Risk Appetite

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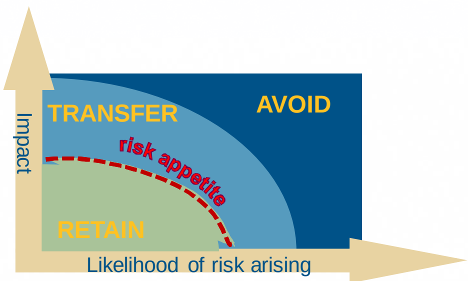
What is risk appetite?

- Risk appetite is the degree of risk that an organisation is willing to accept in order to achieve its objectives, both in terms of levels and types of risk.



- The level of aggregate risk that a company can undertake and successfully manage over an extended period of time.
- A company's ability and/or willingness to absorb declines in the value of an asset, liability, trade, transaction, or portfolio.
- The broad-based amount of risk a company or other entity is willing to accept in pursuit of its mission or vision

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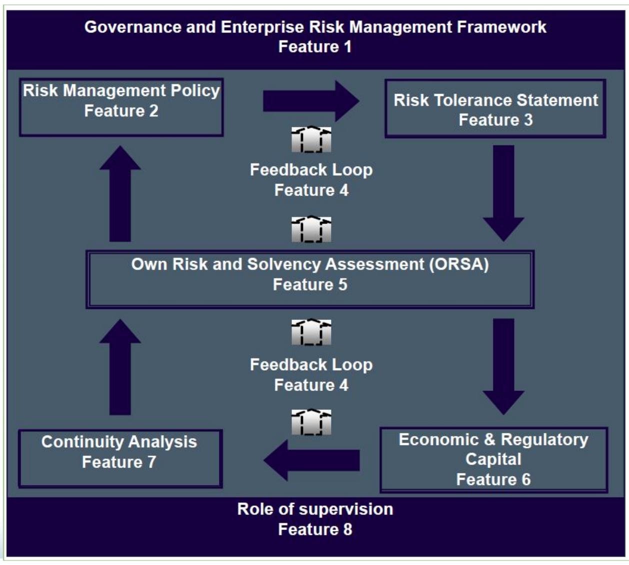
Regulatory perspective (IAIS)



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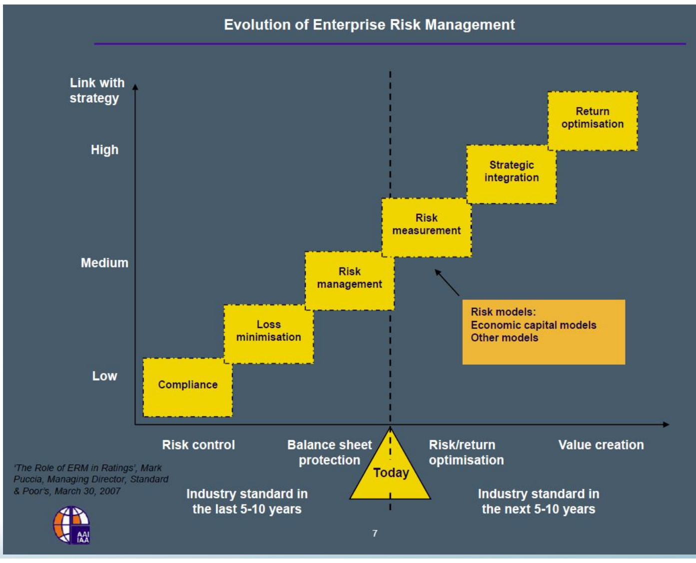
Credit ratings view of ERM



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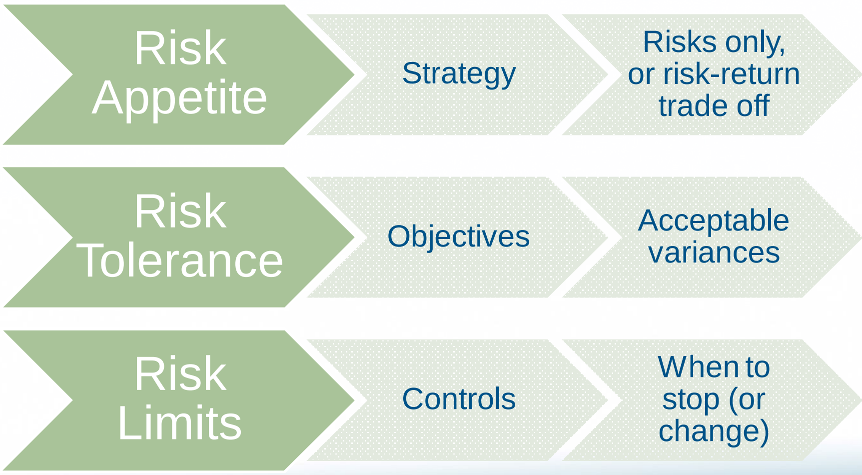
Terminology



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Solvency II and risk appetite

- The Solvency II Directive says *"insurance and reinsurance undertakings shall have in place an effective **risk management system** comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, on an individual and aggregated level, to which they are or could be exposed, and their interdependencies".*

- CEIOPS Final Advice (former CP33) calls for *"A clearly defined and well documented **risk management strategy** that includes the risk management objectives, key risk management principles, general risk appetite and assignment of risk management responsibilities across all the activities of the undertaking and is consistent with the undertaking's overall business strategy;"*

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Central Bank of Ireland and risk appetite

- Central bank's Corporate Governance Code states

  "The board is required to understand the risks to which the institution is exposed and shall establish a documented risk appetite for the institution."

- Requirements
  - Qualitative and Quantitative Metrics required (VaR, acceptable stress losses etc)
  - Assess short, medium and long term horizons
  - Regular reporting to the board on compliance
  - Annual review
  - Material deviation and proposed remedies reported to Central Bank within 5 days
- Compliance with the code must be ensured by 30th June 2011.

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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

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Risk Appetite – General Points

- Insurance companies in business to take risk
  - Which risks do they want to run?
  - Which risks do they want to minimise?
  - How much risk do they wish to take?

- Board responsible for defining risk appetite
  - Quantitative or Qualitative

Quantitative	Qualitative
Capital sufficient to absorb all losses over next year with 99.5% probability	Don't wish to take longevity risk

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Identifying your risks

- Market
- Underwriting / insurance (mortality, morbidity, persistency)
- Operational / outsourcing
- Liquidity
- Credit (counterparty)

- Sales volume / Distributor
- Exchange Rates
- Shareholder

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Risk Categories – IAA / IAIS headings

Risk Category	Modelling Technique(s)
Enterprise /all risk categories	• Dynamic Financial Analysis
Underwriting (including reinsurance)	• Financial Condition Report (FCR) and/or underwriting modelling or reviews
Market	• Value at risk (VAR) or Tail VAR • Interest rate models • Scenario tests
Credit	• Credit risk models
Liquidity	• Asset/Liability modelling
Operational	• Internal loss data • External loss data • Scenario analysis, simulations

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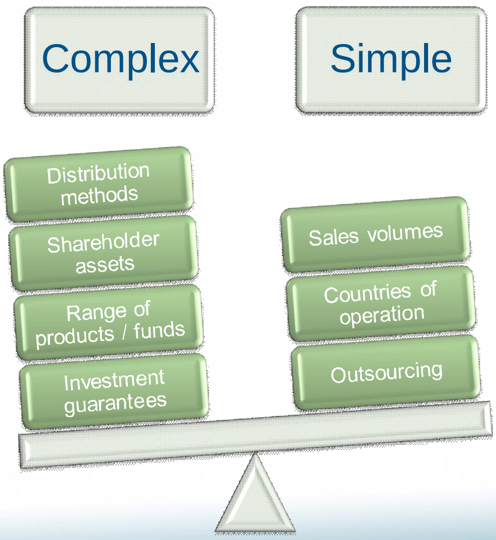
Spectrum of risks



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Setting Risk Appetite objectives

- Involves consideration of various stakeholders (board, parent, policyholders, regulator)
- Objectives of stakeholders might conflict

Objective	Criteria
Adequate capitalisation	• Maintain regulatory requirements • Meet target economic requirements (Risk capital)
Stable profitability and growth	• Maintain earnings stability • Limits on maximum losses in 1-in-200-year event
Sufficient liquidity	• Maintain debt coverage ratio • Continued ability to pay dividends
Sound reputation	• Avoidance of regulatory sanctions • Maintenance of high standards of corporate governance

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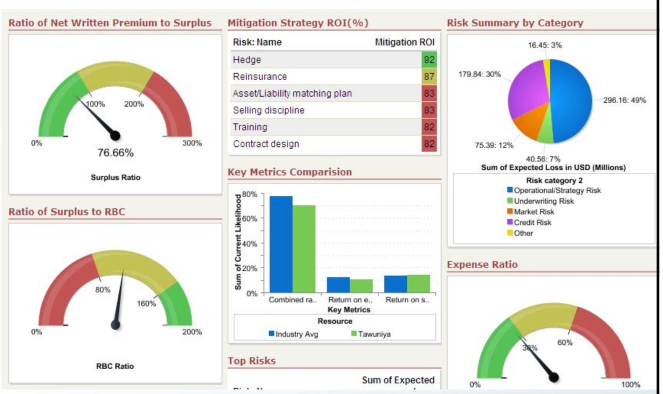
Risk Reporting

- Risk Dashboard
  - Current and emerging risks
  - Trends
- Variety of measures
  - Economic capital
  - Key risk indicators
  - Key residual risks
- Tailored
  - Internal
  - External



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Possible starting points in your company

- 3 or 5 year business plan (medium term plan)
- Risk Register – usually owned by risk management function
- Actuarial Financial Condition Report
- Economic Capital models – often group-wide
- Internal Audit – assessment of risk based audit activities
- UK ICA style assessments – e.g. “Pillar 2” assessments
- Solvency II (Risk Function and CRO)
- Any Board statements on “Strategic” Solvency Cover

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Summary

- A Board approved Risk Appetite is required by 30 June
- Quantitative and Qualitative components
- Risk Appetite – Risk Tolerance – Risk Limit
- Ensure a Board reporting process is in place
- Identify risk controls, and action plans for remedies on a breach
- Need to have clear breach notification process

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Appendix - 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.