

Reviewing your Risk Appetite Statement

Presented by
Mike Claffey

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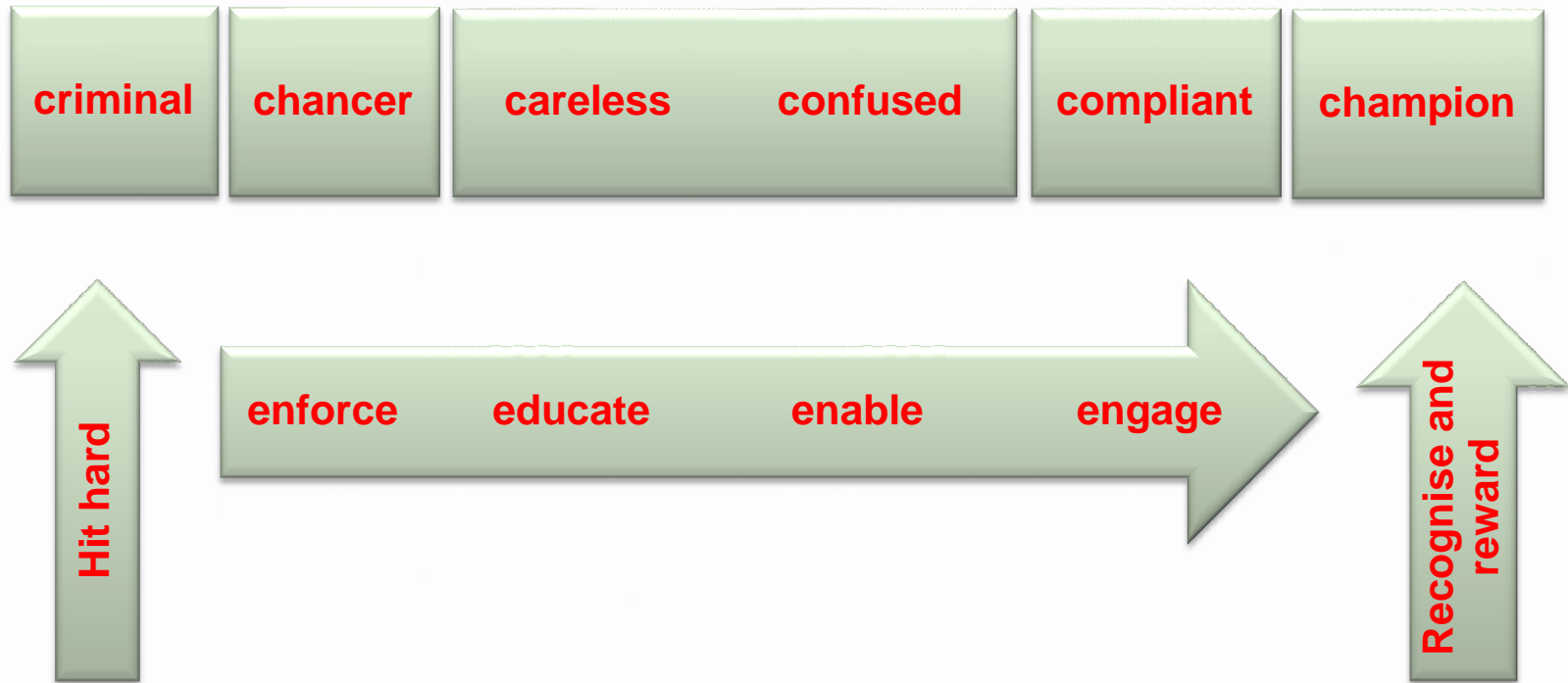
Introduction to Risk Appetite Statements

WHAT WE KNOW



Ron Francis
Skateboard, Oil on
canvas, 110 x 110 cm

Real world target regulation



Source: Professor Campbell Gemmill CEO Scottish Environment Protection Agency

Risk Appetite Statements are a Regulatory Requirement

- You may have some or all of:
 - Chief Risk Officer ('CRO')
 - Risk Register (management input, log, matrix of probability and impact)
 - Risk Policies (liquidity, insurance, counterparty, market, operational, etc).
Typically Board approved.
 - **Risk Appetite Statement**
 - Risk Monitoring (dashboard – 'RAG' status)
- More Board papers, more formal decisions
- And a Solvency II implementation project!

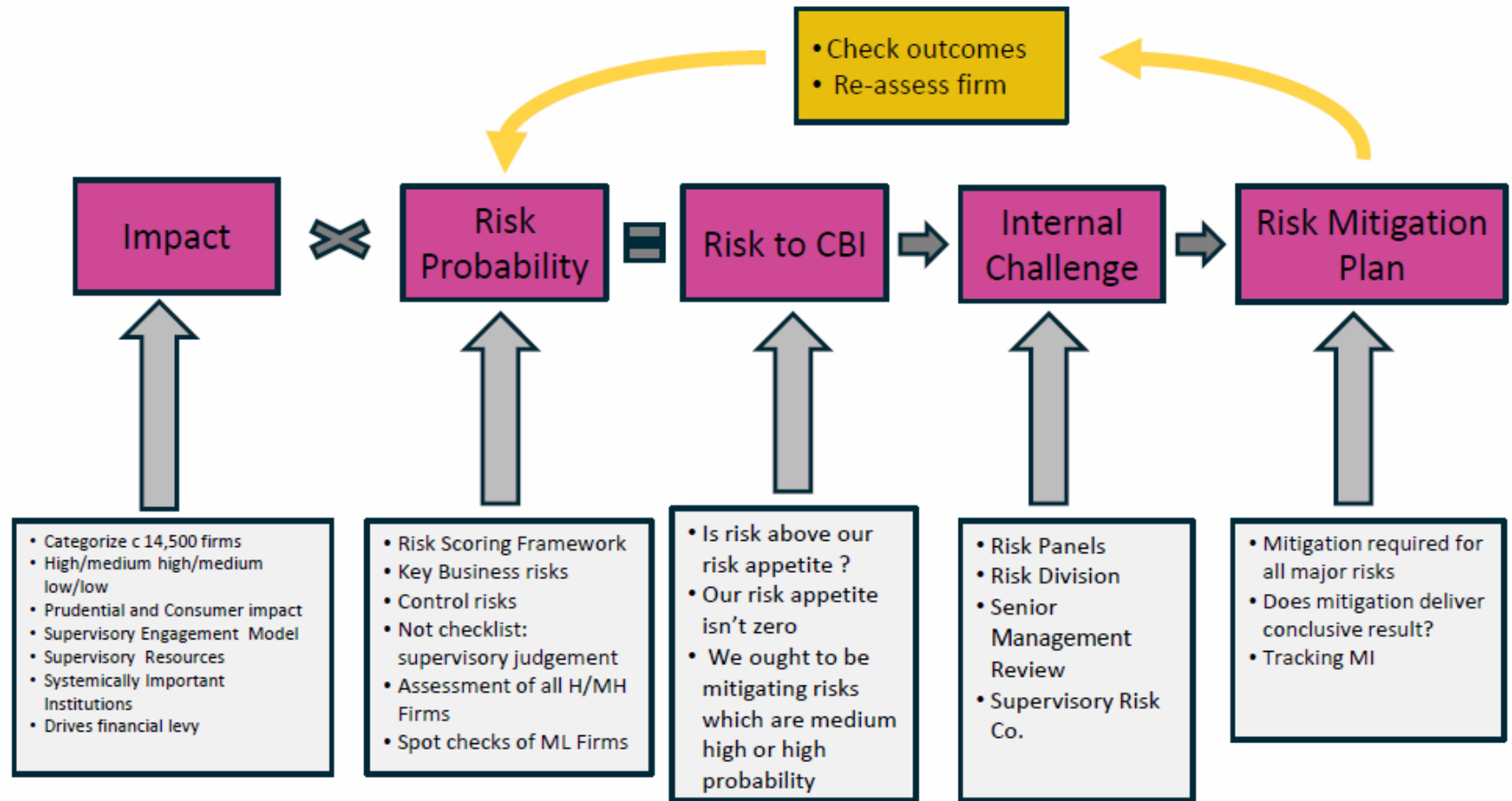
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Some comments aimed at Boards and INED's ...

- We expect that the Board wants a stable, well regulated, adequately capitalised, profitable enterprise with a prudent risk appetite that is linked to its strategic business model
- ...
- Insist the risk/reward trade is clearly defined with clear risk appetite statements & risk limits, ongoing monitoring of risk with reporting at board level for breaches

CBI industry briefing 12 October 2011

PRISM Overview



Safeguarding Stability, Protecting Consumers

CBI letter to industry 22 December 2011

RAS issues that may require further attention:

1. Approved by the Board
2. Include all material risks (underwriting and market risk mentioned)
3. Quantitative as well as qualitative ...measurable and quantifiable (not just current solvency)
4. Short, medium and long term horizons (e.g. over the cycle)
5. Clear trigger levels for each material risk
6. Escalation procedure
7. Who is responsible for monitoring and escalation
8. Communicated to all relevant staff

Possible response

Approved by the Board

- Board action

Include all material risks

- CBI PRISM headings or Solvency II? (next slide)

Quantitative as well as qualitative ...

- Identify target drivers for risk headings (see later slide)

Short, medium and long term horizons (e.g. over the cycle)

- See later slide

Clear trigger levels for each material risk

- Internal and external reporting – events notification

Escalation procedure

- Document an appropriate policy (CRO)

Who is responsible for monitoring and escalation

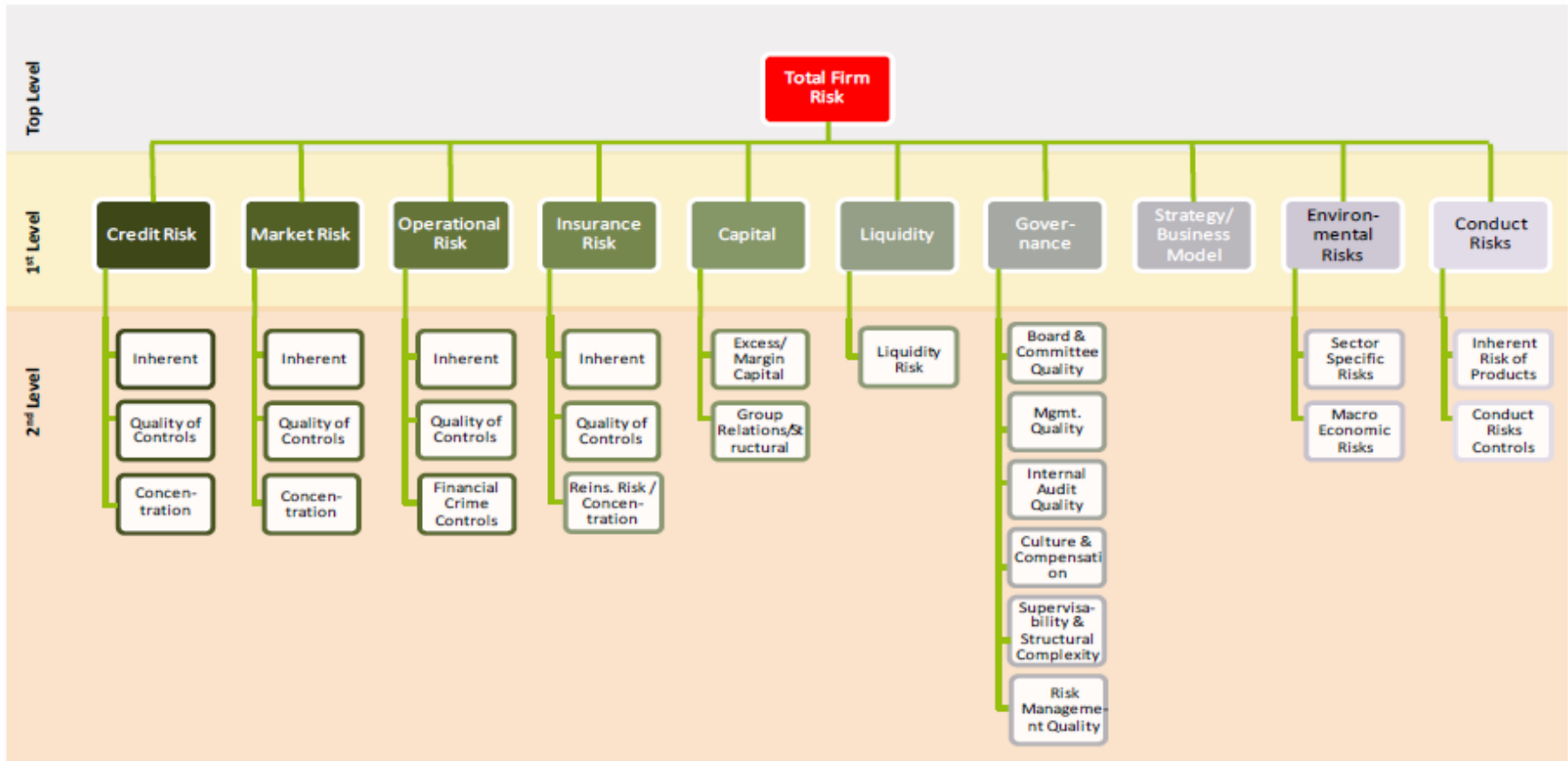
- Document an appropriate policy (CRO)

Communicated to all relevant staff

- Define 'relevant' – maybe all staff?

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Risk Probability – we will require our supervisors to make structured judgements on the risks their firms present



The mechanics


RISK APPETITE STATEMENTS

Building a risk appetite statement


Risk Appetite – Statement of business strategy and objectives



Risk Tolerances – definition of risk categories and subheadings, and acceptable variances



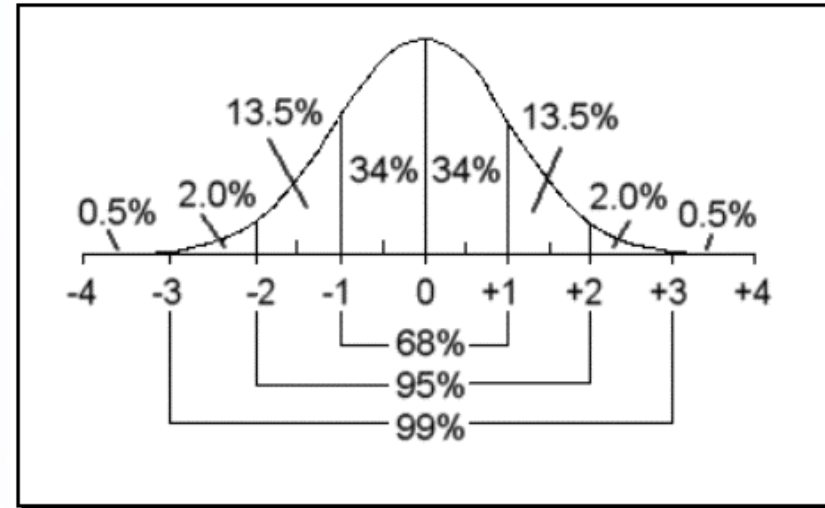
Risk Limits – maximum and minimum, gross and net of controls, plus risk mitigations



Allocation of responsibilities, Metrics and Reporting

The science bit

- Identify your input drivers
- Identify a range of outcomes
- Examples
 - Profits = F(premiums, products, expenses, markets, reserves)
 - Capital = F(premiums, products, expenses, markets, reserves)
 - Ex-gratia payments = F(target market, distribution, admin)
- Your risk tolerance statement
 - Plot your range of outcomes
 - Identify your target outcome (e.g. 1 in 200 = 99.5%, 1 in 5 = 80%)
 - Back-solve for the trigger input drivers
- Works well when you have lots of data!



A model to use when thinking of RAS

- Identify your management levers ('input drivers')
 - New business (open or closed)
 - Products sold (pricing, countries, experience, SP or RP)
 - Administration (outsource, insource)
 - Distribution Channels (broker, direct sales, banking partners)
- How far forward do you plan?
 - Typically 12 months, with a 3-5 year following 'trend'
 - Note underlying reserves are long term (whole of life)
- How volatile is your recent past?
 - Earnings, capital, liquidity, etc (under your risk headings)

Addressing the long term

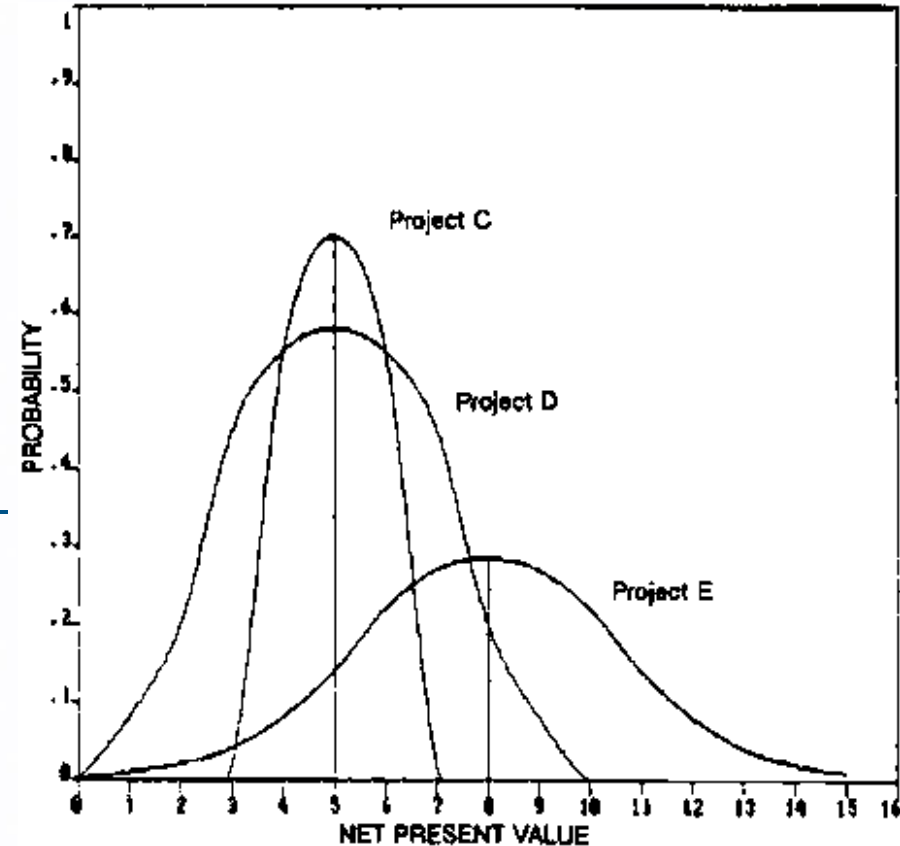
- What can you do now that will have implications in 10+ years?
 - Sell small volume of whole of life business and large volume of fixed term business (e.g. Italy)
 - Sell business with later administration consequences – premium reviews, “lifestyle” switching, pension payment options
 - Sell long dated guarantees (investment, longevity)
 - Close to new business
 - Outsource (or insource) admin
 - Build up illiquid solvency assets (e.g. Italian substitute tax asset, but also BEL (VIF) under Solvency II)

Long term (cont ...)

- What happens in the long term?
 - Analyse your cash reserves – long term mortality or expense strain?
 - Investment guarantees – range of outcomes, hedging, liquidity
 - Small unit linked policies – low amc income, high expenses?
 - Consequences of high or low lapses?
- Closed Fund – how to manage a small portfolio of policies
 - Trying to merge small life companies, or selling as run-off vehicles
 - How to ultimately liquidate a life company?
- Extreme scenarios – breakup of Euro, demographic catastrophes, technology change

Scenario planning and testing

- Business planning (typically 3-5 years), scenarios for Group
- Financial Condition Report (regulatory requirement)
- Reverse Stress Test (FSA concept – what “kills” the company?)
- Identifying and rehearsing your variance of outcomes



The practice

RISK APPETITE STATEMENTS

Can monitoring only be retrospective?

- Current and historic trends on key metrics – solvency cover, profits, sales, expenses
- Actual versus expected (typically against 12 month budgets)
 - Annual budgets – earnings, capital, dividends
 - Quarterly reforecasting – typically to year end for Group planning (so IFRS, or EV measures)
 - Five year projected solvency cover (FCR) – rarely produced more than annually (often triennially only)
 - ‘Step change’ plans – licence extension, new markets, closure, developments

Forward looking

- What level of uncertainty do you face?
 - Uncertain solvency cover, profits, sales, investment markets, TPA delivery, new product ideas?
- Recalculate confidence intervals around current key metrics
 - Current solvency buffers (e.g. resilience shocks)
 - Various scenario outputs from business plan
- Ask about business plans that are never achieved (e.g. 50% of target achieved year on year)
 - Perhaps split business plans into “known” (e.g. inforce), “likely” (e.g. new business 2012), and “possible” (e.g. Group ambitions to achieve market share)
 - Do you need a “risk appetite” for accurate business planning?

Company stereotypes – long term view

	Short	Medium	Long
New Company	3 year capital buffer, recruitment, getting sales	Date for breakeven (e.g. dividends)	Viable model
Single Country, Single Distributor	Next product / tranche delivery	Concentration risk, ops efficiency	Strategy conflicts
Multiple Countries, simple products	Finding distribution, capital	Operational efficiencies, breadth of activities	Ultimate size and capacity?
Multiple Countries, complex (e.g. VA)	Pricing, risk mitigation	Solvency risk rather than liquidity risk	Cost of guarantees
Run-off	Reserves	Credible exit plan	Final liquidation

Other points

- How do you discuss your risk/reward appetite?
 - Return on capital (hurdle rate from shareholder)
 - How about maximum level of expected profits?
 - Or single source of profits (e.g. one product grouping)?
 - How about maximum level of commission?
- How about diversification targets?
 - Balance within product groups (term cover versus annuity)
 - Country or product silos (profit stability)
 - Correlation of risks – which ones are really independent?
- Should capital measures be on Solvency I or Solvency II?

Think of risk budgets, not risk ‘appetites’

Business planning – financial consequences

Budgets

Risks

Sales

Expenses

Market returns

Minimise

Enterprise risk management – risk consequences

Priorities

Allocate Capital

Risks

Management

Financial

Variances

Summary

- Risk Appetite Statements are relative – be clear on your audience
- You avoid some risks, and manage others to target
- This is a measurement exercise – targets, actuals, commentary on variances
- Need to widen the awareness – think about staff briefings
- Work on the “use” test – consider RAS consequences within any financial planning work

Further information

APPENDICES

Available materials - RAS

- CBI Corporate Governance Code
 - PRISM
 - CBI industry briefings (e.g. INED briefing in October 2011)
 - CBI industry letter (December 2011)
 - Milliman review of current practice (September 2011)
 - Solvency II materials – mostly ORSA related
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- Risk Appetite Statement (as per CBI) = “All material risks that the company is exposed to”

Risk Categories – IAA / IAIS headings

Risk Category	Modelling Technique(s)
Enterprise /all risk categories	<ul style="list-style-type: none"> • Dynamic Financial Analysis
Underwriting (including reinsurance)	<ul style="list-style-type: none"> • Financial Condition Report (FCR) and/or underwriting modelling or reviews
Market	<ul style="list-style-type: none"> • Value at risk (VAR) or Tail VAR • Interest rate models • Scenario tests
Credit	<ul style="list-style-type: none"> • Credit risk models
Liquidity	<ul style="list-style-type: none"> • Asset/Liability modelling
Operational	<ul style="list-style-type: none"> • Internal loss data • External loss data • Scenario analysis, simulations

Further references and sources

- Society of Actuaries in Ireland – “Constructing a Risk Appetite Framework: an Introduction” (plus useful links in appendices)
- International Actuarial Association – “Note on Enterprise Risk Management for Capital and Solvency Purposes in the Insurance Industry” (which refers to IAIS guidelines)
- Institute of Actuaries of Australia – “Risk Appetite: Practical Issues for the Global Financial Services Industry”

Appendix - Extract from Corporate Governance Code

14.0 Risk Appetite

- 14.1 The board is required to understand the risks to which the institution is exposed and shall establish a documented risk appetite for the institution. The appetite shall be expressed in qualitative terms and also include quantitative metrics to allow tracking of performance and compliance with agreed strategy (e.g. Value at Risk, leverage ratio, range of tolerance for bad debts, acceptable stress losses, economic capital measures). It shall be subject to annual review by the board.
- 14.2 The risk appetite definition shall be comprehensive and clear to all stakeholders. The definition shall clearly define the appetite and address separately the short, medium and long term horizons.
- 14.3 The board shall ensure that the risk management framework and internal controls reflect the risk appetite and that there are adequate arrangements in place to ensure that there is regular reporting to the board on compliance with the risk appetite.
- 14.4 In the event of a material deviation from the defined risk appetite measure, the details of the deviation and of the appropriate action to remedy the deviation shall be communicated to the Central Bank by the board promptly in writing and no later than 5 business days of the Board becoming aware of the deviation.
- 14.5 The board shall satisfy itself that all key Control Functions such as internal audit, compliance and risk management are independent of business units, and have adequate resources and authority to operate effectively.
- 14.6 The board shall ensure that it receives timely, accurate and sufficiently detailed information from risk and Control Functions.
- 14.7 The board shall ensure that the institution's remuneration practices do not promote excessive risk taking. The board shall design and implement a remuneration policy to meet that objective and evaluate compliance with this policy.