

Risk Appetite Statements – one year on

May 2012



As the first anniversary of the deadline for implementation of the Central Bank of Ireland's "Corporate Governance Code for Credit Institutions and Insurance Undertakings" fast approaches, many risk appetite statements will be undergoing their first annual review. We look at some of the key questions that could form part of this review process.

REMINDER OF THE REQUIREMENTS OF THE CORPORATE GOVERNANCE CODE

The Corporate Governance Code sets out a number of requirements specific to the construction and maintenance of risk appetite statements, including:

1. Use of both quantitative and qualitative metrics on risk appetite
2. Annual review
3. Comprehensive and clear to all stakeholders
4. Address short, medium and long term horizons
5. Regular reporting on compliance with risk appetite

There are a number of additional requirements in relation to risk appetite, such as the requirement that any material deviation from stated risk appetite be reported to the Central Bank within five business days of the Board becoming aware of any such deviation. Further requirements are also placed specifically on the Board, such as the requirement to ensure that remuneration practices do not promote excessive risk-taking by the undertaking.

The deadline for putting in place board-approved risk appetite statements was 30th June 2011. Therefore, the first anniversary is approaching and the risk appetite statement is subject to annual review by the Board. To assist with this task, we have compiled a checklist of key questions against which to measure the current risk appetite statement of your organisation. This could help to identify areas where change is needed. Not all of these questions will necessarily be relevant to all companies though.

LETTER TO INDUSTRY

On 22nd December 2011, the Central Bank wrote to all insurance and reinsurance undertakings to share the results of its review of a sample of risk appetite statements. The outcome of this review was that, in the opinion of the Central Bank, the general quality of risk appetite statements that it reviewed was not of

"an acceptable standard". The Central Bank went on to identify areas where improvement may be needed, namely:

1. The risk appetite statement must be board-approved
2. All material risks must be included
3. Risk appetite must be expressed in quantitative terms as well as qualitatively
4. Risk appetite should be addressed separately over short, medium and long term horizons
5. There must be clear trigger levels for each risk (allowing time for remedial action) including "material breach" limits
6. Escalation procedure must be clearly documented and communicated
7. Whoever is responsible for monitoring and escalation must be identified in the statement
8. The risk appetite statement must be communicated to all relevant staff

The letter also stated quite clearly that "a Risk Appetite Statement written solely in the context of current solvency capital requirements is not acceptable."

KEY QUESTIONS FOR FIRMS

Against the backdrop of the Central Bank's letter and given the requirement for an annual review, firms may wish to consider the following questions when reviewing their risk appetite statement:

- Have the recommendations contained in the letter from the Central Bank to industry been reflected in your risk appetite statement?
- Which of the following risks are explicitly mentioned in your risk appetite statement:
 - Operational;
 - Insurance;

- Market;
- Liquidity;
- Counterparty;
- Reputational;
- Regulatory;
- Strategic?
- Does your risk appetite statement aggregate risks across the company?
- Does your risk appetite statement align with the strategic objectives of the organisation?
- Has there been a material change in the risk profile of your organisation over the year since the risk appetite statement was first implemented?
- Does your risk appetite statement focus on the economic balance sheet of the undertaking or only the current solvency balance sheet?
- Is there a good mix of quantitative and qualitative metrics (i.e. what is the overall proportional split between these two types of metric)?
- Are your risk metrics prospective or retrospective or is there a mix of both?
- Does your risk appetite statement include user-friendly metrics and reporting dashboards?
- Does your risk appetite statement use any early warning signals, e.g. a “traffic light system”, to signal potential issues in advance?
- Does your risk appetite statement contain an overall statement of risk appetite at the company level (similar to, say, a mission statement)?
- Were all key stakeholders consulted in the latest revision to the risk appetite statement?
- Are local and group (where appropriate) risk appetite statements aligned?
- How is risk appetite communicated throughout your organisation?
- Has all of the terminology used within your risk appetite statement been clearly defined so that it can be easily understood by all stakeholders?
- Does your risk appetite statement explore risk preferences/budgets (i.e. the types/amounts of risk that stakeholders would like to take on)?
- Is your risk appetite statement focussed on minimising risk or on achieving the right balance between risk and reward?
- Does your risk appetite statement mention the remuneration policy of the organisation?

NEXT STEPS

If the risk appetite statement of your organisation hasn't yet been through its first annual review we hope that you will find this checklist a useful resource in identifying possible changes and improvements that could be made ahead of the required annual review. Where relevant, these changes could help to improve the usefulness of the risk appetite statement as well as more closely meeting the needs and expectations of each of the various stakeholders.

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