

## Interim Measures for Solvency II - Preparing the Risk Management Function

October 2013



Based on EIOPA's final guidelines to regulators for the implementation of the System of Governance requirements, insurers will need to establish a Risk Management Function with Solvency II responsibilities, perhaps as early as 1 January 2014.

In addition, the current Central Bank of Ireland consultation on the Corporate Governance Code for Credit Institutions and Insurance Undertakings requires insurers to appoint a Chief Risk Officer. This note analyses the implications for insurers, setting out the key issues to address.

### INTRODUCTION

Following a recent consultation process, the European Insurance and Occupational Pensions Authority (EIOPA) published final guidelines for the preparation for Solvency II (**the guidelines**) on 27 September. The aim of the guidelines is to introduce specific aspects of Solvency II requirements into national supervision from 1 January 2014, in advance of the full implementation of the Solvency II regime.

During this 'interim phase', national supervisors will require (re)insurance undertakings to meet the interim Solvency II requirements in addition to the need to continue to comply with existing Solvency I requirements.

The guidelines on System of Governance will require (re)insurance undertakings to put in place an Actuarial Function, and a Risk Management Function (RMF) amongst other things. In a recent briefing note we considered the implications of preparing the Actuarial Function. In this briefing note, we focus on the requirement to put in place a RMF, considering the practical implications for companies in meeting the requirements.

The Central Bank of Ireland (CBI) has indicated that it intends to issue guidelines that will largely mirror the EIOPA guidelines, which will apply to regulated (re)insurance undertakings with an Irish head office. Following publication of the EIOPA final guidelines, we expect the CBI guidelines to be published soon.

In addition, the CBI has released a recent consultation paper (CP69) on proposed changes to the Corporate Governance Code for Credit Institutions and Insurance Undertakings. The proposed changes include a requirement for all insurers to have a chief risk officer (CRO). This briefing note also considers the implications of this proposed change for insurers in the context of the interim Solvency II requirements, and the preparations for the full implementation of Solvency II.

This briefing note focuses on the implications for solo undertakings. It should be noted that there are additional requirements that may apply for groups.

### RMF RESPONSIBILITIES

The responsibilities of the RMF under Solvency II are set out in article 44 of the Solvency II Directive.<sup>1</sup> Under this Directive, detailed requirements are set out in respect of the Risk Management System (RMS). The primary role of the RMF is to facilitate implementation of the RMS, along with specific requirements in relation to internal models (where these are used).

The guidelines for the interim phase contain a number of requirements for insurers in relation to

<sup>1</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

the RMS. Primary responsibility for the effectiveness of the RMS rests with the board. The board is responsible for setting the company's risk appetite and any numerical limits underpinning its tolerance for risk, along with approving the main risk policies and the company's strategy in relation to the acceptance and mitigation of risk. The RMF itself is specifically charged with reporting to management and the board on risks that have been identified as potentially material, along with other specific areas of risks, both on its own initiative and at the request of the board.

In reality, the responsibilities of the RMF go beyond simply identifying and monitoring risks and reporting those to the board. The RMF will be at the heart of the work involved in developing and improving the company's risk strategy, risk appetite and detailed risk tolerance limits, with input and ultimate sign-off from the board. In addition, there is a detailed list of risk management policies that are a cornerstone of the RMS under both the Directive and the guidelines, and the RMF will be central to preparing these policies for board approval, to facilitate the implementation of the RMS.

### **RISK MANAGEMENT POLICIES**

There are minor differences in the detail of the risk policies required under the guidelines and those required under the Directive, but in substance the policies required are the same. Under the guidelines, national supervisors will require each undertaking to have in place a risk management policy which specifically covers the following areas:

- Underwriting and reserving risk
- Operational risk
- Reinsurance and other risk mitigation techniques
- Asset-liability management
- Investment risk (including derivatives)
- Liquidity risk

The Solvency II Directive refers explicitly to derivatives in the context of the investment risk policy whereas the guidelines refer to derivatives separately, but the guidelines are clear that the use of derivatives must be appropriate in the context of the company's risk management policy on investments.

In addition, under the Directive, the liquidity risk policy also covers concentration risk which is not explicitly referred to in the guidelines.

Importantly, the guidelines set out specific requirements that must be met by the risk management policies in each area. Meeting the detailed requirements of these policies is an important element of successfully establishing the RMF under Solvency II and we have summarised the key elements of the various policies in an appendix to this briefing note.

In addition to the responsibilities set out in the guidelines on the System of Governance, the RMF will have responsibilities in relation to the production of the Forward Looking Assessment of Own Risk and, where applicable, internal models.

### **PRACTICAL CONSIDERATIONS**

The practical implications of the requirements set out in the guidelines in respect of the RMF will depend on the circumstances of each company. Under the Corporate Governance Code, all Irish insurers will have determined a risk appetite and many will have developed a risk management framework with a number of risk management policies.

However, it is important for companies to confirm that the risk management policies in place meet the detailed requirements of the guidelines, incorporating each of the risks set out in the guidelines and addressing the various requirements set out under each risk.

Many companies, and particularly companies with a medium high or high rating under the CBI's PRISM framework will already have a CRO in place or an equivalent (e.g., head of risk), although for less complex companies it is likely that the CRO will also discharge other functions. It is likely therefore that for many companies, the CRO would become responsible for the operation of the RMF under Solvency II. However, it would be important to document the tasks and responsibilities of the RMF to ensure that these meet the requirements of the guidelines. It is likely therefore that a mapping exercise will be required, even where a company already has a CRO or RMF in place, to assess the current responsibilities in the context of those set out in the guidelines.

The RMF will not operate in a vacuum. In particular, there are aspects of the responsibilities of the Actuarial Function which overlap with the work of the RMF, and in determining an appropriate organisational structure insurers will need to consider the interaction between these key functions.

In setting the terms of reference of the RMF, it would make practical sense for companies to consider the requirements of CP69, the recent CBI consultation paper on the review of Corporate Governance Code, in relation to the role and responsibilities of the CRO. These requirements are discussed in more detail below.

### CHIEF RISK OFFICER RESPONSIBILITIES

CP69 will require insurers to appoint a CRO. Under the draft revised code, the CRO will have “distinct responsibility for the risk management function”. This responsibility will include:

- Managing the risk control function
- Monitoring the institution’s risk management framework across the entire organisation
- Maintaining effective processes to identify, manage, monitor and report risks to which the company is or might be exposed
- Promoting sound and effective risk management
- Facilitating the setting of risk appetite by the board
- Providing comprehensive and timely information to the board on the company’s material risks

The CRO will need to have relevant expertise, qualifications and background and have sufficient seniority and independence to challenge or influence decisions which affect an institution’s exposure to risk. The CRO will report to the board risk committee and have direct access to the chairman of the board.

The appointment of a full-time dedicated CRO is unlikely to be proportionate for some companies, and the draft revised code recognises this. Where an institution is not designated as ‘high impact’ under the CBI’s PRISM rating system, and where the nature, scale and complexity of the business does not justify a full-time CRO, the role of CRO may be discharged by another pre-approved control function (PCF). However, this is subject to the proviso that there should be no conflict of interest, and the CBI must be notified of the arrangement.

As described above, most companies will already have a CRO in place, so the requirements of the revised code are unlikely to place a significant burden on these companies. However, it would be important to review the terms of reference of the CRO to ensure that the requirements of the revised code are being met. Particular challenges may arise

for companies where the CRO role is discharged by someone with other responsibilities.

Many companies, particularly those in the medium-low PRISM rating category, will not currently have a CRO dedicated full time to that role. Typically, responsibility for risk will be discharged by a member of the senior management team such as the CFO or chief actuary. It will be important to ensure that this individual meets the requirements of the revised code—i.e., is a PCF holder, is suitably senior and independent to challenge decisions, and has the appropriate skills and experience to discharge the role.

### TIMESCALES

The CBI has announced its intention to apply the EIOPA guidelines to regulated entities based on its PRISM model.

For high- and medium-high-impact companies, a RMF will be required from 1 January 2014 and the various responsibilities of the RMF will apply from then.

On the face of it, medium-low- and low-impact companies will have an additional year before they are required to put in place an RMF that can meet all of its required responsibilities, i.e., from 1 January 2015. Companies that are part of groups will also need to factor in the requirements of the group when planning for implementation of the guidelines.

The CBI has indicated its intention to publish a revised version of the Corporate Governance Code in December 2013 following completion of the consultation period in respect of CP69. CP69 notes that “institutions will be provided with a reasonable timeframe for the implementation of the revised Code which will take account of the materiality of any amendments made”.

Therefore, it is likely that for most companies (at least those with a PRISM rating of medium-high or higher), the timescale for implementing any changes in respect of the RMF will be driven by the guidelines. For those companies with a PRISM rating of medium-low, it is possible that the revised Corporate Governance Code will take effect before the 1 January 2015 deadline for implementing a RMF under the guidelines, and hence the timescales for those companies may be driven by the changes to the Corporate Governance Code, rather than by the guidelines.

## SUMMARY

The requirements for the appointment of a CRO and the establishment of an RMF are likely to become more formalised over 2014 and into 2015. For some companies, this will not be a significant change from their current position. For others, some preparatory work will be required. In particular, consideration will need to be given to the overlap between these roles as well as any interaction with the work of the Actuarial Function.

We anticipate that many companies will seek to appoint a single suitably qualified individual to discharge the CRO role and lead the RMF. For some companies, primarily those in the medium-low PRISM rating category, it is possible that this role will be merged with the responsibilities of another PCF role. In doing so, it will be important for companies to address any potential conflicts of interest that may arise and to ensure that the CRO has sufficient time, experience, skills, independence and seniority to exercise the role effectively.

The guidelines set out detailed requirements of the risk management policies which must be put in place by 1 January 2014 (or 1 January 2015 for medium low companies). The guidelines specify a range of detailed elements that must be included in the risk management policies as a minimum. Even where companies already have risk management policies in place, it will be important to review those in the context of the requirements set out in the guidelines.

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## APPENDIX

### Summary of risk policies required under EIOPA's final guidelines

Under the guidelines, national supervisors will require each undertaking to have in place a risk management policy which specifically covers the following areas:

- Underwriting and reserving risk
- Operational risk
- Reinsurance and other risk mitigation techniques
- Asset-liability management
- Investment risk (including derivatives)
- Liquidity risk

Each company's underwriting and reserving risk policy will need to cover at least:

- The types and characteristics of its insurance business, including the types of risk it is willing to underwrite
- How it will ensure the adequacy of premiums to cover expenses and claims
- The identification of the risks arising from the insurer's obligations, including embedded options and guaranteed surrender values
- How, in designing new insurance products, the company takes account of constraints relating to investments and takes account of reinsurance and other risk mitigation techniques

The operational risk policy should at least cover:

- Identification of operational risks the undertaking is or might be exposed to and assessment of how to mitigate them
- Activities and internal processes for managing operational risks (including the IT system supporting them)
- Risk tolerance limits with respect to the main operational risks

In addition, undertakings will need to develop a process for identifying, analysing and reporting operational risk events and will need to establish a process for identifying and monitoring such events. It will also need to develop and analyse an appropriate set of operational risk scenarios covering at least:

- The failure of a key process, person or system

- The occurrence of external events

The reinsurance and risk mitigation policy should at least cover:

- Identification of the level of risk transfer appropriate to the company's risk limits and the kinds of reinsurance arrangement that are most appropriate given the company's risk profile
- Principles for the selection of risk mitigation counterparties and procedures for monitoring creditworthiness and diversification of counterparties
- Procedures for assessing the effective risk transfer and consideration of basis risk
- Liquidity management to deal with any timing mismatch between claims payment and reinsurance recoverables

Companies will also need to analyse, assess and document the effectiveness of all of the risk mitigation techniques used.

In relation to asset liability management, the risk policy will need to at least cover:

- A description of the procedure for identifying and assessing different natures of mismatches between assets and liabilities, at least with regard to term and currency
- A description of any risk mitigation techniques and the expected impact of those techniques in respect of asset liability management
- A description of deliberate mismatches allowed
- A description of the underlying methodology and frequency of stress tests and scenario tests to be carried out

There are a significant number of detailed elements which must be included in the risk management policy in respect of investments. These include:

- The level of security, quality, liquidity, profitability and availability the company is aiming for with the whole investment portfolio and how it intends to achieve this

- Its quantitative limits on assets and exposures, including off-balance-sheet exposures
- Consideration of the financial market environment
- The conditions under which the undertaking can lend or pledge assets
- The link between market risk and other risks in highly adverse scenarios
- The procedure for appropriately valuing and verifying investment assets
- The procedures to monitor the performance of investments and review the policy where necessary
- How assets are to be selected in the best interest of policyholders and beneficiaries

In addition, when a company uses derivatives, it should implement the procedures in line with its risk management policy on investments to monitor the performance of the derivatives.

In respect of liquidity risk, the risk management policy will at least need to cover:

- The procedure for determining the level of mismatch between the cash inflows and cash outflows of direct insurance and reinsurance contracts (e.g., premiums, lapses or surrenders)
- Consideration of total liquidity needs in the short and medium term, including an appropriate liquidity buffer to guard against a shortfall
- Consideration of the level and monitoring of liquidity assets including a quantification of potential costs or financial losses arising from a forced sale
- Identification and costs of alternative financing tools
- Consideration of the effect on the liquidity situation of expected new business