Practical risk management:
The story so far

Risk Series – Paper 7
We conclude our series of papers on practical risk management topics with a summary of the results of our survey of UK insurers’ operational practices. This has examined the extent to which insurance companies have been and are still developing their risk functions.
Introduction

Starting with a belief that many insurers have untapped opportunities to extract greater value from their investment in risk management, Willis Towers Watson has published a series of papers (see box) over recent months focusing on risk management frameworks and how they might realise those opportunities.

We close the series with a summary of the results from the survey that accompanied this series, which looked at how reality compares with the theory. The respondents of the survey were from different sized UK-based life and general insurance companies (see Figure 1).

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Risk function investment

As we outlined in the first paper in the series, the ability to derive greater business value from risk management activities presupposes that companies have been and are prepared to invest in them to help drive risk and reward decision making, stronger governance and a more risk-aware business culture across the organisation.

The survey confirms this to be largely the case. The vast majority of companies reported that risk management is an area that they have developed over recent years – albeit partly in response to either the regulatory needs of Solvency II, or due to downscaling following the implementation of Solvency II. Just over three quarters of companies surveyed have reshaped their risk function in recent years. ‘Large’ insurers have been the most prolific in this respect, with 80% reshaping their risk function compared to 60% of their ‘Small’ counterparts. The difference was more pronounced when we analysed by type of business, with 90% of life insurers having recently reshaped the risk function compared to just 56% of general insurers.

Coupled with the trend of risk management function restructuring, companies are also using a wide range of tools. The highest priority areas, particularly among larger companies, have been credit risk modelling, economic scenario generation and proxy models for ongoing solvency monitoring. Among all respondents, dynamic management information and liquidity modelling were the two areas that had not been developed to such a large extent, and we see this as a key area where companies will be developing their capabilities in future years.

The takeaway, from our point of view, is that most companies are at least gearing up for the challenges of moving risk management beyond the needs of regulatory compliance, even if some have only taken tentative steps on the journey.

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Impact on decision making

Despite the fact that, in the majority of companies, more time and resource has been invested in risk management, a more telling test of changing attitudes is how it is being used in the business. This is particularly relevant when seeking to cement practical business advantages in some of the areas we discussed in previous papers, including stress and scenario testing (paper 2), risk appetite (paper 4) and capital management (paper 5).

One of the areas we were especially interested in investigating therefore was the extent to which companies’ economic capital is embedded in different areas of the business. We asked participants to rank themselves on a 1 – 5 scale (5 being highly embedded) – see Figure 2. The findings show that larger companies have a more embedded economic capital measure than smaller companies, reflecting their relative capacity and also often the maturity of the risk function. The findings also show that most companies still have scope to incorporate risk management more widely in day-to-day activities.

Interestingly, companies that have had their existing risk function in place for less than three years showed significantly higher levels of capital embedding in all key areas of the business, indicating the importance of fresh thinking and impetus in effecting change. Other notable trends include that life insurers have typically embedded economic capital metrics more widely than general insurers in all areas except reinsurance, and for insurers where the chief risk officer (CRO) is an actuary, there tends to be a markedly greater embedding of economic capital metrics.

The findings show that larger companies have a more embedded economic capital measure than smaller companies, reflecting their relative maturity.
The responsibilities within governance structures

Paper 3 in our series examined the role of governance in the effective and timely management of risk, based on an assumption of the predominance of the ‘three lines of defence’ (3LOD) model among insurers. The survey confirmed this assumption, but highlighted some fairly substantial variations in the responsibilities of the first line in that model (Figure 3), often linked to the size of the organisation. For example, in our survey, more of the activities (such as setting the risk appetite, designing the ORSA approach and reverse stress testing) were the responsibility of line one in smaller companies than medium sized insurers. This will be in no small part due to the skills, availability of tools and level of resource in risk functions for smaller companies.

While compliance was considered a first line activity by some medium and large sized insurers, we were unsurprised that this is still mostly considered a second line responsibility. We regard this as an activity that will increasingly become viewed as a first line activity over time, whereby assurance of this compliance would be considered a line two activity.

The responsibility for writing the risk policies is split between line one and line two, and this possibly reflects the diverging opinions of risk ownership and the responsibilities related to this, as well as the development and embeddedness of the risk within different organisations.

Figure 3. For what is the first line in the 3LOD model responsible?
While the level of variation is surprising, who does what is less important than clarity about the respective roles and responsibilities of each line. Here, the survey results highlight some potential conflicts and confusion between line one and two responsibilities, in areas such as articulating and determining risk appetite, ownership of internal models and communication flow. Sometimes this can be linked to a simple matter of resources and efficiency, with several respondents mentioning staffing constraint issues. Others talked about the need to resolve overlapping or unclear responsibilities, including the input into various management and operating committees. One respondent noted frustrations about “challenge for challenge’s sake, without regard for proportionality or the value added”, a comment we regularly encounter in our conversations with insurers.

Areas of potential conflict weren’t confined to the layers of the 3LOD model. Some cited the need to improve coordination between the Risk and Finance functions with one respondent noting that: “Finance view themselves as operationally outside the risk framework and oversight of Risk.”

Another important aspect of risk governance highlighted in our third paper was the need to have the ear of senior leaders. Major factors identified in achieving this were the CRO’s reporting lines and involvement in committees. It is encouraging therefore that the majority of CROs report directly to the chief executive and that risk teams are extensively involved in management committees and board meetings in nearly all companies (Figure 4).

Figure 4. Involvement of risk teams in key company strategy meetings

![Involvement of risk teams in key company strategy meetings](image)

- All Boards
- All executive committees
- All asset/liability committees
- All investment committees
- All WP committees
Another interesting finding from the survey was the position of the Chief Actuary within the governance structure. Interestingly, and possibly reflecting the cost of specialist skills and resources, the smaller insurers had more Chief Actuaries that were split between line one and line two, than other insurers and there were proportionally less Chief Actuaries in the second line to the first for medium insurers.

Figure 5. Where does the Chief Actuary sit?
Feeding risk appetite

In the fourth paper in our series, we talked about the advantages of using the risk appetite framework to balance risk and reward business decisions rather than simply as a control mechanism. Unsurprisingly, the survey showed that larger insurers are more advanced in this regard, with greater analysis of dividend capability and quality of capital, in particular (Figure 6).

In the meantime, risk tolerances and buffers continue to play an important role. Here again, responses showed a clear correlation to company size. The bottom end target Solvency II risk appetite buffer for most small insurers was under 20%, whilst for the significant majority of larger and medium sized firms it was over. Of the larger firms that we surveyed, more than half of them put this figure at 40% or above. Interestingly, when we again only considered medium-sized firms, we found that a third of the general insurers surveyed set this buffer at 40% or above, compared to only 2 out of the 14 of life insurers.

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Conclusion: Risk management in transition

In recent years, the demands of Solvency II have inevitably been a major driver of the expansion of risk management teams and metrics. As work to meet compliance requirements becomes more familiar and routine, companies should find themselves with more capacity and incentive to focus on extracting real business value from risk management.

Challenges of tomorrow will require insurers to again rethink the composition of the risk function, perhaps with a refocus on technology as insurers charge ahead with ever more investment in this area.

Our survey provides some indicators of this transition starting to take place in pockets of the industry. In particular, it highlights the increasing importance of technical challenge, using technology and wider insurance business understanding in risk functions. For example, if we consider companies that said they had reshaped their risk function in the last three years versus those that hadn't, the former employed nearly double the percentage of actuaries in their risk teams (excluding compliance). Moreover, those companies were nearly four times as likely to have an actuary as their CRO.

And, in terms of the risk team’s wider influence in the business, newer risk functions have a more deeply embedded use of economic capital models to support business decisions and have led the wider adoption of risk tools and processes in business areas from asset and liability management and investment decisions to employee performance management.

While it’s still relatively early days for this alternative view of the role of risk management that we have outlined in the recent series of papers, the changing mix and skills sets of risk teams suggests that many companies buy into it and are setting their sights on it.
Further information

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