Case Study on Risk-based Supervision

Instructions

You are an insurance supervisor responsible for supervision of X Co. Review the facts regarding X Co below and:

1. In your groups, make an assessment of its risk profile, using the following risk categories in the table below. For some categories you will assess inherent risk separately from management and controls. Be prepared to justify your results to the group.

   Risk categories:

   - For each risk category, assign a percentage significance rating, the total of all which must be 100%.

   - This percentage should reflect the relative importance of that risk to the company's business e.g. an insurer would be expected to have a relatively high significance weighting for insurance risk compared to credit risk, whereas a bank would be likely to have high credit risk and little, if any, insurance risk. Similarly risk management may be relatively more important for a large, complex insurer than for a small, low risk business with strong operational controls.

   Inherent Risk assessment:

   - For the risks (a) to (f), then assign an 'inherent risk quality' score of 1-5 (where 1 is lowest risk and 5 is highest risk). The 'inherent risk quality' score reflects the extent to which you think the company is vulnerable to financial losses from the individual inherent risk. (So, while the significance weighting of the individual risk area may be unchanged due to the nature of the business of the company, the likelihood of losses from that risk may vary over time depending on the circumstances of the company e.g. an insurance company may always have insurance risk as its highest risk, however if it is doing business that is particularly complex and innovative it would have a higher risk quality score than an insurer that is doing more straightforward, lower risk business.)

   - Note that you are not considering the internal controls at all in this part of the rating process. You should only consider the inherent risk, without considering how the company manages this risk.

   - It is often difficult to strictly differentiate between what should be factored into significance weighting and what should go into risk quality score. The important thing is to capture it in one or the other, and not to 'double count' an issue.

   - You can also use the ratings of 'unknown', if you have no information about a risk category, or 'not applicable', if you consider it so.

   Management and Control assessment:

- For the risks (a) to (f), then assign a 'strength' score of 1-5 (where 1 is strongest control and 5 is weakest control). The strength score should reflect your view of the internal controls, based on the below information.

- You can also use the ratings of 'unknown' if you have no information about a category or 'not applicable' if you consider it so.

Net Risk assessment:

- For the risks (g) to (i), then assign a 'strength' score of 1-5 (where 1 is strongest control and 5 is weakest control). The strength score should reflect your view of the internal controls, based on the below information.
- For the risks (a) to (f), the Net Risk is the simple average of the inherent risk quality score and management and control strength score

- You can also use the ratings of 'unknown' if you have no information about a category or 'not applicable' if you consider it so.

Category of risk	Inherent risk quality score (1-5) **(M)**	Management and controls strength score (1-5) **(N)**	Net Risk **(O)** = **((M)+(N)) /2**	Significance weighting (%) **(P)**	Result **(O)** x **(P)**
(a) Insurance risk					
(b) Credit risk					
(c) Market risk					
(d) Operational risk					
(e) Strategy and Planning risk					
(f) Liquidity risk					
(g) Board					
(h) Management					
(i) Risk governance					
				Total=100%	

2. Use your above assessment and results to develop an appropriate supervisory plan for the company for the next 12 months (and beyond if you wish). The plan should identify specific on and offsite supervisory activities appropriate to the company's circumstances.

3. Each group will take turn to present its supervisory plan to all the other seminar participants. You should be prepared to take questions from the other participants. Your presentation should be not more than 10 minutes.

FACTS:

Setting for this exercise

Today is the end of September 2010.

The local holding company of X Co is majority owned by a large European financial conglomerate. The balance of shares is listed on the local stock exchange.

As insurance supervisor, you do not have any regulatory powers over any financial leasing operations.

In your country the capital city and main regional centres of population are mostly inland. There is a highly developed long coastal area, named the Sea Change coast, in which the predominant form of property is low rise strata title buildings of 2 to 6 apartments. The Sea Change climate is most appealing nearly all year round but for 2 to 3 months each year the area is subject to seasonal high winds and heavy rainfall and sometimes hail storms.

Overview from company report to shareholders

The company continued to maintain its longstanding position as a leading general insurance company in its chosen market, with its well known residential home insurance policy (approximately 50% of its business) and its other principal products Motor (including third party liability) Commercial Fire and Industrial risks (approximately 20% each). Other incidental personal lines make up the balance of its business.

By premium volume X Co is in the top 3 of local insurers.

A solid capital position with adequate buffers and capital management practices underpins **our financial position**. The risk appetite for a loss from any single investment, insurance or operational event remains low.

The investment strategy is conservative with predominantly highly rated fixed interest assets. These assets are managed around short benchmark duration by an experienced investment team.

Over the last 3 years the insurance operations have been profitable but with some variability. The company has fared well compared to its peers in the level of return it has provided to its shareholders.

The group strategy is to leverage its local client base through other services. In the year ended June 2010, the group did not perform as strongly in its other significant operation of financial leasing. This area is underdeveloped and a potential source of additional market for our insurance products. The recent strategy is to try and make this area of operations more profitable.

In recent years the insurers have not suffered any extreme events. However there has an increased annual frequency of severe (but not extreme) weather related events resulting in losses not quite reaching the insurer retention. Over the last 12 months our company and indeed insurers are moving to tighten pricing and underwriting and adopt measures to provide more stable profits.

In December 2009 the Board took the first step in changing the **Organisational structure by the appointment of** a new Chief Executive Officer (CEO) and subsequently in July appointed its first Chief Risk Officer (CRO). The new CEO has restructured the X Co operations from July 2010, so reporting to him are the CRO, the Chief Financial Officer (CFO), and another 2 new executive managers- Head of Personal Business, Head of Commercial Business.

X Co has installed a **new Information Technology system** in April 2010, which provides underwriting and claims systems, as well as the financial accounting system, for X Co.

The most recent actuarial report on the **Insurance business** for the company was prepared for the year ended 30 June 2010 and was forwarded to the Regulator by end August 2010.

The report identified some deterioration in X Co's experience in the property line. Other insurers have been impacted by an increase in frequency of weather events. Based on the high level valuation data, the Actuary noted the overall level of this deterioration is consistent with other insurers. As market leader she has therefore recommended a review of the reinsurance program to ensure greater resilience to multiple event losses. Further she has recommended X Co undertake a more detailed post renewal analysis of the exposures to understand fully any trends before making any change to the reinsurance program.

In the motor business line the report noted that future results may be impacted by an increasing trend of a number of law firms actively targeting claimants in this area.

A specialist broker in the community title and strata title property business has previously placed, using the previous paper system, a small amount of strata title business with X Co. Under X Co's new IT system and standard broking agreement, all policy data is entered into the X Co system directly by the broker's administration staff. Under consumer legislation, all strata title insurance renews at 1 July and the last renewal the specialist broker has placed all his business volume (with sum insured around 2b in the Sea Change coast) with X Co. The increased volume from this specialist broker is pleasing evidence of our CFO's commitment to investment in new technology systems and the early payback from such investment.

Our European parent company has other general insurance subsidiaries in neighbouring countries and in line with parent group policy the reinsurance arrangements are made with a variety of insurers including locally authorised reinsurers.

As signalled in an earlier market update, the company had commenced an internal review and tender for the assessment of claims by external firms. The CFO has just written to the Regulator to advise that, following a tender process, the company has appointed a Loss Assessors Co to undertake the assessment of claims effective for new claims from 1 December 2010. As part of the tender Loss Assessors Co put forward a compelling business case not only to assess claims but receive claim notifications through its own call centre and to settle a majority of claims through its advanced proprietary technology. The main office of Loss Assessors Co is based in a neighbouring country where it is the predominant provider of these services.

The restructure has seen a change in the internal audit reporting line, with this function now having a direct reporting line to the CFO, sending a copy of this report to the Audit Committee. The company considers that the direct line report to the CFO is necessary for administrative purposes, as the Audit Committee cannot be expected to carry out day to day oversight of the staff in this area. The company considers the Internal Audit function still achieves independence through the direct reporting opportunities it has to the Audit Committee at each quarterly meeting of the Audit Committee.

The restructure led to a number of older staff leaving the organisation and the company is recruiting to fill a number of vacancies in senior positions.

Supervisory notes

Senior management

Although the CEO is new to X Co, you have previously dealt with him in his former role as CEO at another company, which specialised in financial leasing. You are aware that he was brought into X Co largely because of his investment expertise, to try and bolster the non-insurance side of the operations. You consider him a capable and experienced senior executive, although you are aware that his former roles have been with somewhat smaller, more specialised companies.

The CFO joined X Co about a year before the CEO, is regarded as particularly skilled in achieving operational efficiencies and finding technological solutions when he worked for other local insurers.

You have not previously had any dealings with the new CRO of X Co, although he has worked for other local insurers before and is regarded as particularly skilled in achieving operational efficiencies and finding technological solutions for companies.

The other two new executive appointments, Head of Personal Business, Head of Commercial Business are unknown to you but have strong resumes showing experience and achievement in the insurance and finance fields.

Recent complaints

You have received a number of complaints recently from policyholders claiming that they have been overcharged premiums on their renewal statements. There have also been a number of complaints from claimants about the requested excess differing to the amount shown on the written renewal statements.

The CFO, who is your principal contact at X Co, advises that this is due to teething problems with the new systems and all complaints are being dealt with promptly.

Actuary

The Actuary is not an employee of the firm, but is a partner in a well regarded professional firm that has provided services to X Co for a number of years. The Actuary is personally highly regarded within the industry, having worked alongside a number of senior partners for some years, and having 7 years experience specific to the local general insurance industry, including significant exposure to the company's main products. The Actuary has been engaged by X Co for the last 3 years and the engagement is reviewed annually.

Lodgements

The company has a good record at submitting returns on time, however were a number of errors in the quarterly returns lodged for March 2010 and June 2010 and they had to be resubmitted a number of times.