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How Opinionated Are You? Risk Management & Financial Condition Reports in General Insurance

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Abstract

Appointed Actuaries are improving the breadth and depth of their reviews of general insurers' risk management frameworks. This is a challenge, requiring the development of new skills and analyses in order to draw suitable conclusions.

This paper develops thinking and shares research on ways in which Appointed Actuaries can improve the quality of their risk management reviews. It reports on the types of changes which Appointed Actuaries are making to their reviews.

It deals with practical issues such as using the work of others (e.g. internal audit), documentation and softer risk management issues (e.g. risk culture). It includes case studies illustrating strengths and weaknesses in risk management frameworks.

***Keywords: risk management, financial condition reports, actuarial opinions*.**

1. Introduction

Appointed Actuaries have been preparing a Financial Condition Report (FCR) each year for licensed Australian general insurers since 2006. Over this period general insurance actuaries have become more comfortable with these assignments. General feedback indicates that the reports' users have found them a valuable single source of information and insight into the recent performance and outlook for each company.

One section of the FCR which has perhaps lagged other areas is the review of an insurer's Risk Management Framework (RMF). APRA has recently suggested that the actuarial profession should improve the breadth and depth of these reviews, including clearer opinions on the suitability and adequacy of the insurer's RMF.

While the recent focus from APRA is important, merely meeting these expectations should not be the sole driver of change. We should aim for continuous improvement, to provide better FCRs to meet the needs of all relevant stakeholders – in particular the insurer's Board & management. This will result in more timely and useful information for the insurer, which should lead to better decision making and improved performance.

Ultimately, the Appointed Actuary (AA) must form a view about whether the insurer's RMF is useful (or not) in helping the insurer manage the threats and opportunities which it faces.

Objectives

My objectives in writing this paper are:

- to support the development of actuaries' skills and confidence in providing opinions on RMFs, particularly for those practitioners who are not risk management experts
- to share my observations, thoughts and experiences on this topic
- to promote further discussion and development in this area.

Other Points

I have written this paper for the 2012 General Insurance Seminar of the Actuaries Institute (Institute). However, given that the recent focus on risk management in FCRs has covered both general and life insurance, some material may be relevant for life insurance actuaries.

This paper is not a comprehensive review of every aspect of insurers' RMFs. It considers the areas which are most likely to be important (although this will depend on each insurer's circumstances).

It is not a definitive guide on how to review an insurer's RMF for an FCR. In part this is because experience and accepted practice in this area are evolving. Also, different approaches may be suitable for different insurers. This paper is one contribution to the development of this area.

This paper represents my own views based on my experience working in general insurance and risk management. While I was a member of the President's 2012 risk management working party (which provided advice on this topic) and I am a member of the Institute's Risk Management Practice Committee (RMPC), the views in this paper are mine and do not necessarily reflect the views of these groups. For further clarification, this paper has not been commissioned by the Institute's General Insurance Practice Committee (GIPC).

The Institute's Information Note on Risk Management (Actuaries Institute, 2012) should be the AA's primary reference for risk management reviews. This paper provides another point of reference. This paper repeats and builds on many of the points made in the Information Note, as well as including other material.

Outline of the Paper

This paper is structured in the following sections:

1. Background to this topic
2. Case studies of risk management successes and failures, and what we can learn from these.
3. Practical challenges faced by the AA in reviewing an insurer's RMF.
4. Areas of an insurer's RMF worth exploring
5. How the AA might organise their RMF review
6. Key conclusions
7. References.

Appendix A sets out some definitions of common risk management terms.

Acknowledgement

I would like to thank Geoff Atkins for peer reviewing this paper, as well as Gae Robinson for her input and thoughts on this topic. However, the views and opinions given, and any remaining errors, remain my responsibility.

2. Background

In this section I provide some context for the topic of risk management reviews.

Why is Risk Management Important?

Strong risk management offers protection against the range of risks a company faces, improving its resilience. Compared to the past, insurers' risk exposures are more complex due to changing markets (e.g. new distribution channels and strategic risks), faster information flows and stronger interactions between risks. Rapid changes in information technology have led to a range of risks which did not previously exist. Furthermore, external scrutiny has never been greater.

A sound RMF offers commercial value, by providing a consistent and controlled basis for decision making. Insurers can take opportunities in an informed, measured and sustainable way. However, it is important that the RMF does not stifle business operations, as some level of risk must be taken to succeed in business.

Risk management is important for the actuarial profession as well. David Goodsall, President of the Actuaries Institute has recently stated that if AA's can prepare reviews of a consistently high standard then we can demonstrate to APRA, insurers and others that we can compete with other professionals in risk management and add value in this area through our understanding of insurers' businesses and the issues they face. Achieving this is a key strategic focus for the Institute.

What is a Risk Management Framework?

Since the term "Risk Management Framework" is used throughout this paper I will define it. I have used the definition in APRA's Prudential Standard GPS 220 *Risk Management* (APRA (2012)):

> *The RMF is the totality of systems, structures, processes and people within the insurer that identify, assess, mitigate and monitor all internal and external sources of risk that could have a material impact on an insurer's operations.*

The RMF is a multidimensional and complex collection of different elements. It should not be confused with the Risk Management Strategy (RMS), an APRA defined term. As described in GPS 220, the RMS is a high level, strategic document which describes key elements of the RMF. In other words the RMS is a risk management policy document.

For interested readers I have included a selection of other risk management definitions in Appendix A.

Historical Context

Australian general insurers mostly fared well in the last decade, in terms of solvency and prudential regulation. During the financial crisis of 2007-09 and following several large natural catastrophes in the Asia-Pacific region in 2010-11, there have been no insolvencies and few impairments of Australian companies underwriting general insurance. Capital levels remain strong, although for some insurers capital injections were required.

While strong profitability and favourable expedience for much of the last ten years helped, a key explanation for this good record is arguably the robust prudential regulation regime covering the industry since 2002. In this period insurers have had to hold more capital, comply with a greater range of regulation and have faced more intense supervision from APRA than in the past. This prudential context is important when we review an insurer's RMF.

Nature of General Insurance

The divergent performance of general insurers and banks in the recent financial crisis serves to highlight the differences between these two industries. Compared to banks, general insurers' liabilities are not at call (unlike many bank deposits) and are not traded securities. Systemic and contagion risks are lower, as is the leverage of individual companies. Underwriting and claims related risks dominate for general insurers, while credit and market risks matter more for banks. General insurers face different risks relative to banks, and need risk management reviews appropriate to their circumstances. The greater involvement of actuaries has also assisted insurers avoid many of the problems of the financial crisis.

While differences exist between general insurance and other businesses, there are common elements for a successful RMF. In the case studies in Section 3 I consider strong and weak aspects of RMFs from a range of industries.

Despite the recent track record, general insurers and actuaries cannot be complacent. Every company has a responsibility to its shareholders (and other stakeholders) to generate the best performance possible while meeting its contractual obligations and protecting the firm against major risks which could impair its operations. General insurers face a range of risks, many of which are reduced through prudential regulation and supervision, including meeting minimum capital requirements. However, there is still a need for an effective RMF to protect stakeholders' interests.

Recent Developments

Most readers will be familiar with recent developments affecting actuarial reviews of Australian general insurers' risk management. For completeness I will briefly recap:

1. In September 2011 RMPC issued an Information Note to assist each AA in reviewing risk management as part of the FCR.
2. In March 2012 APRA held a meeting with general insurance AAs (and a separate meeting with life insurance AAs), to make the point that risk management reviews need to be broader and deeper, and that the FCR

should contain a clear opinion from the AA on the suitability and adequacy of the RMF.

3. In response the Institute President convened a working party for advice on how to proceed and respond to APRA. This group completed its work in June 2012, suggesting enhancements to the Information Note, further workshops or training for AAs if requested and proposing communication to actuaries and other parties during the process.
4. An Exposure Draft for the revised Information Note was circulated in June 2012 for comment. An Insights session was held to discuss the issues in the same month. The final updated Information Note is due for release shortly.
5. Changes have been made to APRA's prudential standards GPS 220 *Risk Management* and GPS 320 *Actuarial and Related Matters* to reflect APRA's requirements. Changes are also proposed for the Institute Professional Standard 305 *Financial Condition Reports for General Insurance,* in order to bring this into line with APRA's expectations.

The Nature of RMFs

RMFs are often complex, involving many people, different risk types (e.g. insurance, financial, strategic and operational risks) and various processes. The complexity increases for large, diverse insurance groups. RMFs do not always work as intended. Despite the existence of RMFs, there is ample scope for poor risk management to occur in practice, typically due to a poor risk culture.

The RMF should not pay undue attention to insignificant risks for the sake of applying a consistent process to all risks the insurer faces.

Responsibility for Risk Management

While setting the scene it is important to remember that the AA is not responsible for the insurer's RMF. This accountability rests with the insurer's Board, while its management is charged with implementing the RMF.

Others provide oversight and assurance (e.g. internal and external auditors). The AA also reviews the RMF, albeit by taking a different approach to auditors.

Annexure A of the Information Note describes these responsibilities in further detail.

Scope and Nature of the AA's Review

The AA will not usually audit the operating effectiveness of the RMF i.e. test the sound functioning of each and every aspect of the RMF in detail. The AA may prepare this more detailed review if they are capable and have agreed this scope with the insurer, although this is unlikely in most situations. Instead, the independent review of operating effectiveness is often performed by the internal auditor.

The AA is required to provide an assessment of the suitability and adequacy of the RMF. By its nature this is higher level than reviewing operating

effectiveness. While the AA is not directly responsible if the RMF fails, and noting that not all problems can be identified in advance, questions will likely be asked after a significant failure if a RMF weakness should have been identified and discussed in the FCR but was not.

The AA's review should not simply sign off on the compliance of key policies (e.g. the RMS) with prudential standards, since a compliant RMF may still have material weaknesses in practice.

What should the AA's risk management review cover? In the past some AA's have only considered risks not covered elsewhere in the FCR, such as operational risks. Under this approach, if insurance risks (underwriting, pricing and claims management) have been reviewed and documented in other sections of the FCR then they are not considered again.

I disagree with this approach. I consider the RMF review as an extension of the entire FCR, tying together all material risks (financial and non-financial) and the framework the insurer uses to identify, measure, control and monitor them. Content from other parts of the FCR need not be repeated, but it should be considered in the RMF review (possibly with a cross reference). The risk management section of the FCR should not be an afterthought.

Internal vs External AAs

In theory it should not matter for the RMF review whether the AA is employed by the insurer or an external consultant. Both situations require a comprehensive review and the AA should have access to the necessary information and people for their review. However, in practice the AA's position may impact how they approach the review in practice.

An internal AA may have the advantage of stronger connections to the insurer's management and staff, through day to day contact with these people. They may be more familiar with the nuances of how the insurer operates. However, the AA should beware of any bias they might have due to this proximity.

An external AA may be able to benchmark the insurer to others, due to their work for several clients. They may also bring a more objective perspective, especially if the insurer represents a relatively small proportion of their work throughout the year. However, external AA's should determine if there are subtleties in how the RMF operates which they are missing.

3. Case Studies

In this section I discuss four case studies – two risk management successes and two failures. The publicly available information on specific details of effective RMFs is limited, but the chosen examples provide some insight on practical risk management.

There are many examples from around the world of large losses or insolvencies in the last 20 years affecting financial services firms. In many cases the losses exceed those from the examples I have included. However, I preferred to discuss two Australian cases of weak risk management.

Each of the four case studies gives some perspective on what has and has not worked in the past in managing each company's risks. It is easier to assess these RMF's in hindsight rather than in advance. My objective is not to dwell on the specific circumstances or to apportion blame for failure. Rather, my aim is to demonstrate particular areas where each RMF succeeded or failed, with a focus on identifying early indicators of problems.

Details for three of these examples have been taken from an earlier risk management paper I wrote. Refer to Riley (2009) for more detail.

HIH

This section is based on the summary of key findings from the HIH Royal Commission, headed by Justice Neville Owen. Refer to Owen (2003) for further information.

On 15 March 2001 the companies in the HIH Insurance group (HIH) were placed into provisional liquidation. The net asset deficiency was subsequently estimated at between $3.6 million and $5.3 million.

The following factors were identified by Owen J as contributing to HIH's demise. Most were connected in some way to its approach (or lack of an adequate approach) to risk management.

Insurance Risk

- Under-reserving was a key factor directly causing HIH to fail. However, many of the points listed below were related to under-reserving.
- Poor underwriting and under-pricing naturally followed consistent under-reserving, particularly for the long tailed lines of business.

Weak Controls

- Many examples of poor controls were identified during the HIH Royal Commission, including:
  - Inadequate scrutiny of outstanding claim reserves by management and the Board.
  - Poor oversight of underwriting in parts of the group (e.g. following UK expansion in the 1990s).

- HIH failed to meet its budgets from 1997 onwards. There was a lack of control over expenditure, limited feedback and no adjustment to expenditure or future budgets as a result.

A Poor Culture, Weak Leadership and Inept Management

- The Board placed "blind faith" in management with little or no testing of the group's activities or of the information provided to it by management.
- There was a lack of attention to detail among the Board and management with no accountability for performance.
- The chairman was ineffective.
- Unpleasant information was hidden, filtered or sanitised.
- There was a lack of integrity associated with internal processes and systems.

Poor Strategy

- Due diligence over the acquisitions in the US, UK and FAI in the mid to late 1990s was deficient.
- There was no proper discussion of a clear and coherent strategy at Board level. Management did not take the initiative to raise strategic issues with directors, while the Board did not ask for this information.
- While it is easy to develop a strategy, the lack of a clear strategy detracted from HIH's operations and financial performance.

Weak Corporate Governance

- No action was taken by management or the Board on problems which were or should have been known.
- There was inadequate disclosure on HIH's financial position to regulators (particularly APRA) and the market.
- HIH was run like a private firm, not an ASX-listed public company. Owen J gave the example that senior management used corporate bank accounts for private purposes.
- The group's corporate governance model did not develop to cope as the group expanded overseas. It was not equipped to provide adequate oversight of overseas operations.
- There were few clearly recorded policies, or where they existed they were often ignored (e.g. after the FAI acquisition some investment balances exceeded limits)
- Limits of authority were not well documented or were poorly understood.
- Conflicts of interest at Board level were handled poorly.
- The audit committee invited all directors to meetings, not just the non-executive directors. These meetings should have generally involved only the latter group.

Aggressive Accounting

- Intangibles and financial reinsurance were used to support reported profits and net assets.
- Backdated reinsurance contracts and large year-end transactions were used to window-dress the balance sheet.

Misleading or Substandard Accounting

- Regulatory solvency was misrepresented by including pledged assets in the capital base and netting off some assets and liabilities without APRA's prior permission (both in breach of prudential regulations).
- Management accounts were not prepared for each licensed insurer, so there was no way of preparing credible prudential returns for each of these subsidiaries.
- The external auditor (Arthur Andersen) did not test the consulting actuary's outstanding claim estimates sufficiently.
- There was a perception that the audits lacked independence, since three former Arthur Andersen partners were HIH Directors.
- In general there was a lack of reliable information. The Board, management and the external auditor should have been aware of this but there is no evidence that anyone attempted to fix it.

Fraud

- There was no evidence that this was widespread. Owen J stated that management attempted to "paper over the widening cracks".
- The raiding of assets by some in the group in the days leading up to the provisional liquidation indicates some level of fraudulent activity.

Inadequate Risk Identification and Management

- I have previously noted the lack of discussion of strategic issues (and related risks) at Board level.
- The short term negative cash flow impacts of the joint venture with Allianz in 2000 were poorly understood. This arrangement hastened HIH's demise. This is one example of poor risk identification and management.

Another important observation is that many of the factors listed above are interrelated.

Owen J found that inadequate prudential supervision also played a part in HIH's failure. The following comments summarise his findings. While APRA made some mistakes (e.g. no action was taken when HIH's capital breached its MCR), there were practical limitations in what APRA could do in a timely manner after it assumed oversight of HIH. It was unfortunate that HIH's final years coincided with a period of transition, as APRA was established in 1998 to replace the Canberra-based Insurance and Superannuation Commission (ISC), following the Wallis inquiry. Many APRA staff were either relocating from Canberra to Sydney (APRA's headquarters) or replacing those who did not relocate. APRA's changes to prudential regulation and supervision from 2002

onwards reflect what was learned from this period, including how it could improve its functions.

Many of the issues listed above are unlikely to reoccur for insurers subject to APRA's current regulatory regime. Since 2002 this framework has been stricter, with higher minimum capital requirements, more comprehensive regulation in a whole range of areas (not just capital) and more proactive supervision. Under the current system we should be able to confidently conclude that matters would not have got to the same state.

However, HIH is still a useful example for demonstrating potential risk management problems within a company. Owen J observed that based on the evidence presented there seemed to be a general ineptitude among senior management at HIH. This calls to mind a quote from Warren Buffett: "risk comes from not knowing what you are doing".

National Australia Bank

This section has been drawn largely from Ashe & McConnell (2007). While it is not from the insurance industry it is an Australian example. The lessons are still relevant for general insurance, as some of the underlying problems are not specific to banking.

Homeside

In 1998 the National Australia Bank (NAB) purchased a US mortgage servicing company, Homeside, Inc. In September 2001 NAB reported losses of nearly A$4 billion from this business, due to a model error (using a gross interest rate rather than a net rate), changes in other model assumptions and a writedown of goodwill. Losses from hedging activities of A$870 million had previously been booked in July 2001.

Homeside was exposed to the risk of lower interest rates; these came in the late 1990s. As rates fell, US borrowers on fixed rates were legally permitted to refinance with little or no penalty, thus eroding the revenues of mortgage servicing companies like Homeside. NAB's traders attempted to hedge this risk but with limited success.

The factors contributing to this loss included:

- Controls applied by NAB elsewhere in the group (e.g. to the Australian businesses) should have been applied to HomeSide as well.
- Inadequate oversight of Homeside from NAB's Melbourne headquarters. Homeside executives exuded confidence, giving an impression of control. Weaknesses in risk management at Homeside (including under resourcing of the risk management function) which were identified during NAB's due diligence before acquiring Homeside were not subsequently addressed. No one had been assigned responsibility to fix these problems.
- Difficulties in hedging Homeside's exposures had been identified as early as 1999 and had been escalated for resolution since then, but these problems had not been addressed.

- A key strategic risk was either not previously identified or had been underestimated. Income from mortgage servicing rights which was lost due to refinancing had not been replaced. The work in servicing new loans was mostly going to competitors, as Homeside did not have a natural distribution channel to attract new business. Stress testing of this scenario was weak.
- The valuation of mortgage servicing rights by NAB had been based on optimistic assumptions.
- Indicators of a poor corporate culture across the group were subsequently identified, including a lax approach to limit management and poor adherence to risk management policies. Furthermore, important findings from an APRA review during this period were not communicated to the entire Board.

NAB was determined to secure offshore growth in the 1990s, having missed earlier acquisition opportunities. Questions were raised over whether the due diligence was sufficiently thorough, or if risks had been glossed over or not properly understood.

While external stakeholders were concerned at what had happened, no major changes occurred other than to divest Homeside. Concerns were raised about the lack of information being released to the market and the lack of accountability among management and the Board for what had happened.

Options Trading Losses

In September 2001, NAB's Foreign Exchange (FX) options trading desk began smoothing profits. By 2003 the large size of NAB's exposures in this market had drawn comment from competitors. This led to the second significant failure for NAB within a decade – the discovery of A$360 million of unauthorised FX losses in January 2004.

The problems identified included:

- An under-resourced back office which could not effectively check all trading activity.
- Poorly structured incentives encouraged fraudulent and excessive risk taking by the FX traders in pursuit of bonuses.
- Some familiar with NAB in this period allege that the CEO at this time (Frank Cicutto) surrounded himself with "yes men". There was a lack of scrutiny of what was occurring and information sent to the CEO was incomplete. Cultural problems remained.

While the size of the FX trading losses was much smaller than those from Homeside, the market's reaction was much more severe. External stakeholders had expected that the risk management problems identified from the Homeside period would be fixed. Soon afterwards, everyone involved from the Chairman and CEO down to the traders involved had either been fired or resigned. APRA imposed greater regulatory oversight with enforced actions from NAB.

Risk Management Structures and Their Use in Practice

Despite these problems, NAB had a RMF which seemed suited to its needs, at least on paper.

Firstly, Turnbull (2007) notes that in 2002 NAB reported that it had been ranked equal first in a corporate governance survey of 250 of the largest Australian listed companies. The survey stated that "corporate governance structures were outstanding. The structures met all the best practice standards and could not be faulted."

Secondly, NAB appeared to have appropriate risk management structures at the time of its problems. The following diagram was presented by Tony Coleman at an Institute risk management seminar on 19 March 2007 (see Coleman (2007)). Mr Coleman noted that many other financial services firms which have not experienced difficulties like NAB have similar structures. Risk management structures and reporting lines are a necessary but not sufficient part of a sound RMF.

Figure 1: NAB's Risk Management Structure: Necessary but not Sufficient

Conclusions

Key lessons from NAB's experience are that the following are important:

- Senior executives and Boards must provide reasonable oversight of a firm's businesses, applying some scepticism to what those in the business have told them.
- Insurers must consider unexpected outcomes. The Homeside losses were partly due to unanticipated low mortgage rates. Many risk management failures emerge from unexpected outcomes. The financial crisis was another example, but on a larger scale.

- A sound risk culture is critical. Shortcomings were identified in the risk management approaches under both Don Argus (CEO from 1990 to 1999) and Frank Cicutto (CEO from 1999 to 2004). Based on reports following the Homeside and FX losses, to some extent neither CEO wanted to hear bad news or views contrary to theirs. A January 2003 letter from APRA stated that "managing the message was frequently given equal, or greater, priority than dealing with the underlying issue."
- Staff should be rewarded for the way they perform their jobs rather than based on reported outcomes alone.
- There is a need for good reporting and resources to analyse and investigate risks. The HomeSide risks were not on the radar of senior executives.
- Questions which are raised need to be answered or addressed.
- Do not rely on old reputations in risk management. Up to the early 1990s NAB's risk management was widely regarded as one of the strongest among Australian financial services companies, as its results during the 1990s recession were better than most others. Companies must not become complacent or the quality of risk management can decline.

I now describe two examples of companies which have demonstrated strong risk management in the past. While these are not Australian general insurers, the features of their RMFs which work are worth drawing out. Considering the target audience for this paper I judged that it was inappropriate to describe specific Australian general insurers with strong risk management frameworks.

Goldman Sachs

Buehler, K. et al. (2008a) outline some of the features of Goldman Sachs (GS) that in their opinion differentiates this company from other financial services firms. The summary that follows is largely drawn from this source.

Around the time that the GS partnership floated as a public company (1999), it grew its trading and principal investments business. By 2009 this proprietary trading business contributed more than half of total earnings, while traditional agency business (i.e. investment banking and advisory business) was smaller. As a result, GS revenues became more volatile than in the past or compared to its peers.

Nonetheless GS is regarded by many as the preeminent investment bank. Of the five major American investment banks that existed before the financial crisis, GS is one of two (the other being Morgan Stanley) that did not fail or need to be acquired by a commercial bank.

The culture at GS has been described as one that embraces risk taking rather than avoiding risk. There is a strong entrepreneurial spirit. However, there are strong protections in place. When capital is put at risk the responsible business unit or person must be aware of the consequences of losing it. Executives ensure that GS staff have at least a basic competency in risk management. They can discuss and debate risk issues freely without fear of punishment.

GS has a business model which responds in a timely manner to the external environment. A good example was the financial crisis. In late 2006 GS identified increased risks in the sub-prime lending market and the related markets for Mortgage Backed Securities (MBS) and Collateralised Debt Obligations (CDO). By early 2007 an aggressive hedging programme was underway to protect its investments. One criticism which has been directed at GS is that while this hedging occurred the bank was still underwriting and promoting MBS and CDO issues in its traditional investment banking arm. GS seems (thus far) to have dealt with this potential regulatory and reputational risk. Ellis (2008) identified that each business unit is responsible and accountable for doing its best to meet its own objectives – this is how this potential conflict has been managed.

In summary, Buehler, K. et al. (2008a) list four reasons for the strong performance of GS:

1. The hiring of quantitative professionals in the early 1980s to develop analytical capabilities, before the other investment banks. This improved GS's understanding of its risk profile and provided a competitive advantage.
2. Strong oversight. This followed large losses in 1994 when US interest rates rose sharply. At the time morale among GS staff fell sharply. The CEO at the time (John Corzine) restructured the firm's risk control systems to address this.
3. The partnership heritage at GS has influenced its culture. Unlike other firms, GS has a history of retaining most earnings until a partner/executive retires. Their financial stake in the long term success of the firm is one factor driving the behaviour of management and staff.
4. The business principles of the firm (i.e. the culture). The executives have developed a culture that acknowledges that protecting the firm's reputation is crucial. One individual or one mistake can ruin this reputation. As such, the firm encourages staff to get an independent opinion on a matter before making a decision.

By all accounts GS is regarded as a well-run business. Some argue that GS has benefited unduly from strong political connections among its alumni. This year a former employee described a broken culture, where GS did not put its clients' interests first. GS has responded by claiming the former worker is disgruntled and his claims are inaccurate. These points serve as a reminder that even if a company starts from a strong position it needs to actively monitor and cultivate its RMF to remain strong. Threats to the RMF, including poor external perceptions, need to be identified and managed.

TXU

The summary below is based on Buehler, K. et al. (2008b).

TXU Corporation (formerly Texas Utilities) was the incumbent electricity utility in northern Texas when deregulation occurred in 2002. At the time the firm was fully integrated, comprising a power generation and retail distribution business.

Deregulation brought greater competition, overinvestment and increased exposure to commodity price volatility. By late 2003 TXU was in difficulty. Its market value had declined and it carried large debts. It was exposed to falling wholesale power prices. TXU restructured based on the following principles:

1. TXU would retain risks where it held a competitive advantage, while transferring or mitigating others.
2. TXU would actively manage its risk capacity to improve its solvency and liquidity.

Most power generators did one of two things at the time; either aggressively hedge the price received for the future sale of electricity to distributors (at reduced prices) or exit the market. The TXU CEO at the time (John Wilder) took a different approach. He concluded that TXU had a natural advantage generating electricity. Further, he figured that any other party would charge TXU a premium to assume the risk of wholesale electricity prices. While others were recommending complex hedging strategies, he concluded that having a vertically integrated business provided protection against this key risk.

TXU divested its non-core businesses, changed its capital structure, outsourced non-core functions and improved the efficiency of its remaining operations. The funds raised were used to repay debt, thus creating additional risk capacity.

TXU unwound some expensive hedges that had been purchased to protect wholesale price risk. Whether by skill or luck, this proved fortuitous. Wholesale power prices more than doubled by the end of 2005 and continued rising over the next two years. The resulting excess cash flow was used to repurchase shares. Over the period 2005-2007 TXU's share price and financial performance was stronger than most other listed shares.

The lesson from this example is that companies should understand their risk capacity. They should also focus on taking risks where they hold a competitive advantage.

Summary

The publicly available information on specific features of RMFs is limited. These case studies have described the experiences of four companies. While different factors are relevant for each, a common element driving success or failure is the health of each risk culture. We can think of this as generally accepted behaviours. Risk culture is explored further in Section 5.

A non-exhaustive list of other examples of company failure from the insurance industry that have not been covered in this paper include Equitable Life, Independent Insurance, GIO Reinsurance, NEM and Bishopsgate. The interested reader may find useful insights on risk management failure by investigating these cases.

In the following sections I explore the ways that the AA can identify strengths and weaknesses in the RMF, drawing on the lessons from these case studies.

4. Challenges for the Appointed Actuary

In this section I describe a number of practical challenges for the AA in reviewing an insurer's RMF.

The Monday Morning Quarterback

This analogy describes American football fans who proclaim to be experts with great insights about what their team should have done at the preceding weekend. Many things seem obvious with the benefit of hindsight, when a plausible narrative explaining their occurrence can be constructed. The same issues apply to risk management failures, where problems seem obvious in hindsight.

The challenge for the AA is to contribute to the identification of problems before they escalate, using insights from the FCR. This is not easy.

Potential Bias

The AA must be alert to any bias (intentional or otherwise) in how an insurer's management and/or the Board characterise their RMF. They may describe it as being better than what it really is. The AA should retain a healthy degree of scepticism in reviewing each RMF.

The AA should also pay attention to potential bias in their own views of the RMF, particularly if they have been involved in developing the RMF or performing other work for the insurer.

Delivering Bad News

It is a challenge for the AA to conclude that a RMF is not good enough, as the insurer may disagree. Before delivering the (draft) report, the AA should meet and talk with management first, explaining the reasoning for the AA's conclusion. The opinion must ultimately be based on the AA's judgement but should also be supported by objective facts and observations. The final message should also be communicated via recommendations so that the insurer can act to improve its RMF.

The Information Note suggests that if the AA has an adverse opinion, the AA should consider requesting advice or peer review from another actuary or risk management expert to test their conclusions.

However the opinion is communicated, the AA should include recommendations in the FCR for specific improvements to the RMF.

High Risk Environments

The AA needs to be alert to high risk situations, where an insurer's RMF may be under more strain than usual. This can be an issue even if the insurer had a good RMF in the past in less stressed circumstances. Examples of situations with higher than normal risk levels include:

- High levels of claim activity after a catastrophe
- External systemic or macroeconomic stresses (e.g. during a financial crisis)
- Rapid growth (e.g. following an acquisition)
- Increasing risk exposures, especially if the insurer does not appear to be monitoring these closely.
- Entering new products or markets
- Corporate reorganisation.

Above average risk levels could emerge anywhere in the RMF, but strategic and operational risk are two vulnerable areas to check. Another issue is disruption to a corporate culture if two businesses are being integrated.

Capability to Opine

Some AA's may find it difficult giving an opinion because there are parts of the RMF where they have had little or no involvement in the past (e.g. reputational risk, risk culture and emerging risks). By contrast the AA will often be more comfortable providing an opinion on more familiar matters, such as reinsurance or capital.

Each AA needs to become sufficiently comfortable with the softer side of risk management. Many of the necessary insights can be gathered through the course of the whole FCR, by observation and asking questions.

Managing Stakeholder Expectations

In my experience Boards generally prefer shorter FCRs, drawing Directors' attention to pertinent issues. APRA have also stated that good risk management reviews should not require significant FCR documentation. However, the AA may wish to demonstrate that all key areas of the RMF are covered (e.g. most or all of those listed in section 3.3 of the Information Note). The AA will need to include a minimum level of documentation to support their opinion.

As outlined in Section 3.5 of the Information Note, two ways to managing this conflict are:

1. Include the detail in an appendix to the report, with the key points provided in the body, or
2. Retain the detail in the AA's working papers, to be referred to if required.

Another challenge for the AA is completing the RMF review efficiently. This is possible once AA's are accustomed to what is required, especially if they can leverage their observations and insights from other parts of the FCR.

Focusing on What Matters

It is important to focus attention on the material risks faced by general insurers. Insurance risks (underwriting, pricing and reserving) tend to dominate most risk profiles. Operational and strategic risks are also usually important. Those insurers with conservative investment strategies and prudent

reinsurance programs tend to have relatively little credit, market and liquidity risk, although circumstances can vary by insurer. AA's should bear this in mind when determining which areas of the RMF should receive the most attention in the risk management review.

Any insurer can have a comprehensive strategy and suite of policies. However, it is execution of business operations and risk management which ultimately drives performance and insurers' continued viability.

Delegation

Some AAs will delegate most of the work for the risk management review to someone on their FCR project team, possibly with more risk management experience. This is acceptable provided they have contributed to the enquiries and they "own" the review. The AA must be familiar with the higher expectations now placed on them for the RMF review.

Conflicts of Interest

In some situations an AA may be asked to review a RMF which they developed (or to which they contributed).

The AA should refer to the independent review of the RMF for another perspective, if there is a conflict of interest in the AA reviewing a RMF which they were closely involved in developing. The AA should discuss the potential conflict with the Board and/or management, and perhaps APRA. It should be noted in the FCR as well.

Refer to Section 3.6 of the Information Note for more detail on managing potential conflicts of interest.

Potential Legal Liability for AA

The Information Note sets out steps and the work that is recommended to support an opinion. If these steps are followed with sufficient care i.e. the AA completes the work, asks suitable questions, draws reasonable conclusions and then documents the scope of their review and the reasons for their conclusions in the FCR, then their legal exposure should be minimised. The circumstances should be no different than for any other part of the FCR.

However, future challenges to the AA's work remain a possibility.

Summary

While some aspects of the RMF review are challenging, they are not insurmountable. Through planning, well directed questions, use of other parts of the FCR and with experience, most of the points above can be addressed or their impact reduced.

5. Areas of Focus

This section sets out some ideas drawn from the earlier parts of this paper and my own experiences. These may be useful for AA's to consider as they prepare for their reviews. The eight areas considered are:

1. Risk culture
2. Resourcing
3. Compliance
4. Risk appetite
5. ICAAP
6. Stress testing
7. Continuous improvement
8. Risk register
9. RMF documentation.

Section 3.3 of the Information Note contains useful guidance on the range of topics to be considered. The points below supplement that section, but do not cover all areas.

Risk Culture

Arguably this is one of the most important areas of a RMF, if not the most important. This is because it strongly influences all other areas of the risk framework. It deals with how the RMF is applied in practice. However, it is often the most difficult to assess.

Many of the problems described in the case studies earlier in this paper stemmed from poor culture. In the case of one company (NAB) this was despite the fact that it had what appeared to be a comprehensive RMF and corporate governance structure. It is a question of not what you have, but how you use it!

The Oxford English Dictionary defines "culture" in this context as "the attitudes and behaviour characteristic of a particular social group". In the HIH Royal Commission Owen J described corporate culture as the "personality that guides the decision making process at all levels of an organisation".

The AA should look for indicators of a healthy risk culture within an insurer. For instance, possible areas for consideration include:

- Is the RMF linked to some core values guiding the firm? These may be documented in the insurer's mission statement, values or corporate objectives. It is usually a good sign if there is evidence that an underlying set of principles are actually followed in practice (e.g. used in setting personal objectives and measuring performance).
- Insurers should seek ways to measure risk culture. One way is via staff engagement surveys which include risk-related questions. As the

management guru Peter Drucker once said, if you can't measure it you can't manage it!

- Is there unprompted recognition by the insurer that they could improve their RMF in some areas? The companies in the case studies of risk management failure would have scored poorly on this measure.
- Does the insurer strive for continuous improvement? At a simple level, are policies reviewed and updated at least annually?
- How strong are the stress tests and practice runs of specific policies or areas of the RMF (e.g. the business continuity plan)? Does the insurer consider how particular situations might impact them, where these have previously affected competitors or companies in other industries?
- Where there have been problems in the past, is there evidence of genuine regret for these shortcomings and a need for change? Has the RMF been reviewed as a result?
- How proactive is the insurer in updating and maintaining its risk register when circumstances change? Slow responses may indicate some neglect of risk issues.
- Do the Board and Management have "deep dive discussions" i.e. request additional risk information and ask questions when needed? There should be evidence of a strong flow of information, unlike the HIH case study.

Indicators of an unhealthy risk culture include:

- A failure to follow up previous recommendations to improve the RMF. These may have been made in a previous FCR or another risk management review (e.g. audit).
- Management and staff who are overly defensive or dismissive of critiques from external stakeholders relating to the RMF.
- Excessive optimism from those in the firm that the current RMF is adequate, particularly when other indicators suggest things could be better.
- Problems which are identified or reported through the insurer's own risk management are ignored or left unresolved.
- A lack of cooperation with various external reviews by the AA, auditors and APRA.
- Insurers giving the impression that risk management is simply compliance, rather than an opportunity to protect the business while gaining a commercial advantage.
- A lack of concern if operating limits are routinely breached.

It is a difficult thing to assess, but if the AA can form a view on an insurer's risk culture they are well placed to opine on the overall RMF. The assessment may follow some scoring methodology (e.g. a balanced scorecard derived from the questions above) or benchmarking to other anonymous firms which the AA is familiar with. Alternatively the assessment may be based purely on the AA's judgement.

Resourcing

Does the insurer devote sufficient resources to risk management, either centrally or throughout its business units? Do those with important responsibilities have the time and resources to properly discharge their role? If not it is possible that important risk related issues will not be drawn to the attention of senior management and/or the Board in a timely manner. This was the case at NAB, where back office staffing was cut and trading was not properly monitored.

A well-resourced Risk Management Function may potentially indicate a stronger risk culture. However, as we have seen in the NAB case study it is not just the level of risk management resources but how they are used that matters.

Compliance

The growth in the number and complexity of regulations faced by Australian general insurers means that their compliance functions are now an important operation.

The AA should consider the insurer's approach to compliance and risk management. Are these performed by the same or different groups? Does a focus on compliance lead to weaker risk management? It is possible for an insurer to comply with all regulations and supervisor requirements yet have a weak RMF (e.g. from a lack of critical thinking about risk, or by not identifying material issues in a timely manner). The AA should not confuse a solid compliance function with a strong RMF.

Adequate compliance and risk management are related to resourcing and culture, as discussed above.

Hunger for Risk Appetite

In the last year or so most Australian general insurers have been working on improving their risk appetite statements. This has been driven mainly by an increased focus from APRA, particularly in the context of ICAAP (see below).

How insurers respond to this is important. Some have already embraced this as an opportunity for the Board and management to think about their businesses and their corporate strategy and how this is executed. In the process some have confirmed the status quo while others have made changes.

For others it is seen as a compliance exercise. This is an undesirable response which may indicate that the RMF requires further scrutiny.

Approaches to risk appetite statements will evolve over time. This is a topic that deserves some extra scrutiny in the next FCR if an insurer's risk appetite is undergoing significant change. The AA should look for risk appetite statements which give an outsider a clear understanding of the level and types of risk which the insurer may take.

ICAAP

APRA expect that the insurer's Internal Capital Adequacy Assessment Process (ICAAP) is connected to its RMF. As such ICAAP should support the review of RMFs in the following ways:

- Testing of extreme risk scenarios should improve, as the AA will have more material to review.
- Insurers should either have or be developing their risk appetite statements. Furthermore the processes for monitoring risk profiles and updating the risk appetite statement in the future should enhance the RMF.
- The insurer's strategic assessment of risk should be better than in the past, if its risk appetite is better. If this leads to fewer internal misunderstandings of the insurer's strategy, by clarifying what is and is not acceptable, then execution of the insurer's plans should improve.

The AA should review the key ICAAP documents, analysis and any other supporting work as part of their RMF review.

Rising Stress Levels

Many risks or risk management problems emerge because companies do not pay sufficient attention to potential but significant changes in their operating environment, and how they should manage this. In insurance the poor management of accumulation risk due to complacency (e.g. following a period of low catastrophe losses) is one example. The low interest rates which drove NAB's Homeside losses are another example. Often this omission comes from overconfidence about a company's prospects.

It is advisable for insurers to apply stress testing to gauge the financial impact of a range of scenarios, as well as appropriate management responses. Those with the best RMFs will have plans which can be implemented if something similar to a stressed scenario emerges.

The implementation of ICAAP among Australian general insurers should lead to greater use of robust stress testing to examine insurers' resilience. In many cases AA's will have a wider range of scenarios to review compared to the past. A lack of adequate stress testing may indicate weakness in the RMF.

Continuous Improvement

A lack of change in the RMF (or at least not considering the need for it) indicates some weakness in the RMF and the insurer's risk culture, especially if the insurer's circumstances are changing.

The AA should not be too concerned if the RMF is not perfect. All RMF's have some room for improvement. However, material weaknesses in a RMF do need to be investigated.

Risk Register

A useful source of information on an insurer's risk profile and risk management approach is its risk register, as it includes specific details of the insurer's business and exposures. This should always receive scrutiny from the AA. Questions should be asked if risks have been omitted which were expected to be on the register.

RMF Documentation

The length of documents such as the RMS is important. If they are too short they will not cover all requirements. However, if they are too long they will be difficult to maintain and lose their potency as policy documents. A balance must be struck. The AA needs to consider whether the key messages in the document are lost because of its length.

The RMS should sit at the middle of the insurer's policy structure, with other policies delving into specific areas in more detail. The RMS should not give the impression of being an afterthought, disconnected from the other policies. For instance, the RMS should describe at a high level how risks related to the reinsurance programme are managed and what is acceptable. The RMS should cross reference the Reinsurance Management Strategy (ReMS) i.e. the reinsurance policy. This would then set out detailed guidance on acceptable counterparty exposures, credit limits, strategies for placing cover locally or overseas, etc.

Summary

The RMF is a broad structure for controlling risk. In addition to the elements listed in section 3.3 of the Information Note, the areas discussed in this section should assist the AA in identifying areas to focus on in the risk management review. Ultimately the items reviewed will depend on each particular insurer's circumstances and their approach to risk management.

6. Organising the AA's Risk Management Review

This section describes how the AA might approach the risk management review. The ideas below are based on my experience and observations from the case studies and other material considered for this paper. Most of these points relate to testing how the RMF operates in practice.

The commentary below draws on section 3 of the Information Note. The reader should use this as the primary guide for their risk management review.

Nature of the Review

I approach a RMF review as follows:

1. Briefly confirm that a comprehensive and compliant RMF "structure" exists, then
2. Focus the remainder of the review on how this operates in practice.

Most insurers will already have a risk management structure in place; if not they would breach APRA's regulations. This structure includes such items as allocated roles and responsibilities, policy documents, a risk management process (e.g. based on ISO 31000 or other recognised risk management standard) and regular reporting to management and the Board.

However, as we have seen in our earlier examples the structural elements of the RMF are necessary but not sufficient for a sound RMF.

The second step is more challenging. This involves testing the quality of the RMF i.e. how all the components are used and whether the RMF can address emerging issues. It involves identifying whether the insurer is simply paying "lip service" to risk management. The areas covered in the previous section are aimed primarily at this second part.

It is important that the nature and scope of the AA's review is clearly understood and documented in the FCR. Usually AA reviews will not provide a detailed audit of the operating effectiveness of the RMF, but instead provide a higher level assessment of the suitability and adequacy of the RMF.

The AA should avoid describing their review process in too much detail. This risks detracting from the insight and observations they can provide on how the RMF works in practice, which are much more valuable.

Another aspect of the AA's review is whether they should cover downside risks only or "upside" opportunities as well. Traditionally risk management has included only the former, but the more recent concept of Enterprise Risk Management (ERM) covers both. ERM is defined in Appendix A.

In my opinion the AA may choose to include upside risks in their review if they wish, but it is the potential downside risks which should receive most attention.

Collecting Input

The AA should obtain opinions on the RMF from others, including some or all of the following: senior management, the Risk Management Function, auditors (perhaps via audit reports or independent reviews) and the Board Audit and Risk Committee chairman. Management views should be solicited in the meetings which the AA usually has with management to discuss other FCR topics.

Evidence Based Opinions

In my opinion the key guiding principle for the AA's review is that opinions must be based on the application of judgement after considering the facts and observations from their review. This may seem obvious but can be overlooked when it comes to writing the FCR.

The AA should include examples to demonstrate that they have tested statements or assertions by the insurer's management about the strength of the RMF. For instance the AA should:

- refer to evidence of change in the RMF in updated versions of the RMS, other policies or changed processes
- illustrate the RMF based on the range of views from those people interviewed. Have different people provided widely divergent views? Are there inconsistencies?
- give examples of topical risk issues discussed at Board or audit committee meetings during the year e.g. risk appetite, or the ease and cost of placing the reinsurance programme and associated discussions around risk retention
- consider whether material risks on the risk register have changed over time. Otherwise, the AA should query whether the risk register is actually used by the insurer
- consider the statement "risk management is embedded in the business", as this is often made by insurers or AA's in their risk management reviews. How is this so? Give examples to support this such as:
    - evidence of risk assessment in the business planning process (e.g. use of scenarios)
    - do internal peer reviews of important functions occur (e.g. underwriting or claims management)?
    - evidence that staff have a high rate of compliance with operating limits, as assessed by the internal auditor
    - evidence that risk owners are assigned responsibility for material risks and are held accountable for them.

It is useful for the AA to review the application of the RMF to insurance risks, as these contribute most of the general insurer's overall risk profile and are an area familiar to the AA.

Test the Practical Operation of the RMF

This section includes points for the AA to consider in testing how the RMF works in practice:

- The AA should be sceptical of what the insurer's management and staff say, as they will have a vested interest in describing the RMF favourably. The AA should be wary if management seem overly confident.
- Can management explain the underlying causes of losses during the year? If not this might indicate insufficient control over the insurer's operations and/or finances. This was a problem for HIH. More specifically:
  - If the insurer experiences a large loss, can this be attributed to a rare event which is consistent with the thresholds in the stated risk appetite? Or is the loss due to poor risk management?
  - Do the insurer's operations give the impression that risk management is out of control? For instance do management receive timely information on their risk exposures? Are there frequent breaches of operating limits?
- Are responsibilities and tasks for all areas of risk management assigned to individuals and/or committees? This was not the case for HIH and NAB and was a factor contributing to the problems that each experienced.
  - In more complex organisational structures do senior management in the group have adequate insight and understanding of the risks in the group's business units? Again, this was not the situation in the two case studies of risk management failure considered earlier.
- Can the Board articulate the insurer's main risks?
- Are the likelihood and impact bands used in the risk management process appropriate? If the bands are inappropriate (e.g. "catastrophic" impacts include relatively small risks when expressed as a proportion of expected profits or capital) then this may indicate that the insurer does not make full use of the process, as management are not scrutinising and challenging the process and the reported information.

The best situation for an insurer is where most risk issues are identified and resolved within the business. Still, some risks will be large or important enough that they should be escalated to the Chief Risk Officer (or Risk Management Function), and perhaps senior management and the Board. The AA should look for evidence that risks are managed within the business units where possible.

Use Your FCR

The AA should draw on the insights on other elements of the insurer's operations and financial position in forming a view on the RMF. While the RMF considers all risks, many of the material risks faced by a general insurer will already be known issues and will have been covered in other parts of the FCR. Views on how these are managed will be useful input to forming an opinion on the RMF. For instance, using insurance risk examples to test and illustrate how the RMF operates is useful.

Identifying Issues

To uncover potential issues with the RMF the following are worth considering:

- The AA should seek lead indicators of potential problems within the RMF. The number and severity of incidents and compliance breaches is a good example of such an indicator. If the AA finds something of interest they should not be afraid to dig deeper. A weakness does not imply that the insurer is going to fail but it is worth noting in the FCR as something the insurer should address.
- High staff turnover can be a lead indicator of problems. This is particularly true for key positions and may indicate cultural problems or instability within the firm. It may lead to a loss of retained corporate knowledge, if the processes around retaining this information are poor.
- Is the insurer currently dealing with material risks it is unfamiliar with, inexperienced in managing or poorly prepared to manage?

Checklists

Checklists are one way of ensuring that all important elements of the RMF are covered. However their use can lead to a mechanical review process, with insufficient critical thought applied to areas relevant to a particular insurer. They should be used with caution.

AA's should consider the points listed in Section 3.3 of the Information Note.

Opinions

To date there are no prescribed formats for the AA to use in giving an opinion. Whatever wording is chosen, the AA should ensure that the opinion is consistent with the scope of their review.

The AA might choose a "clean" opinion wording along the following lines:

> *"The RMF is suitable and adequate, after considering the nature, scale and complexity of the insurer's operations. I did not identify any material issues giving cause for concern."*

If the AA lacks sufficient exposure or interaction with the RMF, they are encouraged to seek access, and if necessary, document the potential limitations in the opinion. More detail on this point is contained in section 3.4 of the Information Note.

The AA must decide how to express the opinion, having formed their view on the RMF. If there are shortcomings or concerns with the RMF these must be described. The AA should be as specific as possible in justifying why they have expressed a concern about the RMF, and convey these concerns to management and the Board as early as possible.

There is a danger in issuing opinions, where those reading the FCR focus on the opinion and ignore other useful commentary on the RMF. The AA should structure their FCR to minimise the chance that these messages are missed.

7. Conclusions

The Australian general insurance industry is currently in a healthy state, based on strong prudential regulation, large capital buffers and favourable experience in the last decade. This supports Appointed Actuaries in their reviews of insurers' RMFs.

However, insurers and AAs cannot be complacent about risk management. Overconfidence can lead to poor practices developing and risk management standards slipping. AAs must be alert to this.

It is important for the AA to clarify the scope of their review with the insurer and ensure they understand the Board's expectations and vice versa. The AA's opinion should be supported by facts and the AA's observations.

The risk management review should consider all of the insurer's risks, including areas outside of traditional actuarial roles such as strategic, operational and reputational risk. A healthy risk culture is a key component for a good RMF and must be a focus in the RMF review.

There is no single approach to best practice risk management. Similarly, there is no single way for an AA to review a RMF. Best practice and experience will develop over time. Whatever approach is taken, the AA should apply some scepticism in the course of their review (particularly to statements by management and staff which are difficult to validate). They should consider all risks but focus on material ones and look for lead indicators of potential problems.

Preparing the RMF review for an insurer in an impaired or challenged state is more difficult. Provided the AA considers all important areas of the RMF and applies sound reasoning to the facts they should be able to provide a suitable opinion and commentary in the FCR. It is critical that the AA discusses these findings with the insurer's management and/or Board as early as possible, to explain the result and avoid any misunderstandings.

Actuaries are well placed to draw on their deep knowledge of general insurers' risks and their mix of commercial and technical skills to make a valuable contribution to reviewing insurers' RMFs.

A Final Thought

The following comments from Owen J following the HIH Royal Commission are useful (emphasis added):

"From time to time as I listened to the evidence about specific transactions or decisions, I found myself asking rhetorically: did anyone stand back and ask themselves the simple question – ***is this right?***"

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Appendix A – Definitions

Risk is "the likelihood of failing to meet objectives". This definition:

- is general and can be applied more broadly than other definitions which are focused on financial measures (e.g. volatility of outcomes). It can be applied to operational and strategic risks, such as reputation risk
- ensures a uniform approach to risk if the firm's corporate objectives and division/business unit objectives are aligned. It encompasses alternative definitions of risk. For instance, objectives can be set to limit the probability of impairment and the volatility of earnings.

Risk Management Framework (RMF) includes "systems (including the structures, processes, policies and roles supporting them) for identifying, assessing, mitigating and monitoring the risks that may affect a regulated institution's ability to meets its obligations to policyholders" (GPS 220, paragraph 7a). The RMF covers all aspects of risk management.

Risk Management Function is the centralised officer or team of an insurer or group responsible for managing the RMF. In large organisations this may be a dedicated, specialist role with a title such as Chief Risk Officer (CRO). In smaller insurers the Risk Management Function may be one of several responsibilities of a senior executive such as the Chief Executive Officer or Chief Financial Officer.

Risk Management Strategy (RMS) is "a high level, strategic document intended to describe the key elements of a regulated institution's risk management framework" (GPS 220, paragraph 29). For most Australian insurers it serves as the main risk management policy document.

The items above are mostly applied to the management of downside risks only. In some cases insurers may choose to adopt an Enterprise Risk Management approach in their RMF, where upside "opportunities" are included.

Enterprise Risk Management (ERM) is "the process by which organisations in all industries assess, control, exploit, finance, and monitor risks from all sources for the purpose of increasing the organisation's short and long term value to its stakeholders" (Information Note, Section 2.3)