Institute
and Faculty
of Actuaries

New Risk Guidelines for Companies

How actuaries can help you to comply

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The new Corporate Governance Code from the Financial Reporting Council (FRC)

New risk guidelines for listed companies came into operation for financial periods starting after October 2014, so will typically apply for the first time for the 2015 financial year and be first reported on in early 2016.

The guidelines will require complying companies to report more details of their risks and (where appropriate) to carry out risk modelling, scenario analysis and stress testing. In order for directors of companies to comply with the guidance, they will need to:

- Identify any material uncertainties to the company's ability to consider it appropriate to adopt the going concern basis of accounting;
- Carry out a robust risk assessment of the principal risks facing the company – describe those risks and explain how they are being managed or mitigated;
- State they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due; and
- Monitor the company's risk management and internal control systems and review their effectiveness.

Many companies will already comply with the requirements, and actuaries are able to help directors report on the processes already in place in a language consistent with the new guidance.

However, for those that don't, actuaries have the modelling and analysis skills to help company directors comply, taking a proportionate approach. Risk management and communication are both fundamental to the training of actuaries. Risk management concepts are embedded throughout the practice specific examination subjects and educational material, including an examination specifically in Actuarial Risk Management (CA1). Furthermore, a dedicated examination (ST9) and seminar is available for actuaries wanting to specialise in enterprise risk management and obtain the globally recognised Chartered Enterprise Risk Actuary (CERA) qualification. Actuaries also benefit from Continuing Professional Development, an active programme of member-led research and ethical and technical standards.

It is for each board to ensure that its risk management framework is robust and effective, and actuaries can adapt to use their skills to add value within the board's desired framework. For many companies, the pension scheme is of significant size relative to the market cap of the company, and as such the risks associated with the scheme are likely to be among the principal risks which may impact the continued going concern basis of the company. Pensions actuaries are best placed to help companies understand and mitigate those risks, and can use similar techniques and scenario analysis for other company risks ensuring consistency.

The extent of actuaries' activities is perhaps best illustrated by the economic capital models now being used for risk management, capital management and regulatory reporting. Banking and insurance regulators now require us to evaluate the additional capital required to ensure that the liabilities will still be covered after an extreme event (typically a 1-in-200 event) during the next twelve months. As well as forming the basis for agreeing the minimum capital required by UK regulators (and, when Solvency II comes into force in 2016, by all insurance regulators in Europe), actuaries use the results of this risk modelling to advise on risk mitigation, capital management and capital allocation within insurers. For example, risk appetites can be agreed with business units and monitored against actual performance and against business plan projections. Economic capital models can also inform proposed strategic actions and pricing and mergers & acquisitions.

Other techniques are commonly used, which can be developed in conjunction with the economic capital model or by using less complex models, as appropriate. These include:

- **Sensitivity testing** (stressing one variable at a time). For example, the impact on a company's balance sheet of a 1% increase or decrease in interest rates might be assessed.
- **Scenario testing** (assessing the impact of a conjectured scenario where several variables are stressed). The recent Eurozone crisis has provided one model for the sort of scenario that can be used for this purpose, where interest rates, inflation, equity and property prices, and credit spreads on government and corporate bonds all move simultaneously, together with consequential changes in counterparty credit risk, new business levels, expense levels and certain types of operational risk such as fraud.
- **Reverse stress testing** (finding how severe a scenario needs to be to cause the failure of the business model). This usually involves identifying the most critical risk factor (or factors) for a business, and assessing how extreme the movement in that risk factor(s) needs to be for the capital to be used up. For example, the business model of the Northern Rock and other banks in 2008 was based on borrowing in the wholesale market, and the freezing up of that market led to Northern Rock's collapse.

For further information about these new requirements and the actuarial skillset, please see the Institute and Faculty of Actuaries website: **http://actuaries.org.uk/practice-areas/risk-management**

Institute
and Faculty
of Actuaries

London

7th Floor · Holborn Gate
326-330 High Holborn · London · WC1V 7PP
Tel: +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111

Edinburgh

Level 2 · Exchange Crescent
7 Conference Square · Edinburgh · EH3 8RA
Tel: +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313

Oxford

1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD
Tel: +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211

Beijing

6/F · Tower 2 · Prosper Centre
5 Guanghua Road · Chaoyang District · Beijing China 100020
Tel: +86 (10) 8573 1522

Hong Kong

2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong
Tel: +11 (0) 852 2147 9418

Singapore

163 Tras Street · #07-05 Lian Huat Building · Singapore 079024
Tel: +65 (0) 6717 2955

www.actuaries.org.uk