Directors' School for Insurers in Costa Rica

Topic 4

Risk Management + Maple Leaf Insurance

(with Appendix – Summary of Accepted Best Practices and International Standards in Corporate Governance and Risk Management)

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SUGESE
Superintendencia General de Seguros
República de Costa Rica

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Mini-Case – Maple Leaf Insurance Company

Maple Leaf Insurance Company, a relatively small general insurer, has outsourced its claims adjusting function. Now, when a claim is reported, the insurer notifies the outsource adjusting company, which then causes one of its adjusting personnel to visit the site of the loss and prepare an estimate as to the amount that will have to be paid to settle the claim. The outsource company then notifies the insurer of the amount and this is set up as a case provision in the insurer's claim files.

Maple Leaf has indicated that the adjusting company is more specialized and has greater expertise in this area than the insurer can support in house.

Mini-Case – Maple Leaf Insurance Company

For claims that can be settled in a straight-forward manner, the adjusting company will pay the claim and then invoice Maple Leaf for the amount.

Mini-Case – Maple Leaf Insurance Company

Comment on the use of an outsource provider in this situation.

- **Any potential concerns for the board of MLIC?**
- **If so, how might they be dealt with?**
- **What are the potential advantages with the use of the outsource firm?**
- **Are they sufficient to offset any disadvantages?**

Mini-Case – Maple Leaf Insurance Company

New Information

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- **Smith is a former senior insurance partner with an international audit firm. He left the audit firm "under a cloud" with many rumours, but the details are kept confidential by the audit firm.**

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- **Smith is a former senior insurance partner with an international audit firm. He left the audit firm "under a cloud" with many rumours, but the details are kept confidential by the audit firm.**

- **The supervisor commences an on-site inspection.**

Mini-Case – Maple Leaf Insurance Company

New Information

- A new CEO, Jim Smith, has just been appointed and the outsourcing deal is one of his first acts as CEO.

- Smith is a former senior insurance partner with an international audit firm. He left the audit firm "under a cloud" with many rumours, but the details are kept confidential by the audit firm.

- The supervisor commences an on-site inspection.

- Inspectors soon hear talk about "funny things" going on in the claims area: experienced employees are being replaced by less experienced staff who are considered to be cronies of Smith.

Mini-Case – Maple Leaf Insurance Company

Identify any risks you see emerging in this situation.

Mini-Case – Maple Leaf Insurance Company

On-site findings of the Supervisor

- **Evidence that the adjusting company was billing Maple Leaf about double the cost of the claim actually being settled.**

Mini-Case – Maple Leaf Insurance Company

On-site findings of the Supervisor

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- **Evidence that the CEO had a fabulous new yacht that was somehow paid for by Maple Leaf.**

Mini-Case – Maple Leaf Insurance Company

On-site findings of the Supervisor

- **Evidence that the adjusting company was billing Maple Leaf about double the cost of the claim actually being settled.**
- **Evidence that the CEO had a fabulous new yacht that was somehow paid for by Maple Leaf.**
- **Evidence that the CEO's wife was being paid a secret salary through an auto body shop service provider of Maple Leaf.**

Mini-Case – Maple Leaf Insurance Company

On-site findings of the Supervisor

- **Evidence that the adjusting company was billing Maple Leaf about double the cost of the claim actually being settled.**
- **Evidence that the CEO had a fabulous new yacht that was somehow paid for by Maple Leaf.**
- **Evidence that the CEO's wife was being paid a secret salary through an auto body shop service provider of Maple Leaf.**
- **Evidence that extensive work was being done to the CEO's summer home, secretly paid for by Maple Leaf.**

Mini-Case – Maple Leaf Insurance Company

If you were the Supervisor, what would you do next?

If you were an independent board member of Maple Leaf, how might you respond to allegations that these situations were occurring?

Mini-Case – Maple Leaf Insurance Company

- **The supervisor wrote to each board member, describing the findings in general terms but not mentioning individual names, e.g. double-billing of claim amounts by outsource adjuster, personal work being carried out but being billed to the company, amounts being paid to an auto body shop which are then being paid out to a relative of a staff member, etc.**
    - **No response at all from the board.**

Mini-Case – Maple Leaf Insurance Company

- Judge grants a search warrant for the claim adjusting company.
    - Claim adjusting company has purchased expensive cars and a condo in Miami, and title has been transferred to Mr. Smith.
    - More than $1.5 million in over-billing by claim adjusting company to Maple Leaf.
- Mr. Smith arrested and spends several nights in jail. Government accepts a plea deal and on a reduced charge Mr. Smith pleads guilty and is sentenced to 1 year of house arrest and required to do several months of charity work.
- But his Chartered Accountant designation is revoked by the CA Institute.

6 Steps to Good Risk Management

1. **Identification: External & Internal Environmental signals, Knowledge of Business**
2. **Assessment: Statistical measures: Severity vs. Frequency, Judgments**
3. **Measurement/Quantification: Simulation, Assigning a dollar value**
4. **Response: Controls, Insurance, Capital Allocation/risk financing**
5. **Reporting: Centralized; Comprehensive/Portfolio of risk**
6. **Monitoring: Responsibilities, Continuity/Frequency, Format**

Risk Management for Insurers

There is an old story about a fish that went on a long journey to find a Zen master. When at last he found the wise old master, he asked him "What is this thing called water that I hear of?" How could a fish not know about water? But the concept of "water" presented a huge challenge to the fish was because he was so thoroughly immersed in it.

Sometimes we overlook risks because they are simply too obvious.

For insurers, risk management is exceptionally important – because unlike other corporations, they are in the business of accepting risks from other parties, absorbing those risks with their capital base and reinsuring excess risks to reinsurers.

Risk Management for Insurers

What risk areas do insurers need to be concerned about?

Each insurer has to look at its own business, including its Significant Activities, to determine where its risks may lie, their potential severity and frequency. The result will be a Risk Profile for the insurer.

For insurers, both international standards and the Costa Rica supervisor identify the following areas as being particularly relevant for insurers:

(a) insurance risk;

(b) credit risk;

(c) liquidity risk;

(d) operational risk;

(e) market risk.

What do we mean by these risk terms?

Risk Management for Insurers

Insurance Risk(1)

Insurance risk arises from the potential for claims or payouts to be made to policyholders or beneficiaries. Exposure to this risk results from adverse events occurring under specified perils and conditions covered by the terms of an insurance policy.

Insurance risk includes uncertainties around:

- **the ultimate amount of net cash flows from premiums, commissions, claims, payouts, and related settlement expenses,**
- **the timing of the receipt and payment of these cash flows, and**
- **policyholder behavior (e.g., lapses).**

(1) OSFI definitions

Risk Management for Insurers

Insurance Risk

Examples:

- **Risk that established claim provisions are not sufficient to discharge the claims to which they relate.**
- **Risk that premiums are not sufficient to pay incurred claims, pay expenses and generate a profit.**
- **Risk of adverse selection . . . etc.**

Risk Management for Insurers

Credit Risk

Credit risk arises from a counterparty's potential inability or unwillingness to fully meet its on-and/or off-balance sheet contractual obligations. Exposure to this risk occurs any time funds are extended, committed, or invested through actual or implied contractual agreements.

Components of credit risk include: loan loss/principal risk, pre-settlement/replacement risk and settlement risk.

Counterparties include: issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.

Risk Management for Insurers

Credit Risk

Examples:

- **Risk that amounts due from reinsurers will not be collected.**
- **Risk that a corporate bond held as an investment by the insurer, will not be able to be repaid by the corporation that issued the bond.**
- **Risk that an important broker/producer will not be able to remit premiums where the policies have been issued by the insurer.**

Risk Management for Insurers

Liquidity Risk

Liquidity risk is the potential for losses to be incurred from holding insufficient liquidity to survive a contingent stress event, whether name-specific or market-wide in origin.

Example:

- **A shock loss generates an immediate need for cash but available assets are real estate holdings which cannot be disposed of except over long period of time.**

Risk Management for Insurers

Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems.

Examples:

- **IT system fails, resulting in substantial loss of clientele.**
- **Internal fraud gives rise to loss of several million US$.**

Risk Management for Insurers

Market Risk

Market risk is the risk of losses in on- and off-balance sheet positions arising from movements in market prices.

Example:

- **An insurer's common share portfolio declines by 50% during the financial crisis.**
- **The insurer has some payments due in Mexican pesos. The Mexican peso declines in value relative to the US$, so there is a loss to the insurer arising from the currency fluctuation.**

Risk Management for Insurers

The challenge for insurers is to assess their company's exposure across these risk areas, thinking about how they can measure and control exposure in each.

You will have to think carefully about your business – you may have some relatively unique business aspects where risks do not fit neatly into the specified categories. But it's critical to identify all important risks.

We suggest you not limit your thinking to the categories mentioned. If it is helpful to sub-divide categories (e.g. market risk might be defined in your country to include "interest rate risk" and "foreign exchange risk"), then do that. The "risk pie" can be divided in many different ways. The key is not to leave any risk areas unassessed.

Risk Management for Insurers

The Risk Appetite

As an important part of the Enterprise Risk Management (ERM) process, each insurer must also set out its Risk Appetite. This involves the consideration of the maximum acceptable risk that the insurer is reasonably able to assume, across the various risk areas.

When defining the Risk Appetite, don't forget to think about how different combinations of risks might occur at the same time, or how they might act together to exacerbate a potential loss situation. The company is an integrated system and so the different areas that may be affected by risks are not independent of each other. (Stress testing helps to highlight inter-related risk areas.)

Risk Appetite

Supervisors (and rating agencies) and standards for good Corporate Governance say that good risk management requires a statement of risk tolerance/appetite.

Many insurance companies, banks, pension plans (most ?) struggle with developing good statements of risk tolerance/appetite !

Why is this ?

Risk Appetite

Ask experienced business managers – to make a statement about how much risk they are willing to accept

- They will make vague statements – and then change the subject

Most companies do not have a formalized risk statement – something that is clear and understandable – let alone passed down to the working management level

Risk Appetite

- Generally – most financial institutions do not have clearly defined risk appetite/tolerance statements – but for the most part – chaos does not result – why?
  - The employees who accept and manage risk usually keep the risk level at a similar level to what it was previously – accept the status quo – this often will work as long as:
    - Risk taking by new employees is restricted – until the new employee has a sense of how things are done
    - Managers are infrequently called on to judge risk of totally new ventures or opportunities
    - The operating and macroprudential environments are not rapidly changing

Risk Appetite

- To construct a good functional risk tolerance/appetite statement – management/boards need 2 things
  - To identify what adverse event(s) that they will base their tolerance/appetite on
  - Estimate the likelihood of that adverse event on their tolerance level

  - + difficulties
    - The quantum of risks they take is not obvious
    - It the individual risks are understood – the aggregation of those risks is usually not understood

Risk Appetite

What is often missing – experiential evidence (or feel) of the risks

- One approach – over years – observation of events, adverse events – the accumulation of experience
- But if risk tolerance is needed sooner than a time frame of many years – is to look backwards at the risk level from the past 5, 10, 20 years of history (company, industry)
  - Risk tolerance/appetite can be set by working from the worst year/worst individual experience/worst accumulations – and assessing the **discomfort** level at getting close to that situation again
    - Look at these comparatives to the institution's
      - **Risk and capital**
      - **Risk and earnings**

Risk appetite – how to visualize

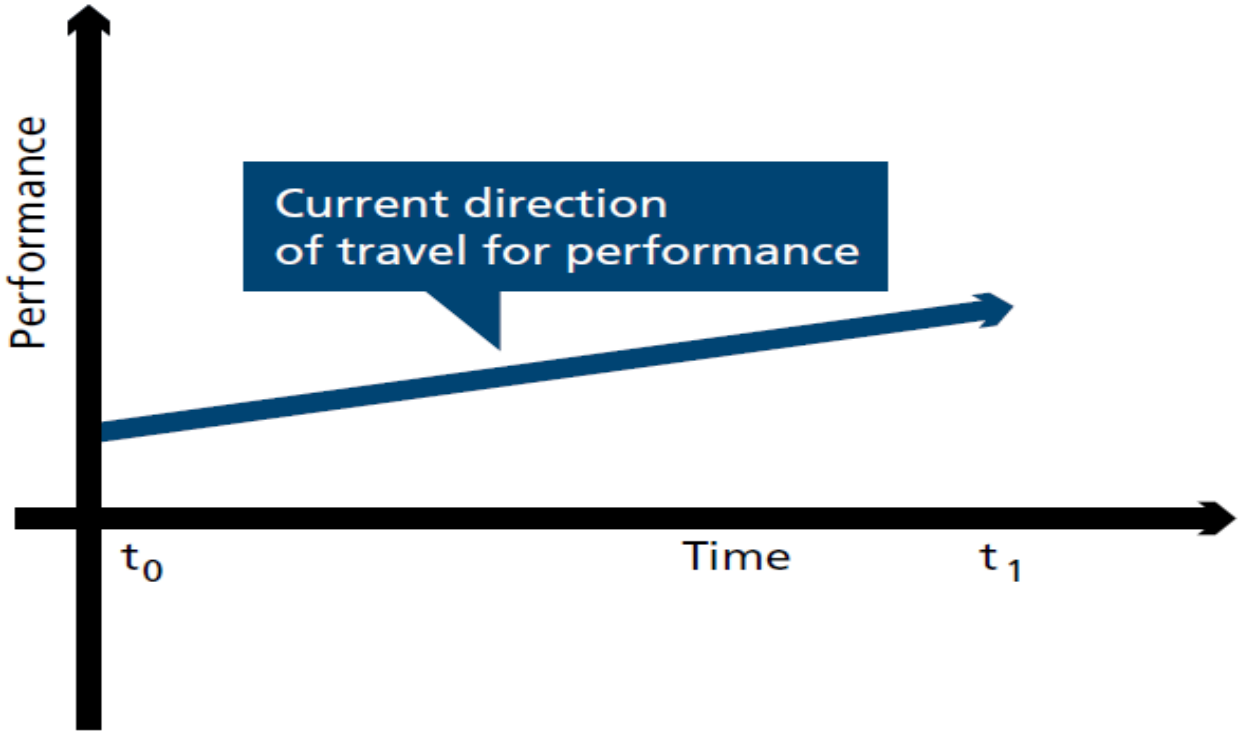


Diagram 1

Risk appetite – how to visualize

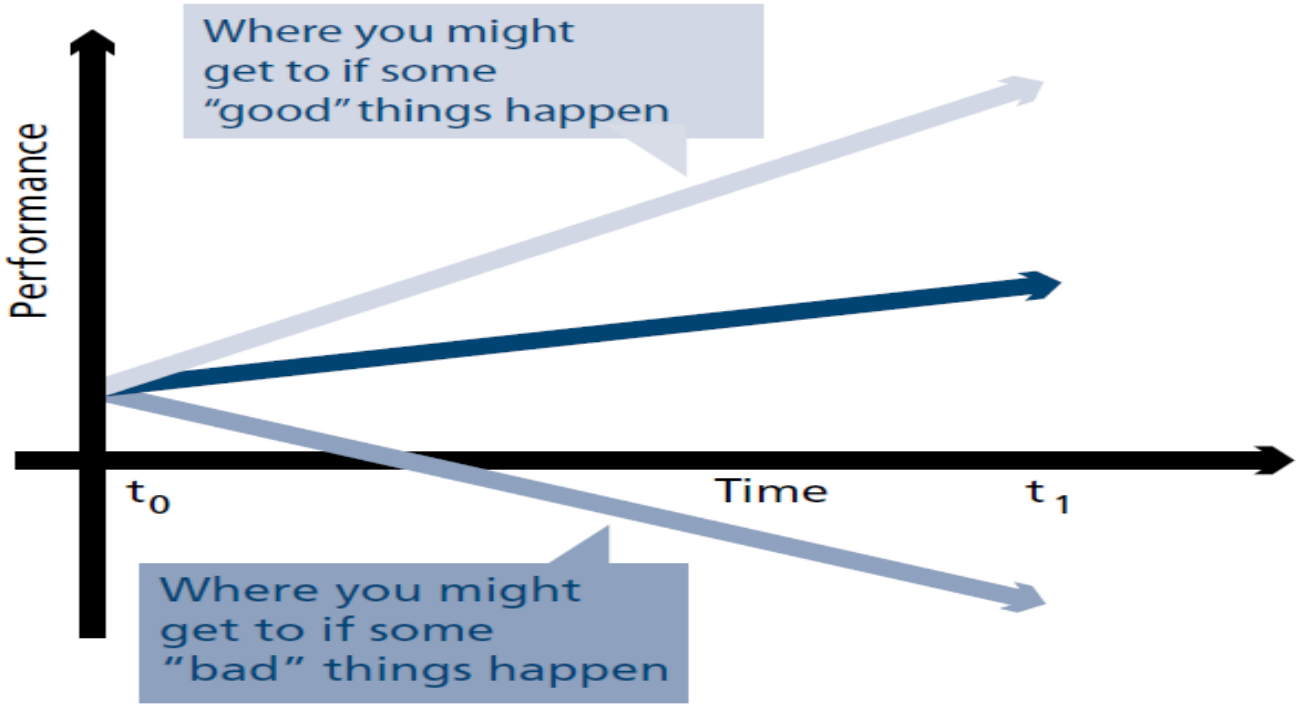


Diagram 2

Risk appetite – how to visualize

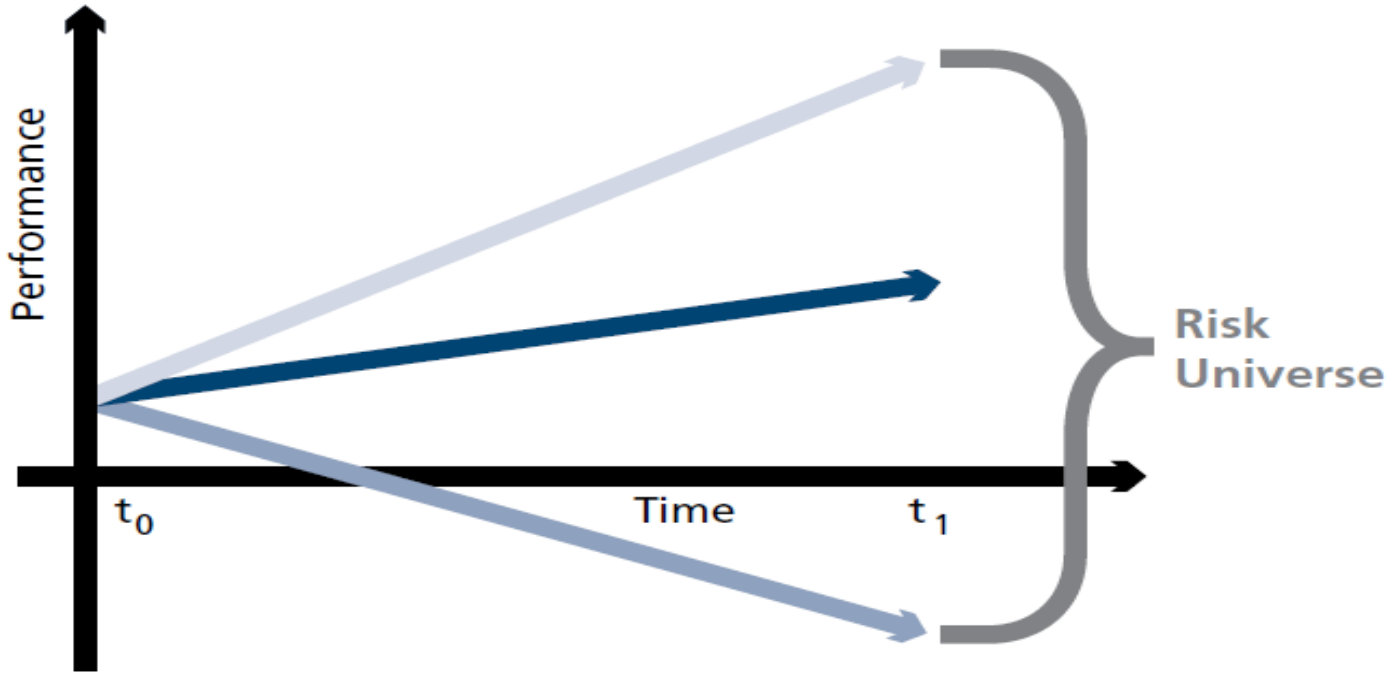


Diagram 3

Risk appetite – how to visualize

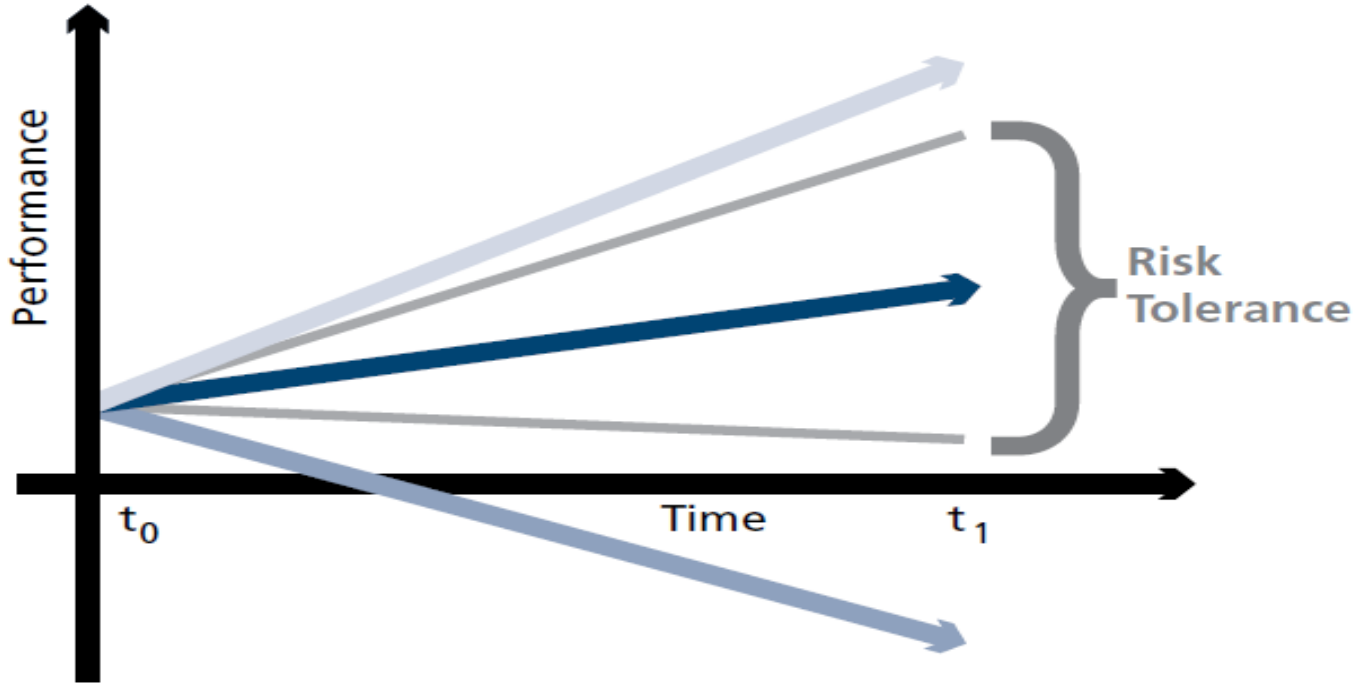


Diagram 4

Risk appetite – how to visualize

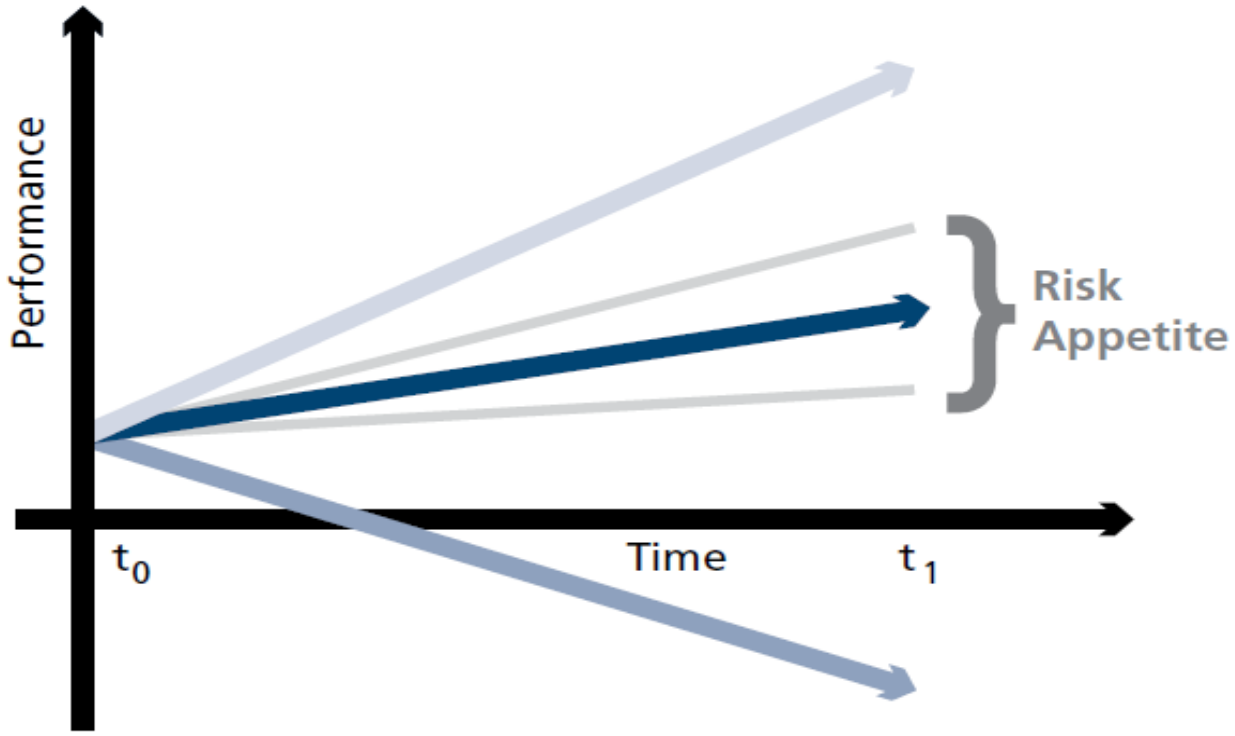


Diagram 5

Definitions

- **Risk Tolerance or risk capacity** – the amount of risk that an organisation might choose to retain after risk mitigation
  - Another: what you can allow the organisation to deal with

- **Risk Appetite** – the amount of risk that an organisation plans to take – usually an amount less than risk tolerance
  - Another: risk appetite is about the pursuit of risk – what you actively go after

Risk Appetite Framework

Risk Appetite Framework

- the overall approach – policies, processes, controls and systems through which risk appetite is established, communicated and monitored
  - Risk appetite statement
  - Risk limits
  - Roles & responsibilities
- Material risks to the institution
- Consider reputational impact

Risk Appetite Framework

Risk Appetite Statement

- The (written) articulation of the aggregate level of risk and the types of risk that an institution is willing to accept (or to avoid) – to achieve objectives
- Includes
  - Qualitative aspects
  - Quantitative measures
    - Expressed relative to earnings, capital, risk measures, liquidity and other measures as appropriate
  - Should address hard to measure & quantify such as reputation and market conduct – and – ethical aspects and asset laundering

Risk Appetite Framework

Risk Capacity

- Maximum level of risk the institution can assume – some refer to this as tolerance
  - Determined by capital (regulatory or economic), liquidity measures, operational environment (infrastructure, capabilities, expertise, market conduct/ethical behaviour, etc)

Risk Appetite Framework

Risk Appetite

- Aggregate level and types of risk an institution is willing to assume
  - Within the risk capacity to achieve strategic objectives and business plan

Risk Appetite Framework

Risk Limits

- Quantitative measure based on forward looking assumptions – allocate the institution's aggregate risk appetite
  - Measure of loss or negative events
  - To business lines
  - Legal entities
  - By specific risk categories – concentrations

Risk Appetite Framework

Risk Appetite Framework - RAF

- Sets the institution's risk profile and is fundamental to the development of business strategy
- Will determine the risks undertaken
- Alignment with
  - business plan
  - Capital planning
  - Compensation schemes
- Common framework and comparable measures across the institution
- Expression of the boundaries within which the institution is expected to operate
- Communicated throughout the institution

Risk Appetite Framework

Risk Appetite Framework

- Communication across the institution
- Top down and bottom up directions
- Fundamental in establishing consistent risk culture
- Evaluate risk opportunities and defense against excessive risk taking
- Natural impact on board discussions, risk management and internal audit
- Adaptable to market conditions

Risk Appetite Framework

Risk Appetite Statement

- Linked to strategy
- Address material risks – normal and stressed conditions
- Establish boundaries
- Quantitative measures
  - Loss or negative outcomes
  - Earnings, capital, liquidity, growth, volatility
- Qualitative
- Set out rationale for accepting risks, avoiding risks
- Aggregate risk appetite needs to be allocated to business units

Risk Appetite Framework - What are some qualitative risk appetite statements

Capital – to satisfy regulatory and credit rating agency expectations	Maintain dividend payout ratio
Growth in profits	Stock price growth
Maintain market share	Avoid adverse publicity regarding consumer complaints
Comply with all regulatory requirements	Make progress in new distribution channels
Maintain service levels to customers	Retain existing corporate accounts
Expand product portfolio	Ensure ongoing liquidity
Avoid catastrophic risk accumulation	Increase diversification in broker channel
Maintain (regulatory) composite risk rating	Improve board skill sets

Risk Appetite Framework - What are some quantitative risk statements

Capital ratio > x%	Investment portfolio – min. 65% gov't guaranteed
Leverage measure < y%	Investment policy – commercial grade, min credit quality BB-d
Combined loss ratio < x%	Interest rate sensitivity < 1.5 yrs duration, as a % of capital
Consumer customer credit scoring > y%	Foreign exchange mismatch < 20% assets/liabilities, as a % of capital
Corporate credit rating > x%	Policy limits – commercial property < $3 mn, special acceptance for >$3 mn
Loan concentration -Industry A > 25%,< 40% -Industry B > 15%, < 25% -Commercial mortgages < 8%	Decline all motor policies – male < 25 years

Risk Appetite Framework

Risk Limits

- The allocation of the aggregate risk appetite to business line, entity, risk categories, concentrations, etc
- For effective monitoring – need to be specific to business operations – correspond to business activities
- Measurable limits helps prevent institutions from unknowingly exceeding its risk capacity and conditions change and act as an effective defense against excessive risk taking
- Need to consider the interaction between risks – both within the business unit and across the institution
  - Stress testing to establish limits – needs to be institution wide

Risk Management for Insurers

The Risk Management Profile

Having identified the important risk situations and having defined a detailed Risk Appetite, the next step is usually to consider identified risks in terms of their expected frequency and severity. This leads to the Risk Management Profile for the insurer.

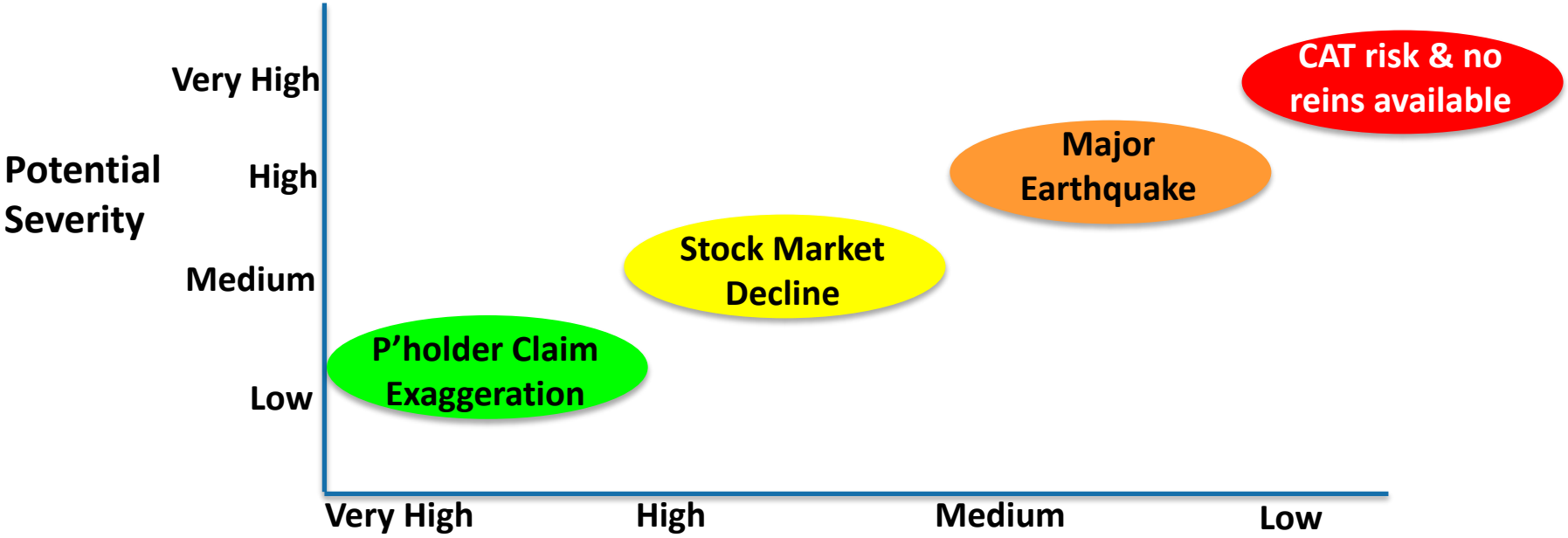
The Risk Management Profile is important because it identifies for the insurer which risks are critically important to monitor and mitigate, as well as the risks which can be subject to less rigorous approaches.

For some risks the decision might be to just let them run because the cost of mitigation may be greater than the potential for loss.

Risk Management for Insurers

Risk Management Profile (with examples)

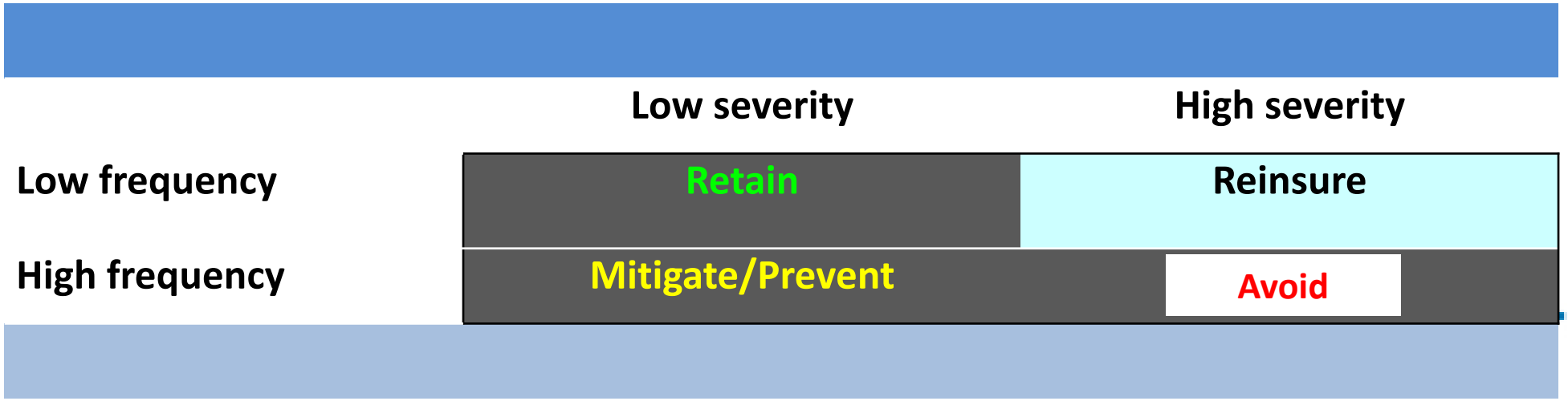
Consider the specific risks in terms of our expectations about their likelihood of occurrence (probability) and the potential for loss if they do occur (severity).



Risk Management for Insurers

For each or our key risk conditions, we should decide, based on our assessment with regard to cost of monitoring/controlling compared to potential for loss, whether we will opt to Retain the risk, Transfer the risk, Prevent the risk or Avoid the risk.

Decisions with regard to Retain, Transfer, Prevent or Avoid, will be guided according to an overall matrix along the following lines:



Risk Management for Insurers

Risk Mitigation

Having identified key risks, having established a comprehensive risk appetite document and having developed a risk management profile, the important goal is to be able to develop an effective system of risk mitigation.

- **If risks can be described sufficiently accurately for a calculation to be made of the probability of occurrence and probable maximum loss, these are normally called insurable risks, or in the case of an insurer, reinsurable risks.**

- **For insurers, reinsurance is probably the single most widely used basis of risk mitigation. Reinsurance transactions will typically reduce the insurer's Insurance Risk (but remember they will *increase* Credit Risk and Operational Risk.)**

Risk Management for Insurers

Risk Mitigation

Risks other than Insurance Risks, such as Credit Risk and Market Risk, can often be quantified but are not amenable to being transferred away by reinsurance. In these cases it is internal controls and monitoring, as well as the precision and comprehensiveness of the Risk Appetite, that provide the main risk level protection required by the company.

There may be other risks that are difficult to quantify or measure, Operational Risks being a good example, and in these cases the quality of internal controls, internal management reporting, internal audit and the independent audit that will have to provide the required risk mitigation processes.

Stress Testing

- Stress testing is an important part of risk management and should be embedded in the enterprise wide risk management program.
- The concept is to pose “what if” type questions, selecting parameters that are significantly adverse but not impossible. Stress testing includes both scenario testing and sensitivity analysis.
- The company’s solvency position is calculated under each of the specified situations. None of the tested situations should result in the company failing to meet its minimum solvency requirement. However, vulnerabilities may become clear and can then be incorporated in risk mitigation strategies.

Stress Testing

- Reverse stress testing involves pushing scenarios until solvency minimum is breached. Are such scenarios within the realm of plausibility? If so, additional risk mitigation measures will be required.

- Stress tests should focus on key risk areas for the company, typically including the areas covered by the Risk Appetite.

- Stress test results should be highlighted in the company's periodic internal management reporting package, including the trend in stress test results over time, by type of test.

Stress Testing

Test results should be reviewed and discussed by directors at every board meeting, with appropriate input to management.

Senior management is responsible for the implementation, management and oversight of the stress testing program and for ensuring that the institution has adequate plans to deal with remote but plausible stress scenarios.

In some countries (Canada is an example), the actuary is required to carry out specific stress testing procedures and to annually opine on the results.

ORSA or "Own Risk and Solvency Analysis"

ORSA[1].

An internal process undertaken by an insurer or insurance group to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios. An ORSA will require insurers to analyze all reasonably foreseeable and relevant material risks (i.e., underwriting, credit, market, operational, liquidity risks, etc.) that could have an impact on an insurer's ability to meet its policyholder obligations.

1. From National Association of Insurance Commissioners, USA, 2018 https://www.naic.org/cipr_topics/topic_own_risk_solvency_assessment.htm Also next two slides.

ORSA or “Own Risk and Solvency Analysis”

ORSA continued

The "O&" in ORSA represents the insurer's "own" assessment of their current and future risks. Insurers and/or insurance groups are required to articulate their own judgment about risk management and the adequacy of their capital position. This is meant to encourage management to anticipate potential capital needs and to take proactive steps to reduce solvency risks.

ORSA or “Own Risk and Solvency Analysis”

ORSA continued

ORSA is not a one-off exercise-it is a continuous evolving process and should be a component of an insurer's enterprise risk-management (ERM) framework. Moreover, there is no mechanical way of conducting an ORSA; how to conduct the ORSA is left to each insurer to decide, and actual results and contents of an ORSA report will vary from company to company. The output will be a set of documents that demonstrate the results of management's self-assessment.

ORSA or "Own Risk and Solvency Analysis"

ORSA continued

The ORSA exercise is now an accepted best practice and is required under International Standards.

Insurers have typically found it initially challenging but as the exercise is repeated over a number of periods it becomes more straightforward. The fact that it is often found to be a challenge illustrates the fact that most insurers were not previously thinking about all the factors that could impact their solvency positions, and so their planning processes were deficient to that extent.

Risk Management for Insurers

An ERM "lesson learned" by many companies is that one of the most important ways of recognizing and mitigating risks is by means of sensitizing employees to the concepts of risk management.

No board member or senior manager is in a position to understand and recognize all the myriad risks facing an insurer in its day-to-day business.

Therefore the quality of the whole program can be immeasurably improved by taking every possible opportunity to reinforce the concepts and their importance with the employees, who will be in a position to flag important but previously unrecognized risks, for attention.

Risk Management for Insurers

Manulife(1) – Risk Management Statement

The Board considers all principal risks facing Manulife, as well as measures to manage these risks. The Audit Committee ensures that comprehensive policies, risk management policies and internal control systems are in place to mitigate our exposures.

Manulife's risk policies, risk management processes, internal controls and management information systems are updated on a regular basis to ensure they match our risk profile and comply with regulatory requirements.

(1) Manulife is a large Canadian life insurer with almost 1 trillion in assets as at August 2018. Excerpts are from 2013 Annual Report.

Risk Management for Insurers

Manulife – Risk Management Statement, continued

As required by the U.S. Sarbanes-Oxley Act, the CEO and the Chief Financial Officer certify our annual financial statements and evaluate and report on the effectiveness of Manulife's disclosure controls and procedures.

The Audit Committee has direct communication, including in camera meetings, with the internal auditor, independent auditor and Appointed Actuary, as well as with our principal regulator, the Office of the Superintendent of Financial Institutions (Canada).

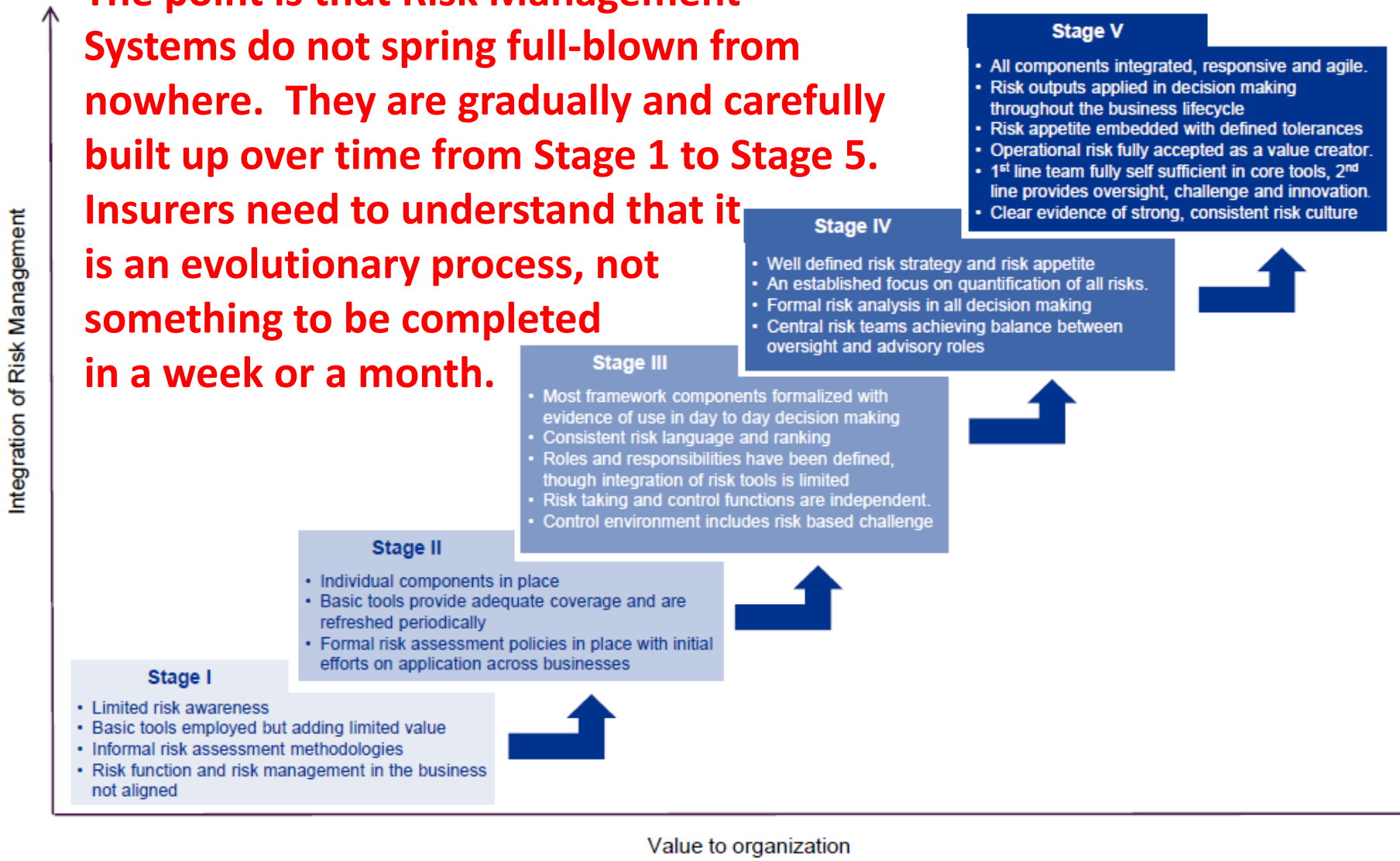
Manulife – Risk Management Culture

A strong risk culture and a common approach to risk management are integral to our risk management practices. Our governance framework is centered on the "three lines of defense" model. As the first line of defense, businesses are accountable for the risks within their unit including the day to day management of the risks and related controls. They are responsible for ensuring their business strategies align with the Company's risk taking philosophy, risk appetite and culture, for thoroughly evaluating and managing risk exposures consistent with our enterprise risk policies and standards of practice, and for delivering returns commensurate with the level of risk assumed. Our businesses are supported by global risk managers and risk management professionals across the enterprise that are responsible for the design and execution of risk mitigation practices that are consistent with the Company's policies and specific risk management strategies. The second line of defense is comprised of the CRO, the Corporate Risk Management function, global oversight functions and divisional CRO's functions. Together this group provides independent oversight of risk taking and risk mitigation activities across the enterprise. Enterprise-level risk oversight committees, including the ERC, also provide oversight of risk taking and risk mitigation activities. As the third line of defense, Internal Audit provides independent analysis of whether controls are effective and appropriate relative to the risk inherent in the business, and whether risk mitigation programs and risk oversight functions are effective in managing risks.

ERM Framework

Maturity of Framework Implementation

The point is that Risk Management Systems do not spring full-blown from nowhere. They are gradually and carefully built up over time from Stage 1 to Stage 5. Insurers need to understand that it is an evolutionary process, not something to be completed in a week or a month.



Slide courtesy of KPMG Toronto Canada. Used with permission.

Corporate Governance and Risk Management

The foregoing slides set out the main headings for the ICPs governing Corporate Governance and Risk Management.

We suggest that you also read the supporting material for each of these headings in the IAIS Insurance Core Principles. Clearly the requirements, if they were all to become part of the formal supervisory regime here in Costa Rica, would be quite extensive. In some cases, such as ICP 8.5, Actuarial, it may not be possible to fully implement with the resources currently available to insurers in Costa Rica.

On the other hand, virtually every one of these points can be considered to be an example of good management practice.

Corporate Governance and Risk Management

In some jurisdictions, good risk management is considered to be a sub-set of good corporate governance.

In other jurisdictions, good corporate governance is considered to be a sub-set of good risk management.

It doesn't matter which way you look at it. In either case the two areas are *critically important* and *mutually reinforcing*.

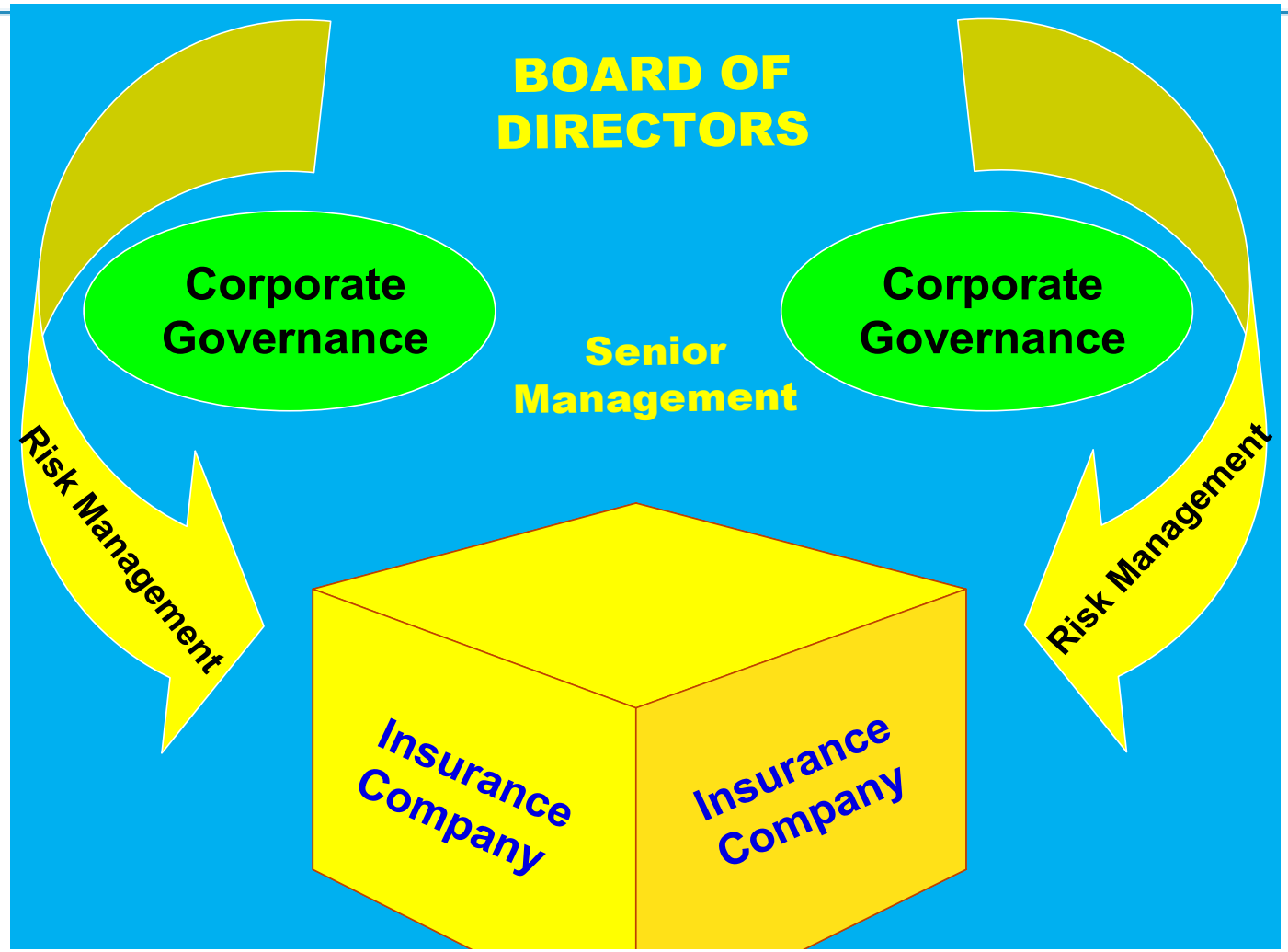
Corporate Governance and Risk Management

Corporate governance consists of the processes, structures, information, and relationships used for directing and overseeing the management of the institution in the best interest of the institution and the key stakeholders that have a significant interest in the ongoing viability of the company.

World Bank
Core Curriculum for
Insurance Supervisors

Risk Management consists of the systematic application of management policies, procedures and practices to the tasks of identifying, analysing, evaluating, treating and monitoring risk.

Corporate Governance and Risk Management



"Stronger Corporate Governance and Its Implications on Risk Management" Anne E. Kleffner, Ryan B. Lee and Bill McGannon, Ivey Business Journal, May/June 2003

Corporate Governance and Risk Management

NOTE: There is no requirement that different individuals be responsible for every different aspect of the ICPs. For example in the field of risk management, a large institution would almost certainly have a Chief Risk Officer, with reporting responsibilities directly to the board. The CRO would have a substantial department of risk management experts supporting the department and being responsible for the wide range of functions described in the ICP.

But small institutions do not have this luxury. The main point to remember is that even in a very small company, *someone* has to be responsible for the different ICP activities. Various individuals may be multi-tasking, as long as conflicts of interest are carefully avoided.

Risk Management Must be Pervasive

When speaking about risk management, the term mostly used these days is Enterprise Risk Management or ERM, because a key characteristic of risk management is that to be effective, the risk management concept must be pervasive throughout the company, i.e. it is a discipline that must be practiced not just by the board and senior management but also very importantly, by all employees across the entire enterprise.

The executive in the corner office does not know what is happening "on the shop floor". It is the day-to-day employees who see how the company is operating and who are in a good position to alert management – and the risk management system – to risks that should be monitored and mitigated.

Appendix – Accepted Best Practices and International Standards in Corporate Governance and Risk Management

San José, Costa Rica, April 22-26,2019

Presented by Lawrie Savage and Bruce Thompson

TORONTOCENTRE
Global Leadership in Financial Supervision

International Standards in Corporate Governance and Risk Management

The International Association of Insurance Supervisors (IAIS) is the standard setting body for insurance supervision world-wide.

IAIS has 190 jurisdictions as members, accounting for more than 90% of the world's insurance premiums.

The "Costa Rica Insurance Commission" is an active member of IAIS.

Most of the key requirements of IAIS standards have been adopted by IAIS because they are recognized internationally as accepted Best Practice.

International Standards

The full set of IAIS standards, or Insurance Core Principles (ICPs) as they are known, are available on the IAIS web site at:

http://www.iaisweb.org/page/supervisory-material/insurance-core-principles

There are 26 ICPs in total, updated in 2018. All the ICPs are relevant to insurance managers and board members and we suggest they be reviewed at your convenience.

Accepted Best Practice[1.] - Corporate Governance

Corporate Governance Overview (ICP 7)

- **The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognizes and protects the interests of policyholders.**

1. The Accepted Best Practices summarized herein are also included in the IAIS Insurance Core Principles.

Accepted Best Practice - Corporate Governance

Objectives and strategies of the insurer (ICP 7.1)

- **The supervisor requires the insurer's Board to set and oversee the implementation of the insurer's business objectives and strategies for achieving those objectives, including its risk strategy and risk appetite, in line with the insurer's long term interests and viability.**

Accepted Best Practice - Corporate Governance

There is appropriate allocation of oversight and management responsibilities (ICP 7.2)

The supervisor requires the insurer's Board to:

- **ensure that the roles and responsibilities allocated to the Board, Senior Management and Key Persons in Control Functions are clearly defined so as to promote an appropriate separation of the oversight function from the management responsibilities;**

- **and provide adequate oversight of the Senior Management.**

Accepted Best Practice - Corporate Governance

The supervisor requires the insurer's Board to have, on an on-going basis: (ICP 7.3)

- **an appropriate number and mix of individuals to ensure that there is an overall adequate level of knowledge, skills and expertise at the Board level commensurate with the governance structure and the nature, scale and complexity of the insurer's business;**
- **appropriate internal governance practices and procedures to support the work of the Board in a manner that promotes the efficient, objective and independent judgment and decision making by the Board;**
- **and adequate powers and resources to be able to discharge its duties fully and effectively.**

Accepted Best Practice - Corporate Governance

The supervisor requires the individual members of the Board to: (ICP 7.4)

- **act in good faith, honestly and reasonably;**
- **exercise due care and diligence;**
- **act in the best interests of the insurer and policyholders, putting those interests of the insurer and policyholders ahead of his/her own interests;**
- **exercise independent judgment and objectivity in his/her decision making, taking due account of the interests of the insurer and policyholders; and**
- **not use his/her position to gain undue personal advantage or cause any detriment to the insurer.**

Accepted Best Practice - Corporate Governance

The supervisor requires the insurer's Board to provide oversight in respect of the design and implementation of sound risk management and internal control systems and functions. (ICP 7.5)

The supervisor requires the insurer's Board to:

- **adopt and oversee the effective implementation of a remuneration policy, which does not induce excessive or inappropriate risk taking, is in line with the identified risk appetite and long term interests of the insurer, and has proper regard to the interests of its stakeholders; and**
- **ensure that such a remuneration policy, at a minimum, covers those individuals who are members of the Board, Senior Management, Key Persons in Control Functions and other employees whose actions may have a material impact on the risk exposure of the insurer. (ICP 7.6)**

Accepted Best Practice - Corporate Governance

The supervisor requires the insurer's Board to ensure there is a reliable financial reporting process for both public and supervisory purposes which is supported by clearly defined roles and responsibilities of the Board, Senior Management and the external auditor. (ICP 7.7)

The supervisor requires the insurer's Board to have systems and controls to ensure the promotion of appropriate, timely and effective communications with the supervisor and relevant stakeholders on the governance of the insurer. (ICP 7.8)

Accepted Best Practice - Corporate Governance

The supervisor requires the insurer's Board to have appropriate policies and procedures to ensure that Senior Management: (ICP 7.9)

- **carries out the day-to-day operations of the insurer effectively and in accordance with the insurer's strategies, policies and procedures;**
- **promotes a culture of sound risk management, compliance and fair treatment of customers;**
- **provides the Board adequate and timely information to enable the Board to carry out its duties and functions including the monitoring and review of the performance and risk exposures of the insurer, and the performance of Senior Management; and**
- **provides to the relevant stakeholders and the supervisor the information required to satisfy the legal and other obligations applicable to the insurer or Senior Management.**

Accepted Best Practice - Corporate Governance

The supervisor has the power to require the insurer to demonstrate the adequacy and effectiveness of its corporate governance framework.

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These are the key Accepted Best Practices in corporate governance, which are also part of international standards.

The extent to which each country has implemented international standards in banking, insurance and securities regulation is reviewed form time to time by the International Monetary Fund, as part of its Financial Sector Assessment Program, or FSAP. As each country is "FSAP'd", it receives a detailed scorecard of observance and the associated reports are available on the IMF web site.

Accepted Best Practice - Risk Management

Overview – Risk Management and Internal Controls (ICP 8)

- **The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.**

Accepted Best Practice - Risk Management

The supervisor requires the insurer to establish, and operate within, effective systems of risk management and internal controls. (ICP 8.1)

The supervisor requires the insurer to have effective control functions with the necessary authority, independence, and resources. (ICP 8.2)

The supervisor requires the insurer to have an effective risk management function capable of assisting the insurer to identify, assess, monitor, manage and report on its key risks in a timely way. (ICP 8.3)

Accepted Best Practice - Risk Management

The supervisor requires the insurer to have an effective compliance function capable of assisting the insurer to meet its legal and regulatory obligations and promote and sustain a corporate culture of compliance and integrity. (ICP 8.4)

The supervisor requires that there is an effective actuarial function capable of evaluating and providing advice to the insurer regarding, at a minimum, technical provisions, premium and pricing activities, and compliance with related statutory and regulatory requirements. (ICP 8.5)

Accepted Best Practice - Risk Management

The supervisor requires the insurer to have an effective internal audit function capable of providing the Board with independent assurance in respect of the insurer's governance, including its risk management and internal controls. (ICP 8.6)

The supervisor requires the insurer to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such as a control function) as applies to non-outsourced activities or functions. (ICP 8.7)

Thank you

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