# INTERNAL RISK REPORTING FOR INSURANCE COMPANIES

by Abhishek Kumar

Do the Board, management and risk committees understand company's risk exposures? Are risk- taking activities in line with internal risk policy and risk management standards? Is capital planning integrated with business planning? Does senior management have adequate information on a regular basis to take strategic decisions confidently? And so on. These are some questions actuaries and other members of senior management team often struggle to answer when queried by various stakeholders such as the regulator, capital markets, credit rating agencies, external auditor and shareholders.

Finance and actuarial teams in insurance companies work extensively to generate ever more granular and increasing amounts of financial information for internal and external stakeholders; so where is the missing link? Analysis of internal risk reporting and its alignment with external reporting is therefore critical to identify the missing link.

This article considers some examples of regulatory developments in the UK illustrating the regulator's expectations on risk-reporting, although similar developments are expected or happening in other jurisdictions, increasing focus from external agencies and some key considerations for risk reporting.

**Regulatory Backdrop (UK)**

1. **Dear CEO Letter**[1]**:** FSA released a proposed "Dear CEO Letter" in November 2010 highlighting its observations on senior ALM committees' practices based on in-depth reviews conducted for large and small banks, building societies, overseas banks operating in UK and some large investment firms. Key observations included:

- **Composition and authority:** It was observed that most effective senior ALM committees appeared to be those that are chaired routinely by the CEO.
- **Forward-looking**: Reviews highlighted a focus on monitoring and commenting on the past rather than proactive management of future.
- **Degree of challenge:** The degree of challenge observed at the committees was hard to identify and FSA expects the minutes of the ALM meetings to give non-attendees insight into discussion and challenge which took place.

Although the above reviews were conducted for banks and investment firms, it is expected that insurance companies will equally qualify for such reviews in the UK, currently also being done under FSA ARROW framework, and overseas by their respective regulators, particularly in light of increasing harmonisation of regulations across the globe and financial services as evidenced by Solvency II and Basel III.

2. **Solvency II – Own Risk and Solvency assessment (ORSA):** Article 44 (Risk Management) and Article 45 (ORSA) of Level 1 directive and respective Level 2 implementing measures clearly set out the need for insurance companies to have *"reporting procedures processes which ensure that information on the material risks faced by the undertaking and the effectiveness of the risk management system are actively monitored and analysed and that appropriate modifications to the system are made where necessary".*

   Further, ORSA guidelines stress the need for communication of ORSA results to internal stakeholders. ORSA results should not only include views and assessment of the current risk profile but also an assessment of future changes to the risk profile by considering forward-looking projections in a wide range of scenarios, not just limited to 1:200. These guidelines also mention the need for a link between capital management and business management possible using the risk appetite framework.

   Although Solvency II is applicable in EEA countries, consideration to these requirements should be given if other jurisdictions desire equivalence in future, in particular in key markets such as US.

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**Increasing focus from external agencies**

External stakeholders such as credit rating agencies and capital markets have increasingly been focussed on the Enterprise Risk Management (ERM) in assessing and rating a company's worth. For Standard & Poors (S&P), ERM is one the eight major rating factors[2] for rating insurance companies. In its ERM reviews, S&P actively look for evidence that the companies thoroughly understand their risk profile by way of a statement of risk tolerance and risk appetite communicated through the Board meeting minutes and risk reports presented to the Board regularly, presenting actual risk positions versus risk limits. Further S&P expect management to discuss and document in detail how business decisions are consistent with company's risk appetite.

**Key aspects of internal risk reporting**

Against this regulatory backdrop and with the growing focus on risk management within insurance

1 Source: http://www.fsa.gov.uk/pubs/guidance/ceo_10_06.pdf
2 Source: Standard & Poors

companies, this article raises some key aspects for the audience to consider in their risk reporting work or to those who intend to introduce efficient risk reporting processes in their companies.

***Do you have a clearly defined risk reporting framework?***

Risk reporting covers a wide variety of information reporting i.e. it could be regulatory reporting such as solvency ratios, reporting for shareholders such as IFRS & MCEV profits or for risk management such as comparison of exposure with risk limits. Further, it could cover metrics from just solvency ratios from capital management perspective to reporting of earnings and economic profits business management perspective.

It is therefore critical to define the characteristics of the risk reporting framework. Characteristics include:

- **Governance:** It is important to identify the relevant owners and stakeholders of risk-reporting information/reports to attach the importance to the reporting process. Consideration should be given to the business governance structure, structure of Executive and Risk committees and their Terms of Reference, any overlaps between the information requirements for these committees. Further, consideration should also be given to whether the reporting information is outcome based (e.g. capital impact) or risk-driver based (e.g. underlying lapse rates) as the sources of required information could be different. A strong control framework for reporting processes is also critical to ensure the quality of reporting information.
- **Scope:** This includes the decision on businesses in scope for reporting (e.g. only life business on the basis of materiality on IFRS profits, capital etc.), risks in scope (e.g. only market, longevity and expense risks for a pension fund) and time horizon (e.g. one year risk perspective for capital management, quarterly monitoring for liquidity risks etc.) over which risk reporting is done. Most companies intend to monitor risks over the business-planning period, which generally ranges from 3-5 years.
- **Alignment with risk management framework:** Risk reporting is one of the pillars of risk management framework. In order for risk monitoring mechanism in the framework to work, companies need relevant metrics, which are in line with the risk policy, strategy and appetite. Risk reporting practices could range from just reporting the risk exposure to comparison of these exposures with risk appetite and risk limits approved by Board and reporting any breaches of these limits. The risk reporting framework defines the type of risk metrics to be covered in risk reports and answers the question – are the metrics for capital management or are the metrics for business management? For example, capital management metrics could be based on 1:200 scenarios for regulatory capital while 1:50 or 1:100 scenarios for business management (generally in line with the risk appetite framework).
- **Risk reports and frequency:** Risk reporting framework should define the type and frequency of risk reports to be produced – should the reports be just quantitative or qualitative as well? For example, risk exposure reports, a quantitative report, could be produced monthly while key risk report, generally a qualitative report by CROs, could be produced quarterly. The framework should also define the level of information, which needs to be reported for different audiences. For example, while Board may just be interested in Risk Dashboard (usually a 1-2 page summary of key risks with traffic lights), members of investment committees and risk committees may prefer full reports and detailed analysis. Risk reports should also be in line with the Terms of Reference for various committees.
- **Links to external reporting:** Lastly, the purpose of a risk reporting framework is to ensure an efficient reporting and hence, wherever possible, existing sources of information from external reporting or vice versa should be leveraged. For example, internal risk reports could show the link to external statutory reports or market reports.

***Is your risk reporting fit for purpose?***

Once the reporting framework has been defined, it is important that it is regularly reviewed to ensure that it is fit for purpose. Some key aspects for the audience to consider are:

- **Risk Taxonomy:** Is the definition of various categories of reported risks in line with the understanding of risks in the organisation and how the business is managed? For example, the investment team might be managing default risk within the credit risk rather than on a stand-alone basis but the reported risk exposure for credit risk in various risk-reports might exclude the default risk. This does not provide a 'like for like' comparison of exposure vs limits. An inconsistent taxonomy used between the risk reporting and business management results in the loss of relevance of risk reporting information for the front-end business functions.
- **Upside vs downside risks:** Most of us would agree that the main purpose of risk reporting is to control the downside risks. Companies, however, might be interested in tracking the upside opportunities and want to include internal information such as benchmarking of risk-adjusted returns and economic profits between products and businesses for capital allocation purposes and external information such as market ratios and competitor analyses.
- **Accuracy vs agility:** Companies should also consider the balance between accuracy of metrics and agility with which they can be reported. It is no point reporting 99.99% as compared to 97% accurate information if it takes a month to compile the former and the numbers lose their relevance. In taking a decision, companies should consider the sensitivity of overall results to the accuracy of the information.

- **Risk measures:** Risk measures can be outcome based or risk-drivers based. Outcome based measures would include measures such as impact on capital, MCEV & IFRS profits, return on equity while risk-drivers based measures will include measures such as underlying investment return, spread volatility, number of counterparties and asset exposure. Generally, risk reports will be a combination of both types of measures.

- **Forward looking view:** Risk reporting would not only include point in time reporting (e.g. capital at risk) and retrospective analysis (e.g. lapse rates trends or investment yields), it would also cover aspects such as "What-if scenarios" or reverse stress testing with any future management actions. The forward-looking view might include key emerging risks such as sovereign crisis, pandemic or climate changes.

***Do you have capabilities to produce reporting information on a regular basis?***

Developing a risk reporting framework can be time-consuming as well as cost intensive. Therefore, companies should evaluate, at an early stage, the future requirements in order to generate regular reporting information. An overriding principle should be to produce the information once and only once, so that risk of duplicating information and providing inconsistent information for different users is mitigated. Requirements, although not limited to, include:

- **Systems:** Generating risk reporting information often includes significant changes/enhancements to IT systems such as investment management systems, policy administration systems or business data storage tools. In particular, companies with presence in different geographies strive to achieve a consistent set of risk reporting framework and this often involves building common data management hardware. Companies should therefore carefully consider involving stakeholders such as IT teams while building or enhancing the risk reporting framework.

- **Skills and resources:** Companies should consider whether they have sufficient skills and resources to analyse the data and produce the required risk reporting information and whether they need any investment in recruitment or training from an early stage. Companies should also consider whether new risk models need to built in order to provide certain risk reporting metrics.

***How is the risk reporting information used in the business?***

In order for the risk reporting framework to work and achieve its desired benefits, there must be a two-way feedback system between risk monitoring and business management. These could include activities such as:

- Regular feedback mechanism from business functions to assess whether they understand the risk reporting information and whether they use this information. The feedback should also include if the risk – reports provide enough commentary how the risks could be managed or "next steps".

- Integration of business planning and capital management

***Is the discussion in Executive committees on risk metrics appropriate and sufficient?***

Following questions should be considered when assessing the effectiveness of discussions in the committees:

- *Are the senior committee members well engaged to understand the underlying approach and assumptions to calculate the key metrics?* If no, this implies there is either a better way to display the information or assumptions and definitions can be clearer. There also may be a need for training for newer members.

- *Are the conclusions arrived in the Executive committees' meeting same as those from the meetings with business functions* – If no, there is a risk that the perception of business lines and Executive committee differs.

- *Is the discussion mainly on retrospective compliance* – Management should discuss the planned future actions and not the compliance for each metrics. Monitoring of limits can be delegated to a sub-committee.

- *Are recommendations accepted without challenge* – Members should be given pros and cons of each recommendation and discussion should be documented.

**Summary**

In summary, in order to achieve most benefits from risk reporting, companies should have a clearly defined risk reporting framework with a fit-for-purpose reporting. In developing such framework, companies should consider the capability needs for skills and resources. Sufficient engagement with business functions is needed at early stage in order to build a risk reporting framework that adequately reflects the business risks and provides information to these functions on how to mitigate or manage these risks. Most importantly, the "Tone from the Top" is fundamental to success of this whole approach to risk reporting.

IDEAS MUST BE PUT TO THE TEST. THAT'S WHY WE MAKE THINGS, OTHERWISE THEY WOULD BE NO MORE THAN IDEAS. THERE IS OFTEN A HUGE DIFFERENCE BETWEEN AN IDEA AND ITS REALISATION. I'VE HAD WHAT I THOUGHT WERE GREAT IDEAS THAT JUST DIDN'T WORK.

**ANDY GOLDSWORTHY**