2011 SUERF Annual Lecture

Risk Management
– A supervisor’s approach

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Summary

❶ **Is risk management relevant for prudential regulation?**

❷ **Solvency II – A regime based on sound risk management principles**

❸ **Supervisors expectations – A guide, not a receipt**

❹ **ORSA – The heart of Solvency II**

❺ **The supervisory review process**

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Is risk management relevant for prudential regulation?

- ✓ Insurance and reinsurance undertakings are in the forefront of the application of **sound and robust practices of risk management**
- ✓ However, historically risk management has not been viewed has a relevant element of the insurance regulatory regime - This has **changed with Solvency II**
- ✓ Appropriate risk management is a **cornerstone of any modern risk-based regulatory regime** and consequently has its own role in the supervisory process
- ✓ "*Regulators should develop enhanced guidance to strengthen risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management*" - **FSB**

Solvency II – A regime based on sound risk management principles

- ✓ SII poses **heavy reliance on robust risk management practices**
- ✓ 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 to which they are or could be exposed
- ✓ Risk management under SII:
  - Is a **continuous process** that should be used in the implementation of the undertaking’s overall strategy
  - Should allow an appropriate understanding of the **nature and significance** of the risks to which the undertaking is exposed, including its **sensitivity** to those risks and its **ability to mitigate** them

Solvency II – A regime based on sound risk management principles

Key elements for a robust implementation

- ✓ It is the **ultimate responsibility of the management body** to ensure that the implemented risk management system is suitable, effective and proportionate
- ✓ The risk management system needs to be **documented and communicated** to the relevant management and staff to ensure it is embedded within the business
- ✓ An effective risk management system should **cover all material risks** the undertaking might be exposed to
- ✓ The risk management system shall be **integrated into the organizational structure** of the undertaking and into its **decision-making processes**

Solvency II – A regime based on sound risk management principles

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Key conditions for effectiveness

- ✓ A clearly defined and well documented **risk management strategy**
- ✓ Adequate **written policies** that include a definition and categorization of the material risks
- ✓ Appropriate **processes and procedures** which enable the undertaking to identify, assess, manage, monitor and report risks
- ✓ Appropriate internal **reporting procedures** and feedback loops
- ✓ A suitable own risk and solvency assessment (**ORSA**) process

Supervisors expectations – A guide, not a receipt

✓ Under Solvency II the **risk-management system shall be comprehensive**, covering at least areas like:

- **Underwriting** and **reserving**
- **Asset–liability management**
- **Investment**, in particular **derivatives** and similar commitments
- **Liquidity**
- **Concentrations**
- **Operational risk**
- **Reinsurance** and other **risk-mitigation** techniques

ORSA – The heart of Solvency II

- ✓ The ORSA aims at **enhancing awareness of the interrelationships** between the **risks** an undertaking is currently exposed to, or may face in the long term, and the **internal capital** needs that follow from this risk exposure
- ✓ The ORSA should help to **promote a strong culture of risk management**, and, more widely, in **soundly running the business**
- ✓ Introducing the ORSA is a **demanding task**
- ✓ There is **no mechanical way** of conducting an ORSA and often a **cultural change** is needed both at the board and in the organization
- ✓ It is a **top-down** process **(Models cannot replace leadership)**

The supervisory review process

Key areas to assess

- ✓ The **scope** and **nature** of **risk and capital measurement systems**
- ✓ The scope, frequency and requirements of the **information presented to the undertaking's management body** and **evidence of key decisions** made based on this information
- ✓ How the undertaking has **integrated its internal model** into its overall risk management strategy and the **level of understanding** of the model by the management team
- ✓ The **methods used** and **assumptions made** on the determination by the undertaking of its **material risk exposures** and **concentrations**
- ✓ The **adequacy** of the undertaking **risk mitigation practices**

Towards an appropriate vision for risk management

Key challenges

- ✓ Undertakings should **not** view risk management **only** has a **regulatory requirement**
- ✓ **Avoid too much focus on documentation**. Less but more thoughtful and effective documentation could be beneficial
- ✓ Supervisors should not approach risk management from a **compliance perspective** but rather from a **business perspective**
- ✓ Supervisors need to **ask the right questions** and **challenge the functioning** of the system
- ✓ Supervisors should **act swiftly** when they **found deficiencies**, imposing repair and monitoring its implementation

Towards an appropriate vision for risk management

Key challenges

- ✓ **Capital is not the answer for poor risk management**
- ✓ **Capital is not the solution for all the risks**
- ✓ **Effective risk management** processes and practices, applied in a consistent way can be a relevant **tool to foster policyholder protection** and **promote stability** in the markets

“Risk comes from not knowing what you're doing.”

Warren Buffett