RISK AND REWARD

As new regulations such as Solvency II reflect an increasingly formal approach to risk management, ***Mark Butterworth*** *looks at the benefits a dedicated risk function can offer businesses*

The modern insurance industry was founded more than 300 years ago and the acceptance of risk is central to the role insurers play. While insurers have been in the business of carrying risk for centuries, it is only in comparatively recent times that a formalised approach to the management of risks across the organisation has been adopted.

Driven by changes demanded by corporate governance codes, the expectations of regulators and, more recently, the requirements of Solvency II, senior managers in insurance firms have developed a risk function in the business with the aim of controlling the undesirable aspects of risk taking and gaining the best rewards for the risks that are accepted through their insurance (or reinsurance) activities.

The Financial Services Authority made clear in its handbook that regulated firms "must establish, implement and maintain adequate risk management policies and procedures..." The same requirement has been carried forward by the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). The handbook does not define what constitutes 'adequate' risk management and many firms have adopted a framework described in the Risk Management Standard published by the Institute of Risk Management or the ISO 31000, Enterprise Risk Management Standard. Both provide a logical framework for risk identification, analysis and treatment – together with a system for monitoring and reporting of risks and controls.

Insurers have invested significant funds in the development of enterprise-wide risk management resources. Often headed by a chief risk officer (CRO), the risk management function takes responsibility for the coordination and monitoring of the formal risk management process. Where firms have a number of divisions or subsidiaries, the decision must be made on whether to centralise the risk team or to place risk specialists in each operation. Often a hybrid approach is taken, with the risk thought leadership being under the wing of the CRO in the corporate centre and risk managers in each unit responsible for ensuring compliance with the group risk strategy.

The risk management stance taken by a firm must be supported by the board and is usually encapsulated in a risk policy document. This describes the attitude to risk, the risk architecture in the firm, such as decentralised, the terms of reference for the risk committee and reporting requirements.

Firms seek to adopt a "three lines of defence" model, with functional managers (such as heads of underwriting or IT managers) carrying responsibility for the management of risks to their area – the first line of defence. The second line is the risk management team, which majors on ensuring that the risk management strategy is effectively operated. The third line of defence is the internal audit team, which monitors and assesses the effectiveness of the risk management framework. The risk team works closely with the internal audit and compliance teams in the assessment and monitoring of risk.

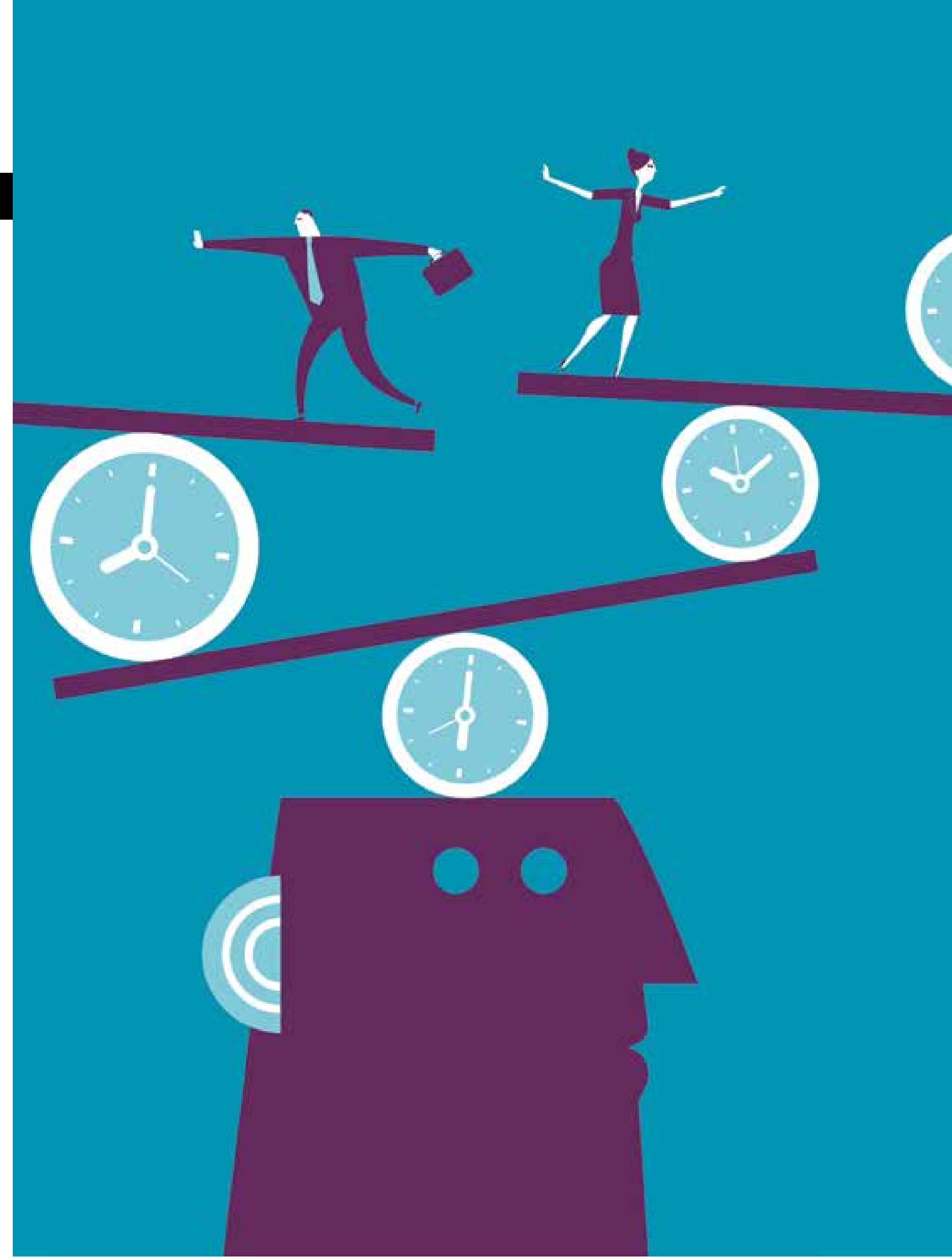

IMAGE: ISTOCK

Categorising the risks

So what are the risks that insurers face? Most firms use categories to organise their risk analysis, with strategic, insurance, financial, operational and group risks being very common categories. Selecting a defined strategy will entail balancing the risks associated with different business activities. Prudential, the UK life, pension and investment company, has a stated strategy to "focus on enhancing our position in Asia, the US and the UK – markets that offer us the greatest opportunity for sustained growth". Clearly, Prudential has a risk appetite to operate in these stated areas, ones it knows well, thereby avoiding the risks associated with venturing into territories it is less familiar with.

In regard to insurance risk, the firm will expect losses to occur and claims to be made under individual policies but the PRA defines insurance risk as "fluctuations in the timing, frequency and severity of insured events". So, the real risk to insurers is in claims being cumulatively higher than expected, either from a greater number of claims or from the costs of each claim exceeding levels assumed in the business plan.

Insurers use various risk control measures to address insurance risk. Steps are taken to avoid overexposure to losses from a single event, such as a flood, by monitoring insured values in real time in flood-prone areas to ensure the overall exposure is within the firm's risk tolerance. Individual underwriter authorities are limited to maximum values depending on the seniority of the underwriter. Similarly, claims settlement authorities are tightly controlled.

Insurance risk is also managed by the use of reinsurance. Depending on the insurer's risk appetite and risk-bearing capacity (its financial strength), major deviations from expected losses can be transferred to reinsurers, at an appropriate premium.

Financial risks

Insurers carry material financial risks, generally sitting under the three headings of market risks, liquidity risks and credit risks. Insurers manage huge sums of money in their accounts, including insurance premiums, claims reserves, operational capital, solvency capital and shareholders' funds. An investment strategy will be devised that minimises investment risk but creates the return the management has budgeted for in the business plan. Insurers need to manage liquidity risk, where funds are invested in a form and a period so that they are readily available should there be a sudden demand for cash to pay claims and meet expenses.

Insurers also have credit risk in the payment of premiums. However, this is largely managed through the requirement for payment of premiums in advance of cover commencing but credit exposure remains where the business is transacted through brokers.

Insurers' main credit risk is in regard to their reinsurers. A significant loss event such as an earthquake can place great strain on reinsurers and possibly lead to insolvency. Insurers endeavour to manage this risk by spreading their reinsurance purchasing across a number of reinsurers and seek to do business with those that have an acceptable credit rating, for example only using reinsurers with a rating of A+ and higher.

Operational risk

A significant source of exposure insurers carry is operational risk. These risks range from IT failures, health & safety, breach of regulation and fraud. An array of risk controls is employed to reduce or remove the exposure.

A firm that is part of a larger organisation will have 'group' risks. These are where the firm is exposed to business strain, for example where a company within the group suffers some serious form of loss and this consequently impacts the firm, perhaps through the loss of capital provided by the parent.

The type of risk and exposure levels the firm is willing to accept are detailed in a risk appetite and tolerance statement. Each operating division must monitor its risk exposures to ensure they remain within the required risk profile. The status of risks, particularly where risk tolerances are being breach, is reported to the risk management committee and the board on a regular (usually monthly) basis. A risk 'dashboard' is used to indicate deviations from the plan in the form of key risk indicators, such as numbers of policyholder complaints, IT downtime and claims settlement costs versus reserves.

Solvency requirements

All these risk management activities are assessed for the potential impact losses might have on financial reserves – the firm's solvency capital. Under the Solvency II requirements, insurers must calculate the appropriate solvency capital to support the risk profile of the firm. This activity forms the central part of the own risk and solvency assessment – the "ORSA". Solvency II also expects the management of the firm to have a clear understanding of the risks the firm faces and the potential volatility of results. The near-worst-case scenario must be assessed and the capital required to ensure that in 99.5% of cases, all claims and expenses can be met, must be held.

Developments in formalised risk management in the past 10 years have resulted in greater staff resources being allocated to the risk function. This specialism is becoming seen as a vital corporate management skill with excellent career opportunities – indeed, in many cases the chief risk officer is a member of the main board. Risk managers need exemplary personal skills as they are required to work across departments and businesses within the organisation and have excellent analytical abilities.

The CII is expanding the risk management component of its Advanced Diploma qualification, with new subjects being introduced in 2014. The benefit to insurance firms that invest in skilled risk managers will be improved business performance as risks to firms are better understood and managed.

Mark Butterworth, managing director, Condie Risk Consultancy