

Case Study on Risk-based Supervision

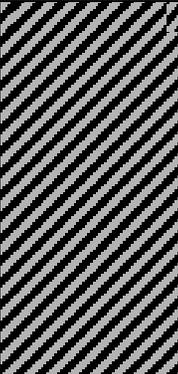
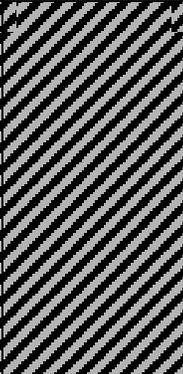
Suggested Solutions

1. Suggested rating scores and comments:

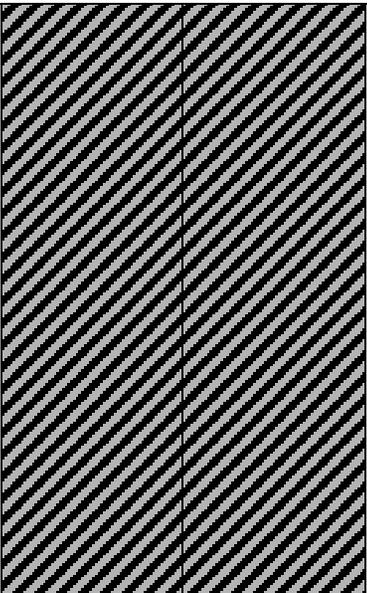
Category of risk	Inherent risk quality score (1-5) (M)	Management and controls strength score (1-5) (N)	Net Risk (O) = ((M)+(N)) / 2	Significance weighting (%) (P)	Result (O) x (P)	Comments
(a) Insurance risk	3	2	2.5	35	0.875	<ul style="list-style-type: none"> Principal business area and therefore potentially largest impact on company, so highest significance weighting. Inherent risk - Traditionally conservative products such as residential property, Motor and commercial lines would normally mean a low risk quality score. However indications in wider industry of variable performance due to multiple severe weather events hence the higher rating of 3. Depending on the reinsurance for Sea Change Coast, the company may have larger single event exposure so some supervisors may rate even higher. As longstanding, leading insurer making profits the facts suggest that insurance underwriting, pricing and conditions are adequate suggest a rating of 1. However to be forward looking the extent of change of insurance controls for the new strata title risks needs supervisory investigation, hence rating of 2 <p>Note that this category should capture insurance risk net of reinsurance. It is important to include the largest single event exposure after reinsurance (e.g. natural</p>

						<p>catastrophe retention) but also to consider the cumulative impact of multiple events where the insurer bears the loss up to their retention.</p> <p>Discussion point: Some supervisors may judge the motor liability and large commercial fire class as higher risk inherently and so rate higher than this. However, other classes such as employer's liability and medical malpractice are more towards the riskier end of the spectrum of insurance risk.</p>
(b) credit risk	Unknown	Unknown		5	Unknown	<ul style="list-style-type: none"> • Insufficient Facts to establish the counterparties and their ratings. In addition the new strata title exposures may result in a change of reinsurer program • No information on the controls around the selection of limits , counterparties, strategy
(c) market risk	2	1	1.5	10	0.15	<ul style="list-style-type: none"> • Traditional general insurance operations typically would have an inherent exposure to balance sheet and market risk, due to potential impact of market movements on the asset management and funding of the insurance obligations. • Facts indicate that the company has a conservative investment strategy and a degree of matched assets and liabilities, hence the quality rating given is considered low. • Similarly on the facts that the controls are strong, hence the strength rating given is considered low
(d) operational risk	3	Unknown		20	Unknown	<ul style="list-style-type: none"> • Significant changes in many operational risk areas (often defined as risk from 'people, processes, systems') makes this currently a large area of inherent risk for X Co: • Significant change from the outsourcing of a large part of the claims management function. Significant outsourcing of functions typically would be captured in

						<p>inherent operational risk. The outsourcing introduces new risks such as new geographic location, alignment of processes</p> <ul style="list-style-type: none"> • Major changes to internal processes from the recent introduction of new IT system across most of company operations. • Until successfully and completely implemented, both the IT system and outsourcing should be regarded as increasing inherent risk. Note that the new IT system could also have meant reduction in inherent operational risk if it has meant replacement of complex, manual processes. Similarly improved claims service and function must result in better claims payment. So we should recognise that in the overall rating. • No information on the controls around the operational risk such as an ops risk framework, ops risk committee, outsourcing policy, IT controls, business continuity testing and planning, Also new people and vacancies throughout the organisation can mean weaken the management control. • Supervisory plan will need to address the 'unknown' by including appropriate information gathering activities, so this area can be fully assessed. • <i>Discussion point:</i> APRA experience that this often the second largest inherent risk to companies (not just insurers). Some supervisory systems break down this risk area further into e.g. outsourcing risk, IT risk <p><i>Discussion point:</i> to what extent should we reflect the recent complaints in this risk rating assessment? The rating should be updated regularly when there is certainty about a change in a risk area, however it should not be overly onerous on the supervisor's time.</p>
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(e) strategy and planning risk	2	Unknown		5	Unknown	<ul style="list-style-type: none"> Facts indicate that the company has a strategy of growing its existing leasing and insurance business. As these are existing business, the company can utilise its existing systems, skills and people it is low inherent risk. There is some new external vulnerability through the location of its outsourced claims provider. Similarly for controls, the facts indicate some significant other (unregulated) business locally, which may expose company to contagion and group risks. We need to explore further to see the extent to which the company may be vulnerable to losses from such a risk e.g. would be higher risk if they are reliant on the other parts of the group for services or for new business.
(f) liquidity risk	1	1	1	5	0.05	<ul style="list-style-type: none"> In an ongoing insurer with marketable fixed interest assets, the premium income alone provides a buffer to pay larger events claims. The fixed interest assets also provide a further source of liquidity. Inherently higher risk area comparable its peers, hence 5% weighting. Low quality rating and strength rating because no indication in facts of any issues of particular vulnerability for X Co.
(g) Board			Unknown	5	Unknown	<ul style="list-style-type: none"> The board should a range of skills and experience and met any prudential requirements on independence or composition of Board or fit and proper. Supervisors may assess any conflict of interest here or a dominant director. The Board's role in setting risk appetite and framework and strategy are considered separately under risk governance and Strategy risk. We have no information in the facts provided about the Board or its operations, hence 'unknown'. The supervisory plan will need to establish activities to fully complete this

					assessment.	
(h) Management			2	5	0.1	<ul style="list-style-type: none"> The Senior Management should a range of skills and experience to properly manage the company's operations. They should also meet any prudential requirements on fit and proper. Supervisors may assess any conflict of interest here or a key person risk director and assess succession planning for key roles. Senior management will likely have the most influence on overall company operations, including control environment and risk awareness/risk culture and this is assessed under risk Governance. We have facts showing the senior management team here is quite experienced and generally well regarded, however a lot of them are new and the rating reflects the supervisory not yet being able to confidently rate them as fully carrying out their roles to the (strong) level expected. <ul style="list-style-type: none"> <i>Discussion point:</i> Often a difficult area for supervisors to judge when they don't have frequent, ongoing contact with individuals, and where negative judgements can affect an individual's livelihood. But it is a vital area impacting directly on how insurers are managed and increasingly an area where supervisors need to make an assessment about quality of individual managers and include that as a fact in the risk profile of a company.
(i) Risk governance			3	15	0.45	<ul style="list-style-type: none"> An important and fundamental risk category for all financial institutions, hence the 15% significance rating. Based on the facts the Board has now appointed a CRO indicating some culture of considered risk taking. No information on the extent of the risk framework. The actuarial review function appears strong with the actuary being independent of the company and well regarded in the

						<p>industry.</p> <p>The internal audit function has recently been restructured and the new reporting lines would not be regarded as best practice. This is because they potentially allow for management influence over the internal audit function and do not demonstrate the same level of independence as a direct reporting line to the audit committee or board. The weaker rating of 3 for this function is based on this point. The supervisor would likely want to satisfy itself about the effective functioning of the internal audit function by some on-site reviews, before being willing to accept the company's position that the function remains operationally independent.</p> <p>External audit is also rated under this category. We have no facts about the external audit function so this should be regarded as Unknown and further investigated</p>
				Total=100%		

2. Suggested supervisory plan:

The following re-orders the inherent risk and risk control categories from highest risk to lowest risk, and adds a column showing possible supervisory actions to address the identified issues. A summary supervisory plan is then attached at the end, showing a breakup of activities for the next 3 months, 6 months, 12 months, 2 years.

INHERENT RISK CATEGORIES (RANKED HIGHEST TO LOWEST RISK)	RATING ASSESSMENT	POSSIBLE SUPERVISORY ACTIONS
<p>(a) Insurance risk (0.875)</p>	<ul style="list-style-type: none"> • Principal business area and therefore potentially largest impact on company, so highest significance weighting. • Inherent risk - Traditionally conservative products such as residential property, Motor and commercial lines would normally mean a low risk quality score. However indications in wider industry of variable performance due to multiple severe weather events hence the higher rating of 3. Depending on the reinsurance for Sea Change Coast, the company may have larger single event exposure so some supervisors may rate even higher. • As longstanding, leading insurer making profits the facts suggest that insurance underwriting, pricing and conditions are adequate suggest a rating of 1. However to be forward looking the extent of change of insurance controls for the new strata title risks needs supervisory investigation, hence rating of 2 <p>Note that this category should capture insurance risk net of reinsurance. It is important to include the largest single event exposure after reinsurance (e.g. natural catastrophe retention) but also to consider the cumulative impact of multiple events where the insurer bears the loss up to their retention.</p> <p>Discussion point: Some supervisors may judge the motor liability and large commercial fire class as higher risk inherently and so rate higher than this. However, other classes such as employer's liability and medical malpractice are more towards the riskier end of the spectrum of insurance risk.</p>	<p>On-site</p> <ul style="list-style-type: none"> • On-site review of insurance operations, including some substantive testing of claims and underwriting files, pricing methodologies and reinsurance. Given size of company and importance of this aspect of business, such a review should be done regularly in line with a minimum supervisory cycle (e.g. full review of insurance operations at least every 2 years). • In current environment, a meeting targeted on the strata title business is urgent. At minimum supervisors should obtain an appreciation of the increase in sums insured in areas with higher weather event exposure, the extent of reinsurance and reinsurer support and assess the extent to which the risk profile has changed. • With less urgency, a focussed review of the motor business line may be considered, given market developments in that sector. • The assessment of the strength rating for management and controls should include, as part of the on-site work, review of policy and procedures for insurance operations, and testing of how these are working in practice (e.g. through meetings with relevant operational managers and sample review of underwriting and claims files). <p>Off-site</p> <ul style="list-style-type: none"> • Review of company's liability valuation, provisioning policy and actuarial methodology - at least annually. • Meeting with actuary to discuss any issues of concern from review • Annual review of reinsurance strategy and management in

		addition to that covered by insurance risk on-site review
(d) Operational risk (Unknown)	<ul style="list-style-type: none"> • Significant changes in many operational risk areas (often defined as risk from ‘people, processes, systems’) makes this currently a large area of inherent risk for X Co: • Significant change from the outsourcing of a large part of the claims management function. Significant outsourcing of functions typically would be captured in inherent operational risk. The outsourcing introduces new risks such as new geographic location, alignment of processes • Major changes to internal processes from the recent introduction of new IT system across most of company operations. • Until successfully and completely implemented, both the IT system and outsourcing should be regarded as increasing inherent risk. Note that the new IT system could also have meant reduction in inherent operational risk if it has meant replacement of complex, manual processes. Similarly improved claims service and function must result in better claims payment. So we should recognise that in the overall rating. • • No information on the controls around the operational risk such as an ops risk framework, ops risk committee, outsourcing policy, IT controls, business continuity testing and planning, Also new people and vacancies throughout the organisation can mean weaken the management control. • • Supervisory plan will need to address the ‘unknown’ by including appropriate information gathering activities, so this area can be fully assessed. • • <i>Discussion point:</i> APRA experience that this often the second largest inherent risk to companies (not just insurers). Some systems such as FIRM break down this risk area further into e.g. outsourcing risk, IT risk • • <i>Discussion point:</i> to what extent should we reflect the recent complaints in this risk rating assessment? The rating should be updated regularly when there is certainty about a change in a risk area, however it should not be overly onerous on the supervisor’s time. 	<ul style="list-style-type: none"> • On-site review of operational risk systems should be a regularly scheduled event, given size of company and impact of this risk area on the business. • Such a review would look at the company’s systems for identification and management of operational risk and focus on how they manage particular risks to their specific operations. This would include review of the operational risk framework, any operational risk committee, outsourcing policy, IT controls, business continuity testing and planning and adequacy of overall staffing <p>On-site</p> <ul style="list-style-type: none"> • In the near future, a focussed review could be undertaken of some of the current specific risks to the company: <ul style="list-style-type: none"> ○ Review the management of the new outsourcing arrangements for claims - to ensure that the company has suitable delegations, monitoring and reporting arrangements, legal protections and administrative arrangements in place. ○ Ascertain the arrangements for existing claims, have some existing staff been retained to run-off old claims. ○ Review the management of IT systems change - discussions with management to ensure appropriate governance, resourcing and systems to deal with these significant changes <p>Off-site</p> <ul style="list-style-type: none"> • Prior to on-site, request and review internal documents relating to above matters, to assess internal management of these projects and any identified issues or concerns. • Following the on-site, a follow up action may be receipt of reports for off-site review on implementation of some of the above projects to ensure continuing progress. <p>On-site</p> <ul style="list-style-type: none"> • Above scheduled on-site review of operational risk, focussing on IT implementation could be tailored to allow assessment of financial control environment.

		<ul style="list-style-type: none"> In a risk based system, on-site review work would not typically include retesting or detailed sampling of the financial control environment. The review may instead include demonstration of how a typical transaction flows through the system. Such a demonstration could be useful to explore how problems in the renewal statements occurred and identify what remedial action has been taken by X Co. <p>Off-site</p> <ul style="list-style-type: none"> Documents to be reviewed prior to the on-site could include internal audit reports, external audit reports, and post-implementation review reports from the IT system implementation.
<p>(i) Risk governance (0.45)</p>	<ul style="list-style-type: none"> An important and fundamental risk category for all financial institutions, hence the 15% significance rating. Based on the facts the Board has now appointed a CRO indicating some culture of considered risk taking. No information on the extent of the risk framework. The actuarial review function appears strong with the actuary being independent of the company and well regarded in the industry. <p>The internal audit function has recently been restructured and the new reporting lines would not be regarded as best practice. This is because they potentially allow for management influence over the internal audit function and do not demonstrate the same level of independence as a direct reporting line to the audit committee or board. The weaker rating of 3 for this function is based on this point. The supervisor would likely want to satisfy itself about the effective functioning of the internal audit function by some on-site reviews, before being willing to accept the company's position that the function remains operationally independent.</p> <p>External audit is also rated under this category. We have no facts about the external audit function so this should be regarded as Unknown and further investigated</p>	<p>On-site</p> <ul style="list-style-type: none"> Review Board papers and minutes to assess governance practices and operations of Board and Committees Meeting with CRO to discuss progress and plans for implementation of risk management framework. Intended outcome would be to get firm commitment to timetable for design and implementation, and to receive regular reports on progress (for off-site review). This review should be a priority action and could be combined with the focussed actions identified above for operational risk to understand how the risk framework is being used. <p>On-site</p> <ul style="list-style-type: none"> Meet privately with internal audit personnel to assess methods and operations, to assist in forming a view on the level of independence of internal audit function. Discuss issues from recent audit reports and how they have been managed. As the external audit area is an Unknown, on-site review could include meeting with the external auditor to discuss methods and operations, and recent issues. Meet with audit committee to discuss similar matters and assess how well it is supporting the internal audit function <i>Discussion point:</i> meetings with internal and external auditors should also be used to provide a forum for the auditors to raise issues with the supervisor. The auditors may have issues that are of concern to them that are not receiving attention by the company that the auditors consider is needed. The supervisors may be able to

		<p>support the auditors in raising issues or recommending improvements to audit issues.</p> <p>Review of the internal audit reorganisation should be a priority function given the risk rating. Sessions to undertake the above activity could be done either as an adjunct to the focussed insurance risk or operational risk reviews above, or separately.</p> <p>Off-site</p> <ul style="list-style-type: none"> • Prior to on-site, review internal and external audit reports, and associated board or management reports, to ensure the audit function is comprehensive, effective and supported within the company. • Routine review of any regular reports submitted by external auditors (e.g. annual attestation, financial statement audits) <p>There is no indication of any concerns with the actuarial function. A meeting with the Actuary should occur regularly in conjunction with their review of liabilities/provisioning (see above) or as necessary if particular issues arise.</p>
(g) Board	<ul style="list-style-type: none"> • The board should a range of skills and experience and met any prudential requirements on independence or composition of Board or fit and proper. Supervisors may assess any conflict of interest here or a dominant director. • The Board's role in setting risk appetite and framework and strategy are considered separately under risk governance and Strategy risk. • We have no information in the facts provided about the Board or its operations, hence 'unknown'. The supervisory plan will need to establish activities to fully complete this assessment. 	<p>On-site</p> <ul style="list-style-type: none"> • Meet with Board to assess experience and skill in managing business, level of awareness of business and prudential/regulatory issues. <p>Off-site</p> <ul style="list-style-type: none"> • Review CVs and research Board members to assist in forming view on skill and experience for Board roles.
b) Credit risk (0.1)	<ul style="list-style-type: none"> • Insufficient Facts to establish the counterparties and their ratings. In addition the new strata title may result in a change of reinsurer program • No information on the controls around the selection of limits , counterparties, strategy 	<p>Off-site</p> <ul style="list-style-type: none"> • Review of reinsurance strategy and management should be covered by insurance risk on-site review (above) on a regular basis. The increased frequency of severe events may indicate a need for aggregate reinsurance. • Actual level of recoveries and counterparties is low risk item based on the facts, off-site review of quarterly and annual returns would be appropriate to monitor this area
(c) Market risk	<ul style="list-style-type: none"> • Traditional general insurance operations typically would have an inherent exposure to balance sheet and market 	<p>Off-site</p> <ul style="list-style-type: none"> • Given low risk item, off-site review of quarterly and

	<p>risk, due to potential impact of market movements on the asset management and funding of the insurance obligations.</p> <ul style="list-style-type: none"> • Facts indicate that the company has a conservative investment strategy and a degree of matched assets and liabilities, hence the quality rating given is considered low. • Similarly on the facts that the controls are strong, hence the strength rating given is considered low 	<p>annual returns would be appropriate to monitor this area.</p> <ul style="list-style-type: none"> • Asset and liability matching and investment strategy would also be areas covered as part of review of actuarial methodologies/reports (above).
(e) Strategy and Planning risk (Unknown)	<ul style="list-style-type: none"> • Facts indicate that the company has a strategy of growing its existing leasing and insurance business. As these are existing business, the company can utilise its existing systems, skills and people it is low inherent risk. There is some new external vulnerability through the location of its outsourced claims provider. • Similarly for controls, the facts indicate some significant other (unregulated) business locally, which may expose company to contagion and group risks. We need to explore further to see the extent to which the company may be vulnerable to losses from such a risk e.g. would be higher risk if they are reliant on the other parts of the group for services or for new business. 	<p>Off-site</p> <ul style="list-style-type: none"> • Review business plan annually to assess any change in strategy or possible acquisition or sale of business • Review financial information on non-regulated areas locally, and abroad if necessary, to assess nature and extent of any transactions and exposures of the insurer to these other operations • Contact other local and abroad supervisors for information and to identify any issues of concern for them from the other operations. Such other issues may be source of potential contagion to X Co. <p>On-site</p> <ul style="list-style-type: none"> • Meet with company to gather information on non-regulated areas and assess extent of involvement (e.g. delegation and control) of X Co in those areas.
(h) Management (0.1)	<ul style="list-style-type: none"> • The Senior Management should a range of skills and experience to properly manage the company's operations. They should also meet any prudential requirements on fit and proper. Supervisors may assess any conflict of interest here or a key person risk director and assess succession planning for key roles. • Senior management will likely have the most influence on overall company operations, including control environment and risk awareness/risk culture and this is assessed under risk Governance. • We have facts showing the senior management team here is quite experienced and generally well regarded, however a lot of them are new and the rating reflects the supervisory not yet being able to confidently rate them as fully carrying out their roles to the (strong) level expected. ▪ <i>Discussion point:</i> Often a difficult area for supervisors to judge when they don't have frequent, ongoing contact with individuals, and where negative judgements can affect an individual's livelihood. But it is a vital area impacting directly on how insurers are managed and increasingly an area where supervisors need to make an assessment about 	<p>On-site</p> <p>Use meetings during on-site review, and any other dealings with company, above to further inform assessment of senior management, not just the executive managers reporting to the CEO, but their direct reports to gauge the strength of senior management and degree to which internal candidates are prepared for succession planning.</p> <p>The existence of a process around succession planning and confirmation that the process has been followed should be known to supervisors. However the candidates involved in succession planning process is a delicate topic and for key roles the most senior supervisor should have the discussion with the CEO or Chairman.</p>

	quality of individual managers and include that as a fact in the risk profile of a company.	
(f) liquidity risk (0.1)	<ul style="list-style-type: none"> In an ongoing insurer with marketable fixed interest assets, the premium income alone provides a buffer to pay larger events claims. The fixed interest assets also provide a further source of liquidity. Inherently higher risk area comparable its peers, hence 5% weighting. Low quality rating and strength rating because no indication in facts of any issues of particular vulnerability for X Co. 	<p>Off-site</p> <ul style="list-style-type: none"> Given low risk item, off-site review of quarterly and annual returns would be appropriate to monitor this area. Liquidity management would also be an area covered as part of review of actuarial methodologies/reports (above). Review of liquidity policy would be done from time to time to ensure remains up to date with business and in line with best practice/regulatory requirements. No indication here that needs to be done as a priority at the moment. To be scheduled over e.g. next 2 years.

Summary - Possible Supervisory Plan

Next 3 months

Priority activities:

- On-site meeting
 - Outsourcing arrangements
 - Assessment of increased Strata title property portfolio
- On-site inspection focused on specific operational risk and related issues:
 - Outsourcing arrangements for claims management
 - Risk management framework implementation progress
- On-site inspection - Board and Committee minutes and papers
- Off-site review - Actuarial liability valuation report and meeting with Actuary to discuss issues

Regular activities:

- Quarterly review - financial statements and capital adequacy returns
- Annual review - audited financial statements and capital adequacy returns

Next 6 months

- On-site insurance risk inspection - focussed mostly on property pricing and aggregate exposure management but some time on motor and motor liability recent experience
- On-site inspection focused on specific operational risk and related issues:
 - IT systems implementation
 - Internal and external audit arrangements
 - Risk management framework implementation progress
- On-site meeting with Board
- Regular off-site activities - Quarterly review - financial statements and capital adequacy returns

Next 12 months

- On-site inspection - full review insurance risk, including:
 - Underwriting, claims management, pricing of all business lines
 - reinsurance strategy and management
- Regular off-site activities - Quarterly review - financial statements and capital adequacy returns
- Off-site inspection - liquidity management policy (*Subject to resourcing given lower risk*)
- Off-site review - strategy and planning review with focus on contagion and group risk (*Subject to resourcing given possibly lower risk-need supervisory judgment of potential for loss*)

Next 24 months

- On-site inspection - full review operational risk, including:
 - Implementation of risk management framework, systems for identification and management of operational risk