should be able to explain the risk that was taken in achieving results. So, for example, a good result is to be welcomed but should be evaluated in the context of how much risk was taken to achieve the result. This is important to avoid developing corporate cultures which reward fortunate decisions rather than decisions taken through good risk management practices.

34.
Reference is made here to *crisis management*. We note that this is defined in Appendix C and distinguished from *contingency planning*. It would be useful to pull these terms out to a definitions section.

On the third bullet we would highlight that the risks do not necessarily need to crystallise at the same time to be dangerous.

The evolution of risk is often a cascade effect whereby one risk crystallising can lead to an increased likelihood of future risks arising. This can lead to the cascade whereby risks occur in relatively quick succession, but not synchronously. Our suggestion is therefore to amend the wording to reflect the situation in which one risk occurring could cause a significant change in the likelihood of another risk (maybe a risk that was not previously considered to be a principal risk and uncertainty). A phrase that is useful to describe this is "ripple effects".

We encourage the FRC to expand the discussion on the identification of the interaction between risks, because interactions can be as important as the risks themselves. Without this we consider that the wording could be interpreted as to whether two risks could occur at exactly the same time; for which we would expect a much lower likelihood.

We also suggest that the guidance avoids intimating that the analysis is *just for the Board,* as it is important that the audience for the information about risks is a wider set of stakeholders within the organisation in order for risk management to be effective.

The fourth bullet could benefit from expanding to include the *residual / tolerated risks* that are alluded to earlier in our commentary. To some extent these risks are referred to implicitly with the current text, but it would help to include explicit reference for the avoidance of doubt.

The sixth bullet refers to *values* and *culture,* whereas, earlier sections referred to *values, behaviours* and in some places *risk culture*. We would suggest the use of a consistent terminology as discussed above.

We note that often the *values, behaviour and culture* is cited as including the *incentives, sanctions, management style* etc. as per Section 3. As we are of the view that the companies should define the risk culture, we suggest it would be helpful to include these additional considerations as to what the FRC considers to be disclosed when a company discloses its (risk) culture.

35.
This paragraph appears to be an extension of the fifth bullet of 34. It may be worth combining these two into the bullet under 34.

Section 6

37.
We would suggest that significant deviations, whether positive or negative, should be included in the report to the Board.

We notice that the concept of *near-miss* has not been mentioned and suggest that it would be worthwhile including near-misses (or other indicators of near-misses) in information to the Board.

We are of the view that this could help with the cultural issues surrounding bringing bad news to the Board, as near-misses are likely to be more frequent and acclimatise Boards to where risks may occur and help to encourage upwards flow of risk information.

We envisage that a conversation about a near-miss and how it could be better avoided in future would be an easier conversation (and therefore more likely to occur) than a discussion about a failure that had transpired.

Section 7

44.
If we were to consider how a failure could happen in spite of adherence to the guidance set out in this paper, we consider that such a failure could occur from the extended enterprise of the organisation. In other words an external event beyond the control of the enterprise management but which creates an unforeseen chain of events. We consider this especially relevant due to the prevalence of the extended enterprise in today's complex economy.

As such we encourage the FRC to place more emphasis on encouraging Boards to understand the risks from their extended enterprise and the their own ability to control / influence these risks (extended risk control), as well as their ability to continue as a going concern in the event that risks in the extended enterprise crystallise (resilience).

Therefore, to this section we would add that enterprises are increasingly *extended enterprises,* and therefore the Board should be giving consideration as to how it would manage and assess risks from suppliers and outsourcers that become informal parts of the group structure.

58.
In this paragraph we would highlight that companies are asked to "explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review, including the process it has applied to deal with material risk management or internal control aspects of any significant problems disclosed in the annual report and accounts."

We would highlight that the FRC could encounter resistance if it is requiring firms to disclose weaknesses by virtue of having to disclose the actions to remedy any significant weaknesses. For example, an overseas competitor that is not subject to the same degree of disclosure requirement may be given a competitive advantage compared to a UK firm that has had to make public disclosures on the remedial actions it has taken. It might be more acceptable to Boards to demonstrate to an independent third party what the nature of the significant failings or weaknesses are and demonstrate the remedial actions taken to the independent third party. The third party would then attest to the effectiveness of the remedial action used to treat significant failings or weaknesses.

The above is not intended to refer to "principal risks and uncertainties" as required to be disclosed under UK company law. We are of the view that it is useful for Boards to disclose the way in which they are being managed and mitigated as per paragraph 45.

Appendix A
[We find this a useful Appendix but do not have any comments.]

Appendix B

Solvency and Liquidity Risks
We note earlier in the paper (30) that other risks that could seriously affect the cash-flow were cited as in scope for consideration. Earlier in our commentary we noted that a major *other risk* was reputation. We highlight again that it might be worth including a reference to reputation as a reputation is strongly linked to the values and behaviours set out earlier in the paper, and an impaired reputation has a direct link to solvency and liquidity risk.

Considering what information is available about the future

We note the following sentence "The Board should satisfy itself that it has sufficient information to make the assessment [of the principal solvency and liquidity risks]".

Guidance from Appendix B (page 19) is a very important part of the document and we encourage the FRC to move this to the main body of the document. We understand that this statement could cause

concerns for Board members over how they can be satisfied that they have sufficient information, but that this is exactly the sort of difficult debate that this paper should be encouraging them to undertake.

We note that the information that can be brought to bear on a decision making process could arise from internal sources or sources external to the enterprise. Furthermore we note that information could be either quantitative or qualitative.

We encourage the FRC to reassure Board members not to be apprehensive of this comment, but to embrace it and use it as an opportunity to expand the set of information that they use in their decision making process, something we consider a core lesson from risk management.

Stress testing and sensitivity analysis

We agree that this is a helpful approach and highlights the way that risk professionals and actuaries in insurance companies have been developing stress testing frameworks, including stress and scenario testing and reverse stress testing, as a part of the Own Risk and Solvency Assessments for their companies.

Appendix C

We find this a helpful appendix and are of the view that some of the concepts referred to in this appendix could be usefully moved to the main body of the draft revised guidance. In particular, we are of the view that the introduction of the terminology *severe stress* would be useful to move into the main body of the guidance – paragraph 20 seems a sensible location for this.

Appendix D

We are of the view that this is a useful list although we have three comments.

Firstly, we suggest that it could benefit from some re-drafting and further structuring, in particular, the questions might benefit from being cross-referenced to particular parts of the guidance to show how the questions are designed to shed light on whether the guidance is being adhered to. This process may lead to the identification of some parts of the guidance that are not captured by this set of questions.

Secondly, we there could usefully be some rephrasing of the questions which are less theoretical and invite the Board to think about the specifics of how their company implements risk management.

For example, the question "how is inappropriate behaviour dealt with?" assumes that there is a common understanding around the Board of what inappropriate behaviour is. It could also be expected to invite a predictable response that inappropriate behaviour should be punished in some manner.

In that example perhaps a more useful question might be to invite the Board to agree what it believes inappropriate behaviour is; what systems are in place for detection; and how the company responds. This might involve a more nuanced schedule of reactions depending on the severity and type of inappropriate behaviour.

The questions might in this case become:

- “How does the company define inappropriate behaviour?”
- “How is it uncovered?”
- “When it is uncovered, how does the company respond?"

More generally questions of the form "How can our company/Board demonstrate that..." might be more productive than questions of the form "How does the company/Board act..." because they focus Board attention on the specifics of their company.

Thirdly, some of the questions could be more stretching to make Boards think more deeply about risks. If the question set is too obvious it will invite boilerplate answers which will not achieve the desired result of inviting the Board to think deeply and imaginatively.

If the FRC would appreciate some assistance the IFoA and IRM would be happy to discuss the questions and offer their input to refine this question set.

Appendix E

We are not of the view that this appendix should be reworked to make it more relevant to Boards. We agree that all the indicators are valid and that were any of them true the Board should have serious cause for concern. However, we are of the view that some of the indicators are too evident and that, at such time as any are true, Boards would already be aware of issues.

For example, the suggestion of non-executive Directors not getting out and about was a good example of an indicator. On the other hand, we doubt many Boards would consider that they did not know what the risks of their firm were; this is an example of a question that could be improved.

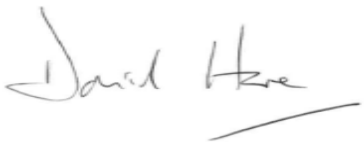
Our suggestion is that more useful indicators would be indicators that are more subtle and are leading indicators of the more substantive issues listed in Appendix E. Such indicators would not necessarily indicate a problem with certitude, but would be a signal to Boards that more investigation should be in order to investigate whether there was a problem that needed addressing.

We would also suggest that any list of warning signs will likely be taken as (almost) definitive, even when it is explicitly said not to. Therefore we would suggest some reworking of this list would be beneficial.

If the FRC would appreciate some assistance with developing a list of these indicators the IFoA and IRM would be pleased to help.

Should you wish to discuss any of the points raised in further detail please do hesitate to contact Paul Shelley, IFoA Policy Manager (paul.shelley@actuaries.org.uk; or 079 1760 4985) or Carolyn Williams, IRM Technical Director (carolyn.williams@theirm.org; 020 7709 0716).

Yours Sincerely



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