KPMG

INSURANCE

Enterprise Risk Management for Insurers: China survey

FINANCIAL SERVICES

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Contents

Introduction

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With signs of recovery and growth in the financial sector during the second half of 2009, many insurers have realigned their operations, to best position themselves for future growth.

There are strong reasons to believe China will be at the forefront of that growth. Growth rates have been impressive in recent years (despite the economic crisis) in both the life and non-life sectors. The insurance market has been open to foreign insurers for many years now, with new branches being established on a regular basis. There is a lively life insurance market, and considerable growth potential in non-life products (particularly in rural regions) and the reinsurance market. The opportunities for growth are very evident to the executives in our survey, though growth could also be constrained by an increased regulatory burden and a constantly changing risk landscape.

Our new survey of risk management by insurers based in mainland China and Hong Kong shows an increased familiarity with enterprise risk management (ERM). An enterprise-wide approach helps the business to identify, assess, quantify, manage, and mitigate organisational risk with the ultimate goal being better decisions leading to long-term sustainable profitability. The attitudes of executives towards ERM are evolving rapidly, with 73 percent of respondents stating that they have already established a department or committee charged with management of enterprise risks.

The majority of the executives in our survey said they were familiar with the concept of ERM and had started down the path of implementing an ERM programme. What is clear, however, is that the strategies and approaches being taken differ markedly in their sophistication. A number of the respondents with responsibility for ERM did not have a direct reporting line to the board, leading us to question whether risk management continues to be overlooked as a key factor in strategic planning.

Nevertheless, we are encouraged to see that a combination of regulatory and other drivers in China and Hong Kong are pulling people in the right direction. Our survey has participation from a majority of the leading insurance institutions, both domestic and foreign, in China. Unless stated otherwise, any reference to China in this report is applicable to the markets of both mainland China and Hong Kong.

We hope you find this report of interest and we would welcome the opportunity to discuss its findings with you further.

Executive summary

Why ERM?

- Risk Management is not only useful for managing the downside, it can also help executives gain the greatest benefits from the upside.

- The business of insurance is becoming more complex. This is partly due to product innovation, but also as a result of insurance companies acquiring (or starting up) businesses in other areas of financial services such as banking, trust and asset management. This means an effective and holistic risk management framework across the entire business is more important than ever.

- Regulators are increasingly focusing on ERM. The path is pretty clear (as has been the case in the banking sector for several years since the introduction of Basel II). Those who start their ERM journey early will not only show a more favourable image of their company with the regulators, but may also have the opportunity to influence the shape of the regulation in this area.

- Investors and rating agencies are increasingly asking for ERM within the companies they cover.

- Due to the financial crisis, non-executive directors are increasingly becoming interested in their companies' businesses at a much more granular level, in particular around how the companies manage all their risks and how risks are inter-connected.

What does it take to implement an effective ERM framework?

- Real commitment at the highest level is needed.

- The process of implementation is not difficult, but it needs dedicated people, technology and investment, together with a structured approach and strong project management.

- As happened with Basel II in banking, the Solvency II regulations in Europe provide a good road map to start from.

- Whatever framework is developed, it must be relevant to the company's business and practical, so that it is used in the day-to-day management of the business.

- Early consultation with the regulator is advisable.

How KPMG can help?

We have a leading position in Europe in Solvency II and ERM through participation in discussions that shaped Solvency II and risk management in the insurance industry. In China, we have dedicated teams of actuaries and risk management professionals based in Beijing, Shanghai and Hong Kong. Based on engagements we have performed for a number of insurance companies around the world, we have developed methodologies to help a structured approach to building the overall framework as well as helping clients put in place the necessary systems and infrastructure for an effective implementation and ultimately, approval by the regulators.

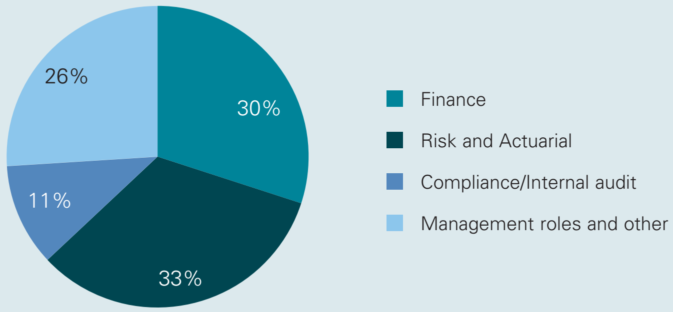
About the survey

During the third quarter of 2009, KPMG conducted a survey of senior executives of insurance companies operating in mainland China and Hong Kong. The survey explored the level of awareness of ERM, responsibility for ERM, policies and models, and expectations for future risk management initiatives.

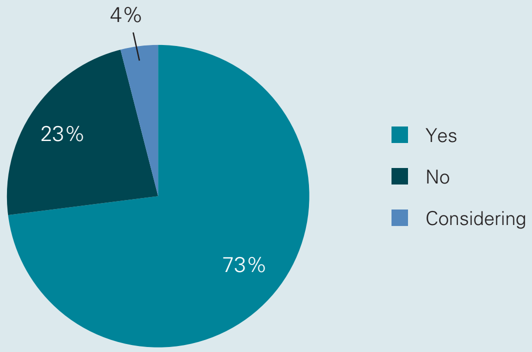
Of the 27 respondents, 20 were based on the mainland and seven in Hong Kong, with 15 representing foreign and 12 representing locally-owned companies.

Slightly more than half of the respondents held a senior finance or risk management position in their organisation, with the remainder holding general management, compliance or actuarial positions.

Primary functional title of survey respondents



Has your company established a separate ERM department or cross-functional committee to manage enterprise risks?



1. The appetite for risk

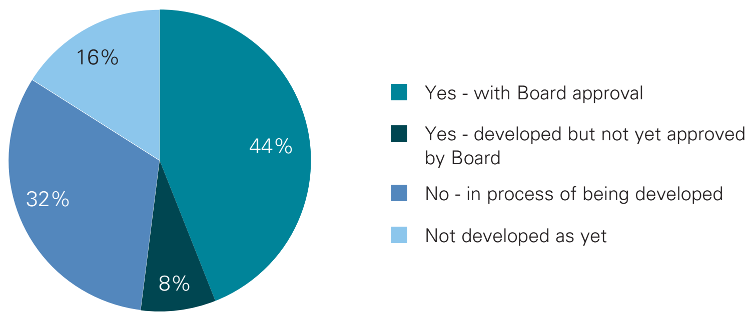
No organisation can succeed unless it pursues opportunities in a calculated manner, which means identifying and then being able to effectively manage risks. It is critical for the board to be able to articulate an organisation's risk appetite, firstly to ensure organisation-wide understanding and acceptance of risk issues, but also to allow risk models to be integrated into strategy, decision making and performance management.

This is especially true in the insurance sector, where risk is fundamental to the business.

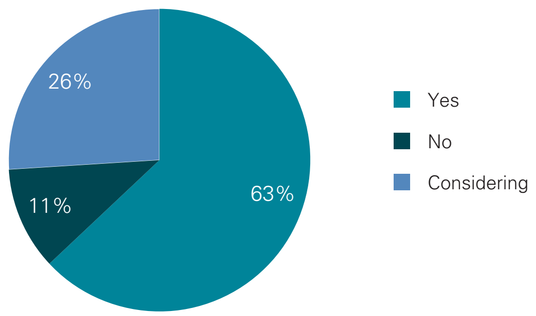
While 73 percent of respondents claim to have an ERM programme, one notable finding from the survey is that almost half of respondents (48 percent) did not have a clearly articulated statement of risk appetite. Understanding this appetite for risk, and thereby being able to communicate internal and external sources of risk, is a key aspect of an ERM framework. It includes management of upside as well as downside risks, so it should be treated as a way to capture opportunity, as well as to guard against difficulties and losses.

Amongst those who have articulated their risk appetite, the board is in most cases involved in approving that risk statement, with only 15 percent of respondents having developed a risk appetite statement in isolation from the board. In 63 percent of cases, the person with primary responsibility for ERM

Has a risk appetite statement been developed by the organisation?



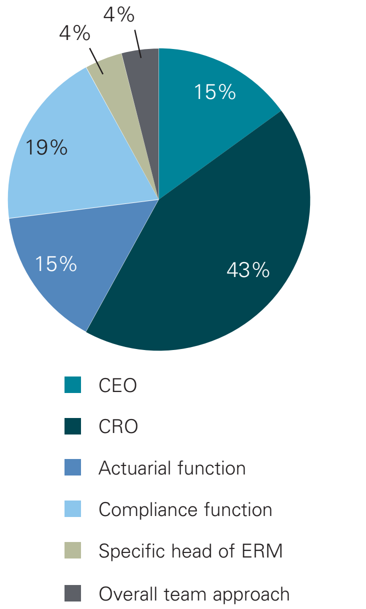
Do you have formal ERM policies?



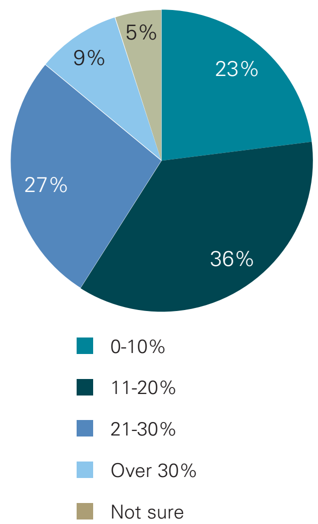
reports directly to either the CEO or board. The key areas for further work are risk appetite and tolerance (44 percent), risk assessment (28 percent), the risk management framework (12 percent) and risk monitoring and reporting (12 percent), which clearly shows that organisations are aware that ERM is a process of evolution.

Another positive finding of the survey is that in over two-thirds of responses, C-level executives are responsible for ERM in the organisation. Forty-four percent of respondents highlighted the Chief Risk Officer (CRO) as the individual responsible for ERM. This appears to be a growing trend and is consistent with the approaches of many western insurers in recent years. However, approximately one-fifth of respondents indicated that the compliance function is responsible for ERM, suggesting that there is some way to go for risk management to develop from a purely compliance-driven exercise to become a catalyst for business success.

Who is responsible for ERM in your organisation?



What proportion of time does your board spend on risk and capital management activities?



Further, 73 percent of respondents said their organisation had set up either a cross-functional risk committee or a department that was dedicated to ERM. In 63 percent of cases, the CEO was a participant in the risk committee, alongside the CRO, the Chief Actuary and Compliance professionals. In contrast, approximately half of respondents stated that the risk management committee did not operate at board level. This illustrates that in many cases, senior executives are aware of, and participate in risk management matters, but that often there is no formal separate board discussion of such matters, something that is now common in many western insurers. That said, over 80 percent of respondents answered that the board spends up to 30 percent of their time on risk and capital management activities.

2. The state of play in China: Regulatory drivers

ERM is an enterprise-wide approach integrated into the business to identify, assess, quantify, manage, and mitigate organisation-wide risk. An ERM system should be holistic, taking into account past and present enterprise risks and extrapolating future issues. This is particularly critical in the insurance industry, where risk is core to the service being provided. The potential for liabilities arising from different divisions and operating units with products characterised by different risk profiles has highlighted the need for insurers to take an enterprise-wide approach. In China, there are also many smaller insurers who need to better understand risk management and many insurers who can use ERM as a framework to guide them to the best commercial opportunities whilst staying aligned to company strategy.

Most large organisations have a risk management programme, but many admit that until recently, they did not make a sufficient investment in risk management or look at their risk issues comprehensively enough. In our survey, 37 percent of insurers do not have formal ERM policies in place, with two-thirds of those considering implementing policies in the near future.

With investors and regulators paying increasing attention to companies' ERM frameworks, the sophistication of a company's ERM capabilities can have important implications, for example affecting their ability to access capital. Globally, ratings agencies are also taking a closer look at risk management frameworks and a number of those agencies are now including ERM policies as a factor in the formulation of credit ratings.

ERM systems are being set up in organisations across China, but our survey shows some inconsistencies and shortcomings in approach. These differences seem to illustrate the fact that for many organisations ERM is a process of evolution with distinct business objectives.

Nevertheless, there are additional regulatory drivers. In our survey, regulatory drivers were cited jointly as the largest influence driving ERM efforts in China, alongside the need to manage general business complexity. Regulations surrounding an insurer's risk management framework in China have developed apace in recent years.

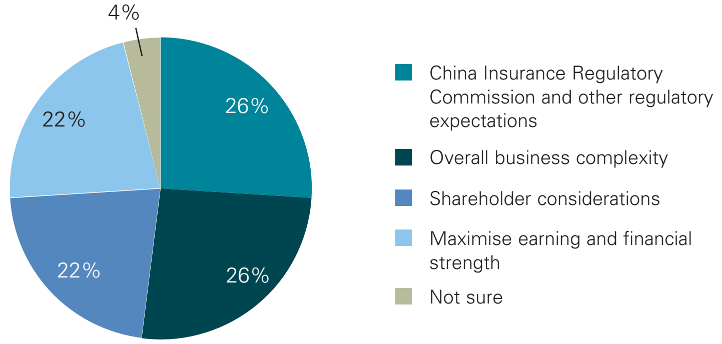
Notable rules include the China Insurance Regulatory Commission (CIRC) risk management circular (2007), which sets out the principles of a sound risk management framework, identifies the risk categories to be assessed and discusses the composition of effective risk controls. In 2008, the CIRC released an updated solvency regulation in respect of insurance companies, which requires the establishment of a risk-based solvency monitoring framework. The State-owned Assets Supervision and Administration Commission (SASAC) introduced risk management requirements for state-owned enterprises in 2006. The Basic Standard for Enterprise Internal Control requires compliance by all mainland China listed companies, whereby they are required to establish, evaluate and assess effectiveness of their internal controls. Hong Kong maintains

similar regulation, stipulated within the Insurance Companies Ordinance and via regulation promulgated by the Office of the Commissioner of Insurance.

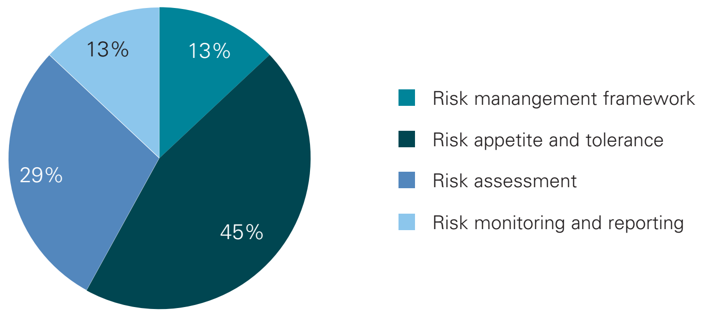
While many of the biggest insurers in China have embarked on major ERM programmes, some are waiting to see how regulatory requirements take further shape before committing investment. In Europe, the advent of key regulatory requirements such as Solvency II have played a major role in accelerating the sophistication of ERM.

Shareholders are also a significant consideration, especially for foreign-owned insurers. This was a consideration highlighted by 20 percent of respondents. "ERM has been deployed in response to our foreign shareholder's request," commented one respondent. Another comment chimes with patterns identified from other survey respondents, which indicate that risk quantification models may be the initial focus of ERM improvements: "The first portion is financial risk ERM deployment, which involves credit risk assessment and reporting, asset portfolio reporting and basic deployment indicators for asset-liability modelling (ALM)." As the following sections discuss, we believe that equal effort should be directed towards integrating these models within the overall control and business decision-making framework.

Which of the following is the key influence driving the ERM efforts in your organisation?



If further work remains to be done in terms of ERM, please indicate which of the following is a major concern to you.



3. The state of play in China: Evolution of economic capital

So far our discussion of ERM for insurers has largely focused on the ERM framework itself. Since an ERM framework includes the areas of capital and solvency management, the framework should encompass the quantification of the various risk categories.

A soundly-managed insurer should be in a position to quantify relevant risks, including insurance, market, liquidity, credit and operational risks. That said, only 48 percent of companies responded that they calculate economic capital, with a further 7 percent considering introducing the assessment. This may be largely due to current limited regulatory requirements regarding a formal quantification of risk, as discussed in the previous section.

Indeed, the introduction of internal capital models as part of Solvency II (see box on page 14) has driven the development of economic capital models for companies in Europe. Such models must reach a minimum level of sophistication, and companies must demonstrate a high degree of model integration within business management and strategy. Further, as the level of modelling sophistication increases, companies need to achieve an equivalent development in the skills and technical knowledge of the modelling team. Such models are also data-hungry, with a result that companies may find their existing data infrastructure needs significant overhaul.

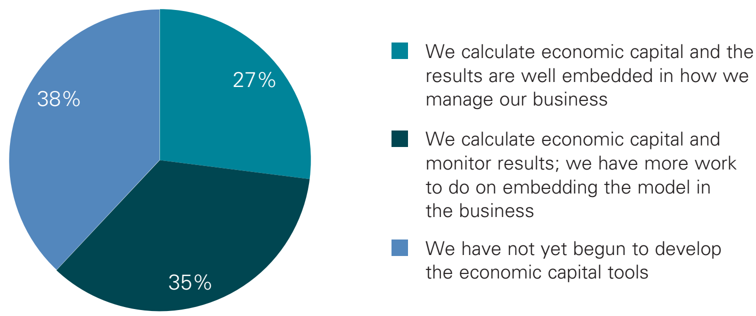
The survey did not reveal stark gaps in the specific risks that respondents model. Respondents stated that they generally model the key risk sub-categories within the market risk and insurance risk categories.

Selection of sub-risks by risk category

Market risks	Life insurance risks	Non-life insurance risks	Operational risks
Interest rate	Mortality	Premium	Event risk
Equity	Longevity	Reserve	Business risk
Credit	Morbidity	Catastrophe	
Currency	Lapse/surrender		
Price (e.g. property)			

As suggested above, the risk quantification exercise provides the board and management with a view of the company's current solvency and projections of future solvency, and provides a view of the sufficiency of current risk mitigation approaches. In this way, the risk quantification and resulting capital management and solvency positions can and should be integral to the board's setting of company strategy. However, only 27 percent of companies say that they embed these results in how the business is managed.

Which best describes the current state of your economic capital model?



4. High hopes for ERM

In the past, ERM tended to be looked at firstly in compliance terms and secondly as a way to assuage risk concerns from external stakeholders, directors and ratings agencies.

It is clear from our survey that many organisations in China have high expectations for ERM. But are these expectations realistic? May there even be other quite different benefits to be gained? As the economy starts to show signs of recovery, leading organisations are also approaching ERM in a more proactive way, to grasp opportunities while understanding the organisational risks that accompany strategic decisions.

Our survey shows that executives have realised, and will continue to realise, benefits from their ERM programmes. These include their ability to conduct capital adequacy assessments and asset-liability modelling (ALM). Economic capital modelling is quickly becoming a key aspect of ERM. The kinds of complex capital adequacy assessments seen in mature markets are not yet mandated, however there are some basic mandatory requirements and insurers in mainland China, Hong Kong, and much of the Asia Pacific region, are clearly anticipating further future developments.

This is quite understandable; there are many other benefits to be accrued from an ERM framework. Many respondents have realised wider business benefits around business planning and even enhanced shareholder value.

Benefits of ERM programme

The underlying control frameworks and integration with broader strategy are ongoing challenges. Many insurers are still putting those foundations in place. Insurers may even risk getting ahead of themselves if they adopt complex models, but are then unable to integrate the model with day-to-day business performance and control.

Instead, we believe that companies should implement the various components of ERM in a well-planned, structured and logical way, and at a steady rate such that the organisation as a whole keeps pace with change.

Lessons from Europe – Insurer risk and solvency management

Within the European Union (EU), the management of risk is about to take on an entirely new structure through the Solvency II regime. When Solvency II is implemented in Europe in 2012, it will transform EU insurance regulation. Solvency II is much more in substance than its name suggests. As well as introducing more sophisticated risk-based solvency capital requirements for insurers, the regulation shifts the focus of supervisors from compliance monitoring and capital to evaluating insurers' risk profiles and the quality of their risk management and governance systems.

Under Solvency II, the capital calculation incorporates an enterprise-wide view of risk management. Each element of a company's risk profile and risk management framework is addressed and has the potential to attract a capital charge, meaning insurers must hold capital against insurance, market, credit and operational risks, to name a few. The insurer must be solvent for the next 12 months with a 99.5 percent level of confidence. A company's risk governance process, encompassing internal controls and risk management, will be a new area of influence for supervisory authorities in the EU. Insurers could attract a capital charge if their risk management is deemed to be deficient.

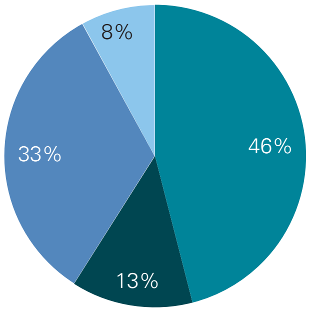
Another feature of Solvency II is the potential to use an 'internal model' developed by the company to calculate some or all risk capital charges, when assessing overall solvency capital. Under Solvency II, such models must be approved by the regulator. Approved models must reach a minimum level of sophistication, have Board approval, and be used in day-to-day management decisions. Should a company decide not to utilise an internal model, its Pillar 1 solvency capital will be established using a 'standard model' with assumptions calibrated across the industry.

From 2012, European insurers will also be required to disclose more information to both their supervisor and within the public domain. Information provided to the supervisor is expected to include information to assist the supervisor in assessing the company's system of governance, the solvency valuation principles, risks faced and risk management systems.

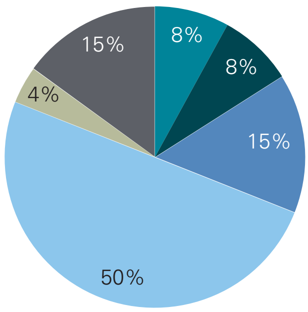
As the survey results show, insurers are putting more thought into the wider concept of ERM. Although current regulation in mainland China and Hong Kong does not require solvency capital to be based on a highly sophisticated or internally developed capital models, this survey indicates that some insurers are ahead of the game having already taken steps to utilise and embed risk modelling techniques.

5. Investing in the future

What change in the level of investment in risk management does your organisation expect to make over the next 18-24 months?



What is the biggest challenge impeding the advancement of ERM over the next 18-24 months?



Around half of the respondents to our survey expect to ramp up their investment in risk management over the coming two years. Thirty-three percent expect investment to increase by up to 20 percent, with 8 percent expecting an increase of between 20-40 percent. Among those responding in "other" categories, a number expected to see an increase, but felt they could not anticipate how large that would be.

Any increase may present new challenges in terms of allocation of resources and organisational structures. Interestingly, almost a quarter of respondents have not established a department/committee for ERM. For many organisations, this will inevitably change over time.

The need to invest in skills and people is the biggest single challenge in rolling out an ERM programme. More specifically, that challenge means reconciling the level of detail and complexity required developing ERM capabilities with staff capacity. It is important to note that this challenge is by no means unique to China and Hong Kong. Getting the right people is a major challenge for insurers worldwide.

Even among senior practitioners, it is difficult to find time and resources, given the expanding scope of ERM programmes. As one executive puts it, "It is a challenge to show the value of ERM in a fast-growing insurance company. All managers at senior and middle level are very busy and struggle to find time to read the ERM framework documents and the project report carefully."

Our view is that, as leading insurers in the region develop and enhance their ERM capabilities, they will be rewarded with valuable competitive advantages. These advantages include, but are not limited to, a heightened awareness of risk and its implications on business planning and decision-making, and more efficient management of capital. Regulatory developments may ultimately accelerate the trend, but insurers that hold off development by waiting for specific regulatory change, risk falling behind the curve.

Conclusion

With the initial foundations in place, the stage is set for more comprehensive risk management and the quantification of a broader spectrum of risk issues. The insurance industry in China is developing rapidly and an ERM framework has never been more important to capture a fluid risk and strategic environment. Our survey confirms that internal cultural acceptance will be a critical part of that and the board needs to take a role in driving ERM activities.

Implementation of an effective and integrated ERM framework is a challenge that insurers worldwide are only beginning to get to grips with. The China and Hong Kong markets present many unique challenges, in terms of the dynamic market environment and massive growth potential, not to mention the challenges presented as the global economy attempts to pull out of the financial crisis.

There is good reason to believe that insurers in mainland China and Hong Kong will continue to develop their approach to risk management over the coming years. Our survey shows that ERM remains in many cases skewed towards pre-existing risk parameters such as capital adequacy and has not in all cases yet been embraced as an enterprise-wide framework.

The survey respondents highlighted several areas of focus for future development needs, predominantly relating to risk appetite and tolerance, risk assessment, the integration of economic capital modelling into business management and strategy, and the importance of developing a strong underlying ERM framework. In our experience, the best results have come when strong foundations are put in place, with strong sponsorship from the board, allowing ERM to steadily integrate into all operational aspects of the business.

There are certainly lessons to learn from the adoption of Solvency II in Europe. With a team of professionals drawing from experience in different markets, KPMG China is well placed to assist clients as the Chinese insurance market develops in the years to come.

About KPMG

KPMG China has over 9,000 staff, working in 12 offices; Beijing, Shenyang, Qingdao, Nanjing, Shanghai, Chengdu, Hangzhou, Fuzhou, Guangzhou, Shenzhen, Hong Kong and Macau.

Our dedicated financial services team brings together partners from audit, tax and advisory practices and is linked closely to other member firms in the KPMG network.

Our Insurance team is a key part of our Financial Services group in China, with key leaders based in each of the main regions of China and a particular focus on regulatory, risk management and financial reporting trends affecting the industry.

KPMG China audits a significant share of the local life and non-life insurance markets based on premium revenues. This includes four of the 10 largest life insurers and three of the top 10 non-life insurers.

In addition, we provide Tax and Advisory Services to many of the industry's key players and have more than 2,000 dedicated Financial Services professionals.

Global thought leadership

Getting the balance right: Long-term capital, risk and regulatory challenges for insurers

Frontiers in finance
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Operational Risk Insurance Survey 2009

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