

Institute of Risk Management consultation paper for the Financial Services Authority
on the role of the risk function and risk professionals under Solvency II

Context:

The Institute of Risk Management (IRM) has recently been made aware of some of the thinking with regards to the developing role of the risk function and the potential for confusion with other required roles, specifically the actuarial function, in the Solvency II world. In particular, we refer to the presentation given by the FSA to the IRM Solvency II Special Interest Group on 1st April 2011. We therefore wish to provide a response to the FSA's consultation process on the role of a risk function under Solvency II regulatory environment.

The role of the Institute:

The Institute of Risk Management (IRM) is the world's leading enterprise-wide risk education Institute. We are independent, well-respected advocates of the risk profession, owned by practising risk professionals. IRM passionately believes in the importance of risk management and that investment in education and continuing professional development leads to more effective risk management. We provide qualifications, short courses and events at a range of levels from introductory to expert. IRM supports risk professionals by providing the skills and tools needed to put theory into practice in order to deal with the demands of a constantly changing, sophisticated and challenging business environment. We operate internationally, with members and students in over 90 countries, drawn from a variety of risk-related disciplines and a wide range of industries. As a not-for-profit organisation, IRM reinvests any surplus from its activities in the development of international qualifications, membership, short courses and events.

The IRM and Solvency II

The Institute, at the request of its members, has formed a Special Interest Group to consider Solvency II. This group, which was formed at the end of 2009, has over 370 members drawn from the insurance community (including risk managers from a wide range of insurance companies, general insurers, captive insurers, bancassurers, life companies, reinsurers and the Lloyd's market). This is an extremely active group that meets monthly to debate issues pertinent to the risk function. One of the objectives of this group is to represent risk professionals within Solvency II debate. (see webpage - <http://www.theirm.org/events/SolvencyII.htm>)

The Institute's perspective on the Solvency II directive and the roles of the actuarial and risk functions:

Broadly, the Institute of Risk management is supportive of the Directive as it recognises the importance of risk management as a discipline and the need for the function to have structure and independence within an organisation. The Institute would urge that in the development of the final rules, the existing alignment of responsibilities for all key functions is maintained and the clarity provided with regard to the respective roles of the risk and actuarial functions is not lost.

The IRM believes that the risk management and actuarial professionals have extremely complementary whilst different skill sets to bring to the analysis and management of risk. Likewise many other functions contribute to the overall management of risk, including finance, legal, compliance, human resources and information technology to name but a few. We believe that a robust risk management structure will include both roles and that both will be held by senior individuals in the organisation. Solvency II should be seen as an opportunity to build bridges between professions and encourage closer working.

It is quite possible that there are individuals that possess both sets of skills, but the Directive should avoid being interpreted to assume that is the case. To draw a distinction, risk management has typically focussed on both the qualitative and quantitative assessment of risk across all risk types (with a focus on forward-looking assessment) as well as responses to business risk exposures. Actuarial analysis has primarily focussed on detailed technical examination of aspects of insurance and credit risk. It is fair to say that actuaries, and equally accountants, have many skills relevant to the management of risk. There is a common theme across the industry whereby other risk specialists have broadened-out their skills to take on wider risk management roles (e.g. catastrophe modellers, operational risk managers, credit analysts, internal auditors etc). Indeed many of these professions, including the actuarial profession, have recently extended their own syllabi to include separate ERM examinations, suggesting that the core qualifications themselves do not give sufficiently broad training.

There should not be a presumption that the Chief Risk Officer of an insurance company should have a specific background or qualification, be it actuarial or otherwise. Indeed there is a trend in the market for companies to appoint business-focused CROs with strong understanding of the core business and excellent relationship management skills. The onus should be for management to demonstrate that any individual holding such an important function has the appropriate skills, experience and personal attributes to provide insight and challenge at the most senior level. Such personal attributes might include capacity to understand the wider context of the business, strong analytical skills, independence and ability to challenge business assumptions.

Each organisation should remain free to determine how best to organise its resources across the risk management, capital modelling and actuarial disciplines. There should not be a presumption as to an 'ideal' organisation or reporting structure. Flexibility should remain as to how each management team determines how best to organise itself.

The financial crisis has shown a clear need for a robust and senior individual providing risk oversight. This person needs skills to oversee a range of risk types from insurance risk and financial risk, through to operational risk. The FSA itself has signalled at the recent Solvency II Conference the importance of responding effectively to governance-related issues. Indeed Solvency II encourages (re)insurers to adopt a holistic, enterprise-wide approach to managing risk. This drives a need for both qualitative and quantitative approaches to analysing risks due to the nature of many strategic and operational risks and the requirement to consider combination risks during stress testing.

The IRM believes that the Directive provides articulation of significant roles that both the actuarial and risk functions are called to perform. Recent debates may have caused unnecessary confusion as to the respective roles that arise out of the scope and governance of the internal model. This may be because of the necessary but wider definition of the internal model. If we consider the calculation kernel as the internal model then the differentiation between the actuarial mandate and the risk management mandate is obvious: the risk function has a role to make sure the risk management framework is appropriate and that would include looking at the risk quantification tools in place. One of these tools would be the calculation kernel, but it would be set alongside the other risk management tools such as stress tests, risk registers and so on.

The actuarial function then, clearly, has a role in the development and execution of the internal model kernel, not least the development of the insurance risk calculation kernel. In most cases the two functions have found the need to cooperate on a range of challenges, for example the development of an operational risk module for the internal model. The actuarial function provides key information and insights that are vital for the smooth operation of a risk management framework, steered by the risk function.

One aspect, connected to the above, that we feel is insufficiently articulated in the Directive is the role of the risk function in providing the Board with guidance around the design of the risk management framework and components of it, and specifically in the qualitative risk processes (in particular risk identification, assessment and control). Equally, we think further emphasis could be placed on the role of the risk function in leading the development of stress testing approaches that complement the calculation kernel.

There is a further good reason for separation of the duties of the actuarial and risk management functions when we consider the role of the actuarial function with regard to technical provisions. These are a significant item on the balance sheet of an insurance company and the actuarial function has a key role, set out in the Directive, around the calculation of these provisions. Following the Three Lines of Defence principles which the Directive applies, there then needs to be some independent risk oversight of reserve risk and the actuarial function would appear to be conflicted in taking this independent role. This suggests the need for an independent risk function providing this oversight.

Lastly there is potential for conflict between the actuarial and risk management function that needs careful management when it comes to giving the Annual Opinion on the reinsurance policy. Each firm should have set out a risk management policy, as set out in Article 44 of the Directive and CP33, that would include the use of reinsurance as a risk management tool to manage insurance risk. Clearly, the risk function is expected to comment on the operation of the risk management framework and it seems wrong to separate out the key risk mitigant of the major risk in most insurers for separate consideration. We would expect the risk manager to call on the skills of the actuarial function in considering the appropriateness of the reinsurance, but would expect this to be contained within a wider role around ensuring the ongoing appropriateness of the risk management system. If the intention is to provide a view independent of the risk management function on the appropriateness of part of the risk management framework, then this should be stated more clearly.

The importance of a qualified and professional risk function:

The IRM is also aware that there have been suggestions that there are no suitable qualifications for risk management professionals. In fact, we know this not to be the case. There is a wide range of specialist risk management qualifications (offering technical specialism in, for example, financial risk management) as well as broader enterprise-wide risk management qualifications. The IRM offers a postgraduate International Diploma in Risk Management providing a professional designation of MIRM, as well as an International Certificate in Risk Management, providing a stepping stone to the Diploma and also the designation of CIRM. The IRM has also launched a specialist qualification in Risk Management for Financial Services. The risk profession is maturing to the point where both qualifications and experience are required to be a credible and effective risk professional within a risk function. The skill set of risk professionals is broad and equips them well to work cross-functionally with many specialist functions and professionals.

However, perhaps more important than just qualifications, the IRM believes the risk management function in insurance companies should be providing the following key roles and skills in supporting the board and management to:

- provide a second line of defence, engaging with management in implementing a risk management framework whilst providing constructive challenge
- design, implement, document, communicate and develop an enterprise-wide risk management framework
- understand all elements of the risk framework and drive the tools and techniques relevant to each aspect of the risk management framework, including a variety of quantification tools

- support the Board and management in articulating and reviewing its risk appetite
- cascade risk appetite, tolerances and limits across the business from group down to entity level and ensure active monitoring of risk exposures versus tolerance limits
- establish and maintain risk governance processes capable of providing management, through risk committee structures, with key information regarding the business's risk exposures and how these are being addressed and with escalation of key risk indicators when appropriate
- develop and embed an ORSA process in the business's strategy setting, business planning and decision making processes
- be actively involved in the business planning and strategy setting process supporting scenario planning and stress testing
- ensure that accountabilities for risk management are appropriately embedded into management's roles and responsibilities and appropriately linked to performance and reward processes
- provide oversight over the development and governance arrangements for the internal model
- understand ALL risk types and provide an enterprise-wide view of risks and how they might impact the business singly and in combination
- manage an embedded process of risk assessment across the business
- bring strong communication skills to the task of explaining complex risk concepts to management and staff across the organisation
- support management in embedding a risk management culture by providing training and development programmes tailored to the business's requirements
- engage actively with other professionals with key roles across the business such as actuaries, lawyers and accountants
- engage with regulators
- bring a range of risk management tools and techniques to the table when addressing specific business challenges

- drill down on risk areas and undertake specialist reviews at the request of management
- understand capital planning
- understand business and risk strategy
- understand actuarial and other quantified risk modelling techniques

This is a comprehensive set of skills which, when taken with the roles and responsibilities set out for the function in the Solvency II Directive, would suggest a specialist full-time role requiring access to and support from the board to be effective. Given the importance of this function within a Solvency II regulatory environment, IRM would encourage further guidance on what constitutes a fully effective risk function.

A risk function will be resourced by risk management professionals who should be professionally qualified or be able to demonstrate equivalent skills and experience. The mark of profession is that it has a canon of accepted knowledge, recognised qualifications and a code of conduct / ethics supported by practical experience. The Institute of Risk Management sees its role as providing these key hallmarks of the risk profession. The IRM's Mission is specifically "leading the risk profession through delivering education and life-long learning".

Conclusions:

The IRM is pleased that the Solvency II Directive is stimulating debate around the role and skills of a risk function. In general, we believe that the Directive is directionally correct and we look forward to seeing further detail as it emerges in the rules.

Please note that the views in this letter are those as represented to the IRM by its members as risk management professionals and are not intended to represent the views of any of the individual organisations by whom the IRM 's members may be employed.

Alex Hindson FIRM
Chairman, Institute of Risk Management

Phil Whittingham FIRM
Chairman, IRM Solvency II SIG

26th April 2011

As endorsed and approved by the Institute of Risk Management Executive Committee



Leading the risk profession

The Institute of Risk Management, 6 Lloyd's Avenue, London EC3N 3AX. T: +44(0)20 7709 9808, E: enquiries@theirm.org, W: www.theirm.org

Limited by Guarantee Registered in England No. 2009507 VAT Registration No. GB. 524 4782 40