

# MARSH



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## **Perspectives on risk culture** Under Solvency II – IRM SII SIG

James Maxwell, London

## Definition of 'risk culture'

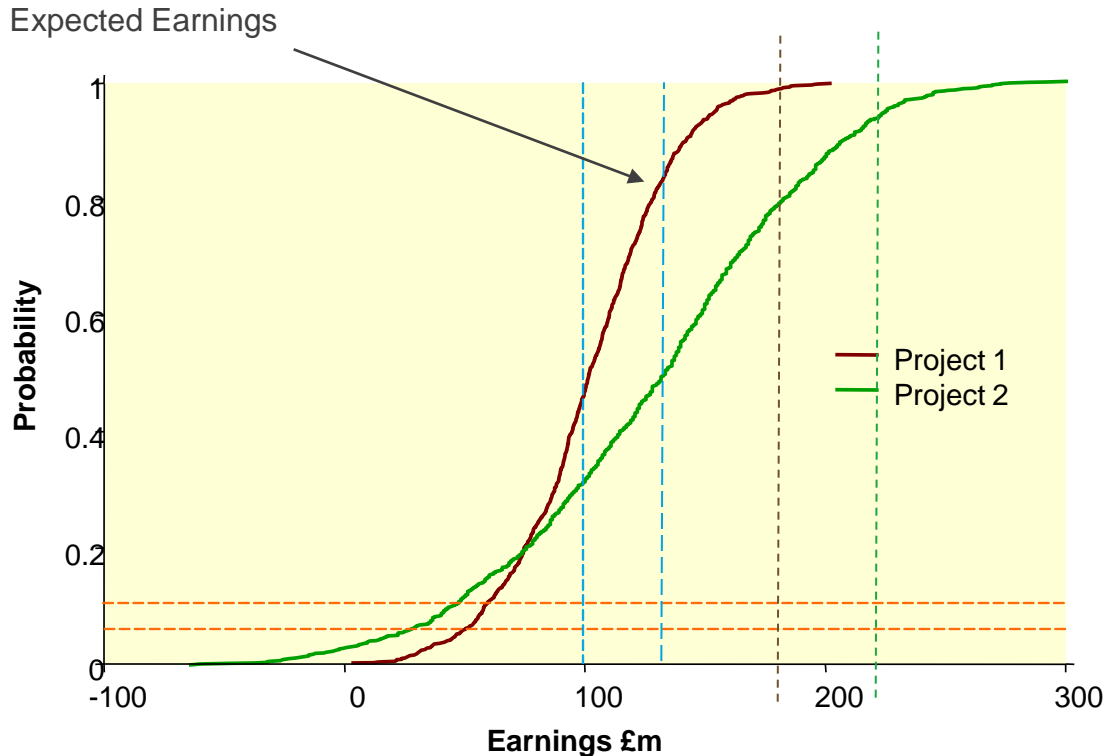
The social and organisational determinants of individual risky decisions. Some organisations foster high risk cultures e.g. financial trading firms. Others will favour a more conservative culture e.g. regulators.

*Oxford Risk Research and Analysis*

The extent to which risk consideration forms a part of the business decision making process, and the nature and size of risks that are undertaken in pursuit of objectives

*Marsh Risk Consulting*

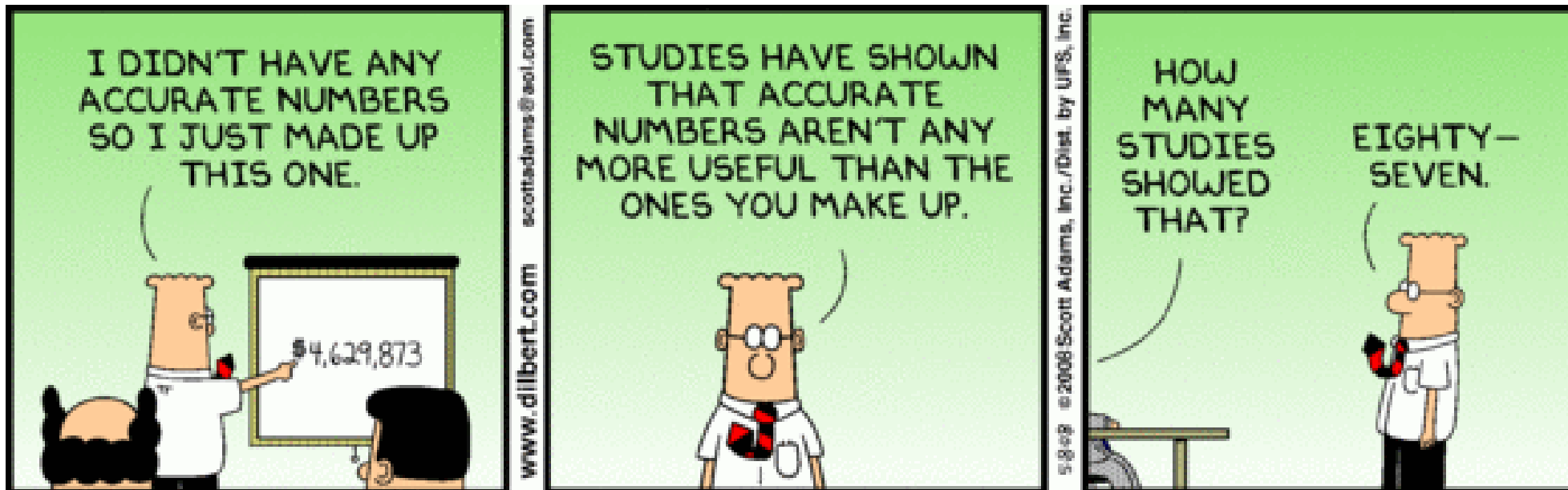
# Risk culture in action – an example



Note: Chart illustrative

- Potential financial outcomes for projects are measured on a range of probabilities taking account of risk variables
- In this sample chart, Project 1 has a lower variability of earnings, while Project 2 has a higher probability of diverting from the expected earnings
  - Project 2 is more risky than project 1
  - Consequently, the possible returns from Project 2 are greater
- Risk appetite and culture becomes a key determinant in the decision
- More effective risk management could allow the company to take on riskier projects in exchange for higher returns.

## Models versus culture



Risk culture is determined by the behaviours and judgement exercised within the business in decision making. Process, metrics and models are very important, but over reliance on numbers can blind the business to the true nature of the risks it faces, and may even provide a false sense of security.

## Hallmarks of an effective risk culture

- There is an explicit and appropriate **tone from the top** – the Board and executives visibly support consideration of risk in decision making and set clear expectations for risk reporting and escalation.
- **Who's who is communicated and understood** – people know what is expected of them, their discretion to act, and for what they are accountable.
- **The value of risk management activity is clear** – early buy-in from the business is sought, and risk management is seen as success enabling rather than business preventing.
- **Models are not a substitute for judgement** – underlying assumptions and correlations need to be constantly challenged. Model outputs are directional, but decisions should ultimately be made by people.

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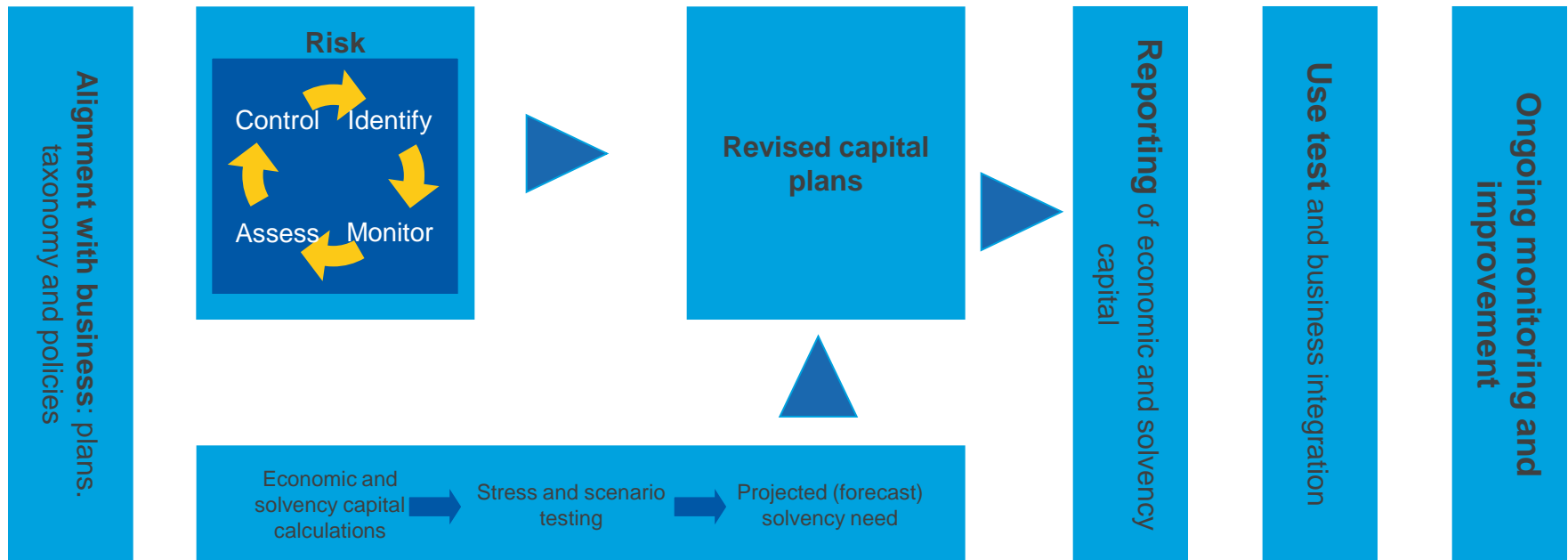
- **Scenario analysis is undertaken thoroughly and regularly** – and ‘extreme events’ are taken into consideration. The overall resilience of the organisation to scenarios incorporating correlated risks is determined, with appropriate contingencies in place.
- The business understand its **risk appetite** (a range) and **tolerance** (a boundary).
- **Performance measurement incorporates consideration of risk**, e.g. RAROC.
- **Individual incentives** are aligned with risk-weighted performance over an appropriate time period. Incentives may not necessarily be financial.
- **Risk managers are enabled** to ask difficult questions, challenge the conventional view and to present a contrary opinion – or even just to say “I don’t understand”. They should carry sufficient credibility and capability to be listened to and to get things done.

## The ORSA requirement under Pillar 2 – risk culture is a key component

- ORSA is a view of risk-based economic capital required by a firm
- It is expected to be in alignment with a firm's business strategy and decision making
- It should be supported by appropriate stress and scenario testing, including testing to destruction
- Its main aim is to ensure a risk based, forward looking view in business decision making, and therefore incorporates both qualitative and quantitative aspects
  - Risk identification, assessment, control and monitoring
  - Appropriate governance arrangements
- To be effective, it should be supported by management buy-in and pass the 'use-test'
- It should be independently assessed

# The ORSA process

**Governance:** roles and responsibilities, reporting requirements, escalation, risk strategy, appetite and tolerance



**Independent Assurance** (internal and external audit)

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