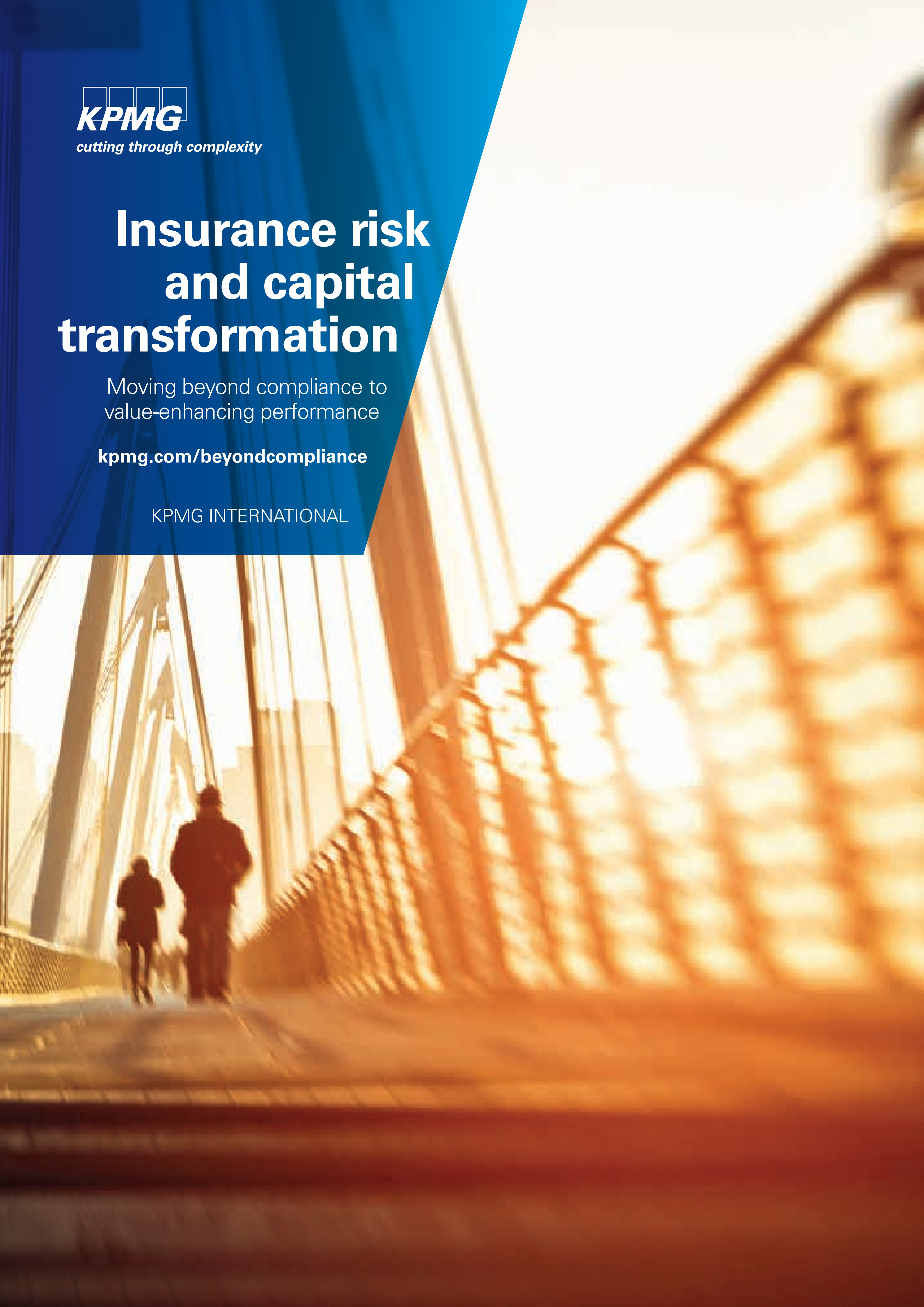
cutting through complexity

Insurance risk and capital transformation

Moving beyond compliance to value-enhancing performance

kpmg.com/beyondcompliance

KPMG INTERNATIONAL



Foreword

This is the third in a series of articles on issues in Finance and Risk in insurance, and the first focusing specifically on Risk. Risk management has always been core to the insurance industry, but separate risk functions and the role of the Chief Risk officer have emerged relatively recently, with a lot of the impetus coming from regulation, and in particular Solvency II in Europe.

Most insurers in established markets have now put an Enterprise Risk Management framework in place, monitored and managed by the Risk function, and supported by increasingly sophisticated modeling and scenario analysis. These developments have typically been positioned as mandatory, but many companies are now stepping back to ask three questions – is this framework:

- **Effective, is it embedded in the business;**
- **Efficient, is the level of activity proportionate to the level of risk, and**
- **Does it add value?**

We explore these questions in this article, and give our views as to what Risk should be focusing on going forwards in order to demonstrate value as well as compliance.

Paul Bishop
Global Head of Insurance
Finance & Risk
KPMG in the UK

Frank Ellenbürger
Global Head of Insurance
KPMG in Germany

> Many insurers are **turning** to their existing risk **management functions** and asking how can we best optimize output to **ensure value-enhancing** performance?

Latest developments in Enterprise Risk Management (ERM)

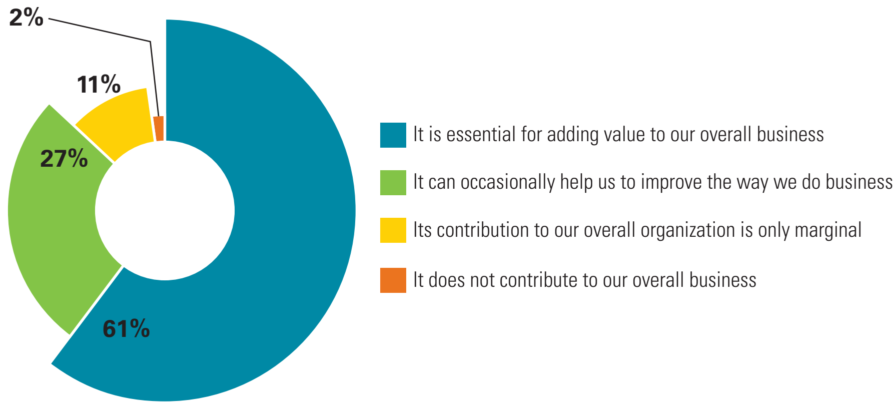
Optimizing output to ensure value-enhancing performance

The current operating environment in many markets is characterized by low growth, flat yield curves and high expectations from external stakeholders, such as analysts, rating agencies and regulators for quality risk and capital management. Considerable pressure is therefore being applied to the management of insurers to grow and write profitable business, achieve an increasing return on capital while at the same time, maintain robust risk and capital management frameworks and reducing operating expenses. Given these imperatives, it is not surprising that many insurers are increasingly turning to their existing risk management functions and asking: how can we best optimize output to ensure value-enhancing performance?

Risk management is not new to the insurance industry, but the pace of change is new. The last ten years have seen considerable change, with risk emerging as a separate function, and the CRO becoming a significant Board level role at many insurance companies. Innovation from the capital and risk modeling work in this period has been used to influence and inform current practices.

> "The last ten years have seen **considerable** change, with **risk emerging** as a separate function, and the **CRO** becoming a significant **Board level role** at many **insurance** companies."

Perceived value of risk management*



*Due to rounding, graph does not add up to 100.
Source: Survey KPMG International, 2013.

A significant proportion of this development has been triggered by regulatory need, which has for many insurance firms tended to be interpreted as requiring a 'compliance' focus rather than being primarily driven by the business itself. For some, these changes have been driven by the volatile and challenging market environment and the need to have a greater understanding of the risks being run.

Solvency II in Europe is a good example of where many insurers have sought to use advanced internal models and risk frameworks as part of their own risk and solvency assessment (ORSA). The tight timeframes that were initially expected for the introduction of Solvency II resulted in many firms establishing large stand-alone teams, whose purpose was to facilitate the relatively quick development of enhanced risk and capital frameworks.

While such activity led to significant advances, the delay in Solvency II's introduction now provides the opportunity for insurers to:

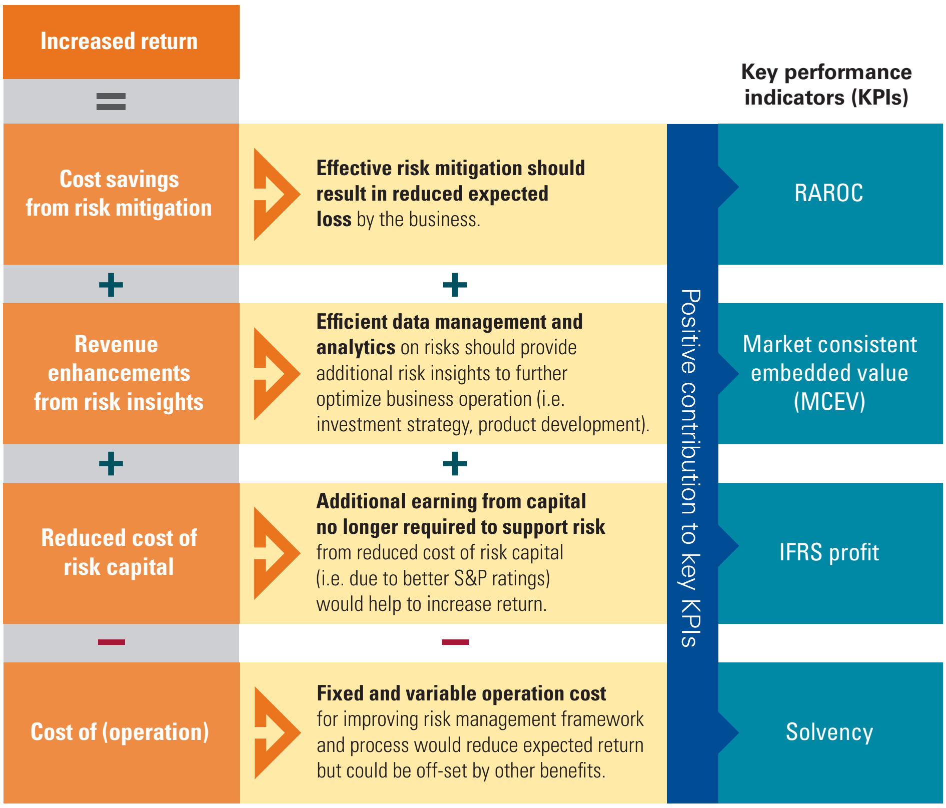
- take stock of development and to reassess the value that such processes and applications may have across the business;
- embed the new practices into established processes – arguably, a key consideration which hasn't necessarily been the focus for many firms to date;
- understand which elements of risk management are value-adding and capable of providing the insights to optimize commercial management of risk and capital going forward; and
- where possible, align upcoming projects on new accounting standards IFRS 4/9 with existing Solvency II systems and processes.

> "85 percent of **Financial Services** firms anticipate that the share of **revenues invested** in risk management will increase over the next **three** years."
>
> Survey: KPMG International, 2013

How does the risk value equation contribute to increased return?

Risk value equation

Contribution to various KPIs



Source: KPMG in the UK, 2013

From a commercial perspective, what are the key drivers required to improve and enhance risk management frameworks?

The theoretical position is easy to articulate. To add value, risk must make a positive contribution to 'RAROC' return on capital – risk adjusted of course. Increased return can be derived from the cost saving from risk mitigation, together with revenue enhancements from risk insights, plus the reduced cost of risk capital less the cost of risk operations. This is illustrated in the following diagram.

Achieving greater efficiencies often means having less complexity. The risk management frameworks and processes established range from having insufficient structure and clarity, where roles and responsibilities are unclear and performance measures are poorly articulated and not aligned sufficiently to business objectives to, at worst, being overly cumbersome and bureaucratic. There exists therefore, substantial scope in a number of key risk areas where insurers can improve performance. Typically these involve ensuring efficient outcomes are being achieved across:

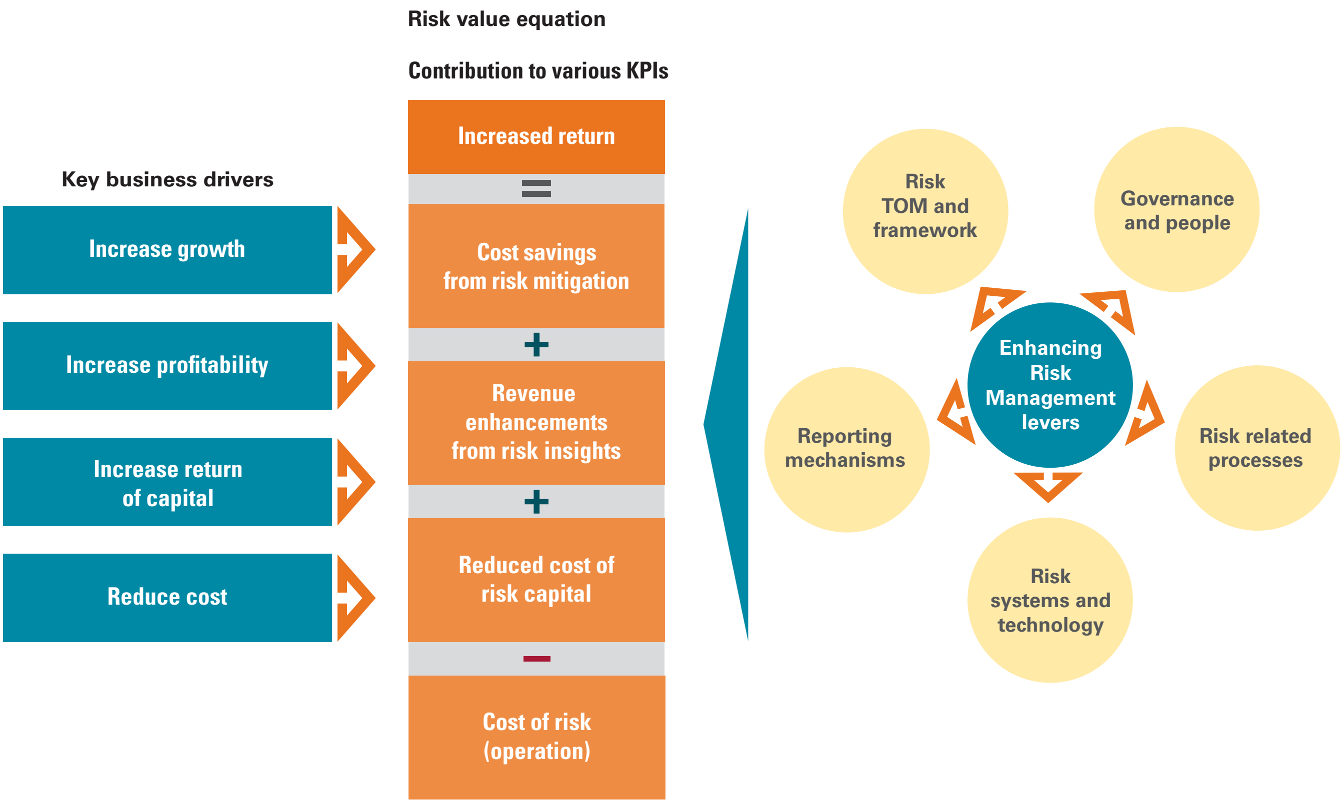
1. the target operating model and risk framework;
2. governance and people;
3. risk-related processes;
4. risk-oriented business systems and technology; and
5. reporting mechanisms.

The diagram below illustrates the risk value equation in relation to the five risk management levers and the key business drivers.

> To **add value**, risk must make a **positive contribution** to 'RAROC' return on capital – **risk adjusted** of course.

A simple equation: a revealing insight

The risk value equation to derive increased return



Source: KPMG in the UK, 2013

Enhancing risk management to deliver value: the five levers

> **Too often**, insurers have established **risk environments** whereby risk and **control frameworks** are not aligned or embedded **across** the **business**.

1. The target operating model and risk framework

Too often, insurers have established risk environments whereby risk and control frameworks are not aligned or embedded across the business. Sometimes ambiguity even exists regarding which parts of the business 'own' what risk. For the most inefficient, little communication or effective linkages between other critical functions of the business, such as finance and their operations of capital management and treasury, exist. These 'disconnects' result in costly inefficiencies.

What can be done to improve this?

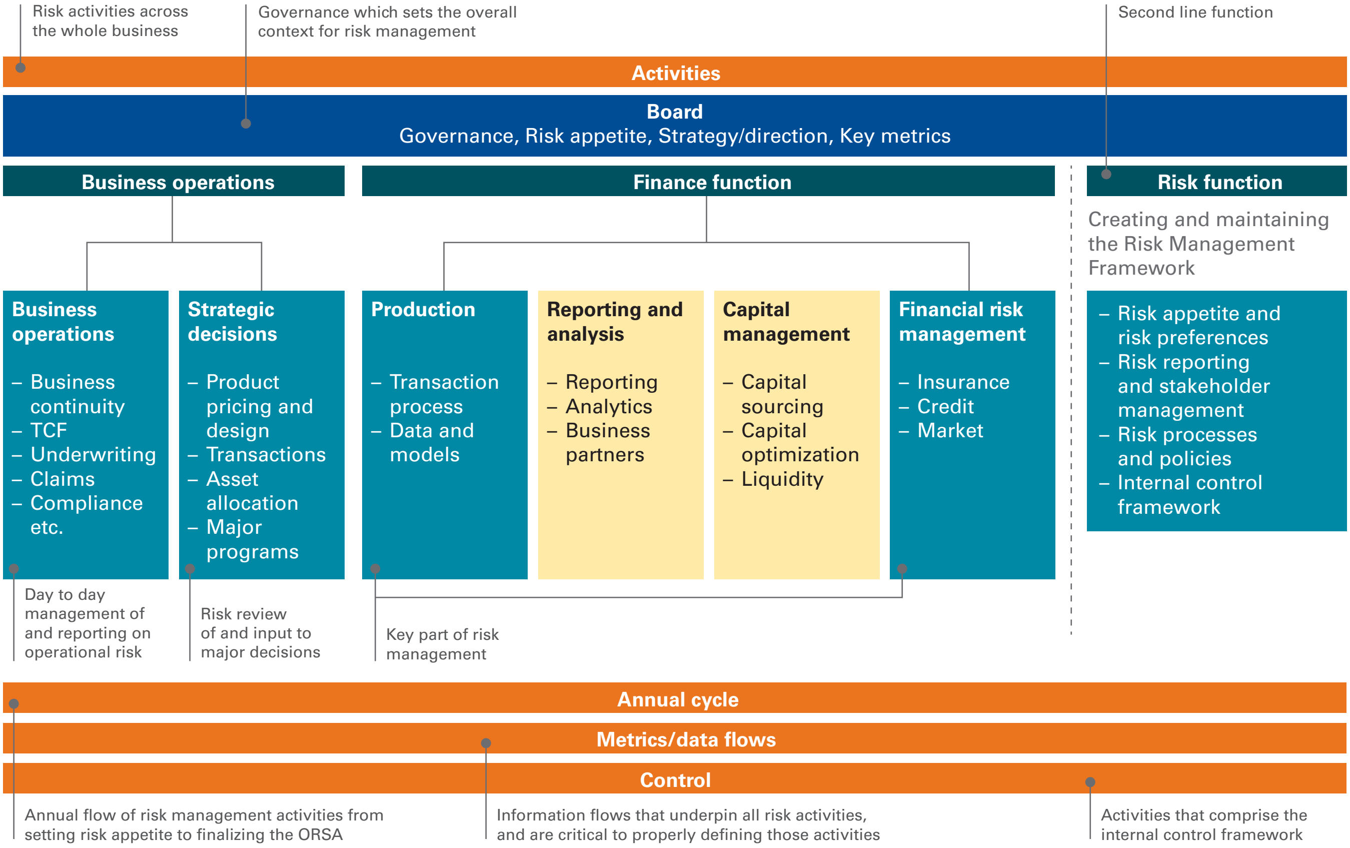
An efficient risk management framework needs to contain a number of fundamental elements. As is widely accepted, the risk framework should comprise the structures, limits and policies set down by the Board within which risk operates through a well defined and embedded risk appetite. The framework itself is the tool used by the business that ensures appropriate monitoring and reporting of the risk activities, and shouldn't be separate from other business processes. Defining the target operating model that allows the risk management activities to be performed is a key priority.

The following diagram provides one view of an appropriate target operating model for risk management:

Under this operating model environment, management of the business and of financial risk on a day to day basis is embedded in the business operations and in finance. The Risk function itself undertakes part of the overall set of risk management activities, maintaining primary responsibility for ensuring overall effective risk governance framework and a holistic view of risk across the business from all the risk related activities that are undertaken. The risk management framework brings together the particular activities undertaken by the risk function, namely:

- establishing risk appetite and tolerance limits as a result of performing insightful analysis concerning risk preferences;
- overcoming organizational silos to assess risks that cut across reporting lines and risk categories;
- identifying new opportunities arising from the analysis performed of financial risks to input into the strategic planning process regarding risk positions, benefiting from feedback loops from within the business;
- ensuring appropriate risk policies and processes have been established;
- establishing sufficient risk reporting and stakeholder management mechanisms, and
- maintaining and supporting the overall internal control framework itself governing the risk activities across the business.

The target operating model and risk framework



Source: KPMG in the UK, 2013

2. Governance and people

Critical to the success of any effective risk framework are the governance and people dimensions. Risk is central to governance, which for many insurance firms, can generally be considered as the system by which they are directed and controlled. Such arrangements change the effectiveness and performance of the Board. In turn, governance is heavily influenced by the quality and experience of the human talent and the culture across the business. Ensuring appropriate reporting lines, skills and management of such activities is therefore essential.

However, for many insurers, there is a lack of clarity regarding the ownership and management of risks undertaken by the front-line operations (commonly described as the first line). Risk roles are often unclear, with many risk functions in the business being inexperienced and under-resourced to manage more multiple risk categories (often focusing on a narrow remit of operational risk and compliance monitoring). There is also at times a general level of confusion with the roles and function performed by the second line risk structures that many insurers, particularly larger groups, have established: they have traditionally not only aggregated risk information from across the various business units but have often been involved in its production. Confusion between roles performed in the first and second lines will invariably lead to less effective performance, affecting the risk culture of the organization and inefficiency through duplication of effort.

> "Governance is **heavily influenced** by the quality and experience of the **human talent** and the culture **across the business**."

How can these issues be overcome?

A first step is clearly articulating the primary function and expectations between the CFO, Chief Actuary and CRO. In the early 1990s, when the concept of a CRO was developing, the CRO role was rather narrow and predominantly consisted of undertaking evaluation of geographical risk exposures, ensuring minimum regulatory compliance, assessing business continuity and having responsibility for training and communication on risk policies, often with some or all of the risks being overseen by the Chief Actuary. In contrast, the CFO usually had primary responsibility for the financial reporting deliverables – limited in quantitative and qualitative detail. CROs typically had limited exposure to financial markets and analysts, and finance generally was seen as consisting of 'number crunchers' and providing limited value in terms of business strategy. The primary focus was on technical expertise and not usually on the wider business knowledge and strategy of the enterprise.

Today, there is much greater convergence of risk and finance, with the CRO taking on much of the responsibility formerly resting with the Chief Actuary, for example:

- increased transparency and communication with financial markets;
- increasing importance of risk information into insurers' management of the company. For example, through the development and embedding of RAROC and economic capital measures into the performance management framework;

> "Today, there is much **greater convergence** of risk and finance, with the **CRO** taking on much of the **responsibility** formerly resting with the **Chief Actuary**."

- finance have first line of defense responsibilities for managing capital and other performance metrics;
- the CRO increasingly is responsible for monitoring, analyzing and reporting mechanisms including external stakeholders such as rating agencies; and
- there is much more interaction and dependency nowadays between functions.

In addition to these roles, changing the operating model can lead to enhanced performance across the business. Heads of business units need to ensure they are given the responsibility to own and drive their risk taking activities in an informed manner, including mitigation within their first line activities to achieve their business objectives. Having a clearly defined risk function at the business level, with well mandated terms of reference, capabilities and empowerment to effect change is needed.

3. Risk-related processes

Risk processes then need to be established in sufficient depth such that they are aligned with how the business can best manage and perform the risk functions required, supported by efficient risk systems and reporting mechanisms.

Consistent and effective risk management processes aid the identification, evaluation, monitoring, control and reporting of risk. However, many insurers continue to struggle in establishing clear linkages between developing their strategic plans, taking business decisions, defining and articulating risk appetite and capital metrics to measurement of key performance outcomes. Cascading those key measures throughout the business, with the necessary supporting infrastructure, remains a challenge for many firms. Ensuring appropriate risk policies are established and aligned with the business model, with a suitable operational control framework, is necessary to create and sustain ongoing performance.

How is this best achieved?

Building an integrated risk and capital management process capable of identifying, measuring and aggregating the impact, and opportunities, of risk performance across the main suite of credit, market, liquidity, insurance and operational risks is needed as a minimum. The ORSA should facilitate most of this analysis with both quantitative and qualitative components integrated to the risk appetite and capital framework. These Risk processes need to identify opportunities as well as threats – areas where because of its expertise and knowledge, its balance of business or its geographical spread, an insurer can take risks at a lower cost (capital and revenue) than its competitors and so generate commercial advantage.

Having an efficient decision-making framework incorporating Risk Management Information (Risk MI) should enable better identification and assessment of such risks and allow greater analysis to be performed in measuring the value of different risk positions that could be taken. Supporting the risk taking activities across the firm should be the primary goal of any second line function. So, while risk oversight and the broader risk management activities occur across the business, the risk function can perform a critical role in providing specific value enhanced outcomes, optimizing the return on capital as set out above.

Undertaking these types of analyses allows the risk function to demonstrate its value to the business, critically, by undertaking proactive analysis of new opportunities for risk positions that can be taken in addition to the traditional risk function role of loss prevention.

> "Building a **functional model** that generates **relevant insight** into the organization's risk **framework requires** having the right data for **business analytics**."

4. Risk-oriented business systems and technology

Many risk systems currently in use by insurers are not quite fit for purpose for the business model or structure employed. This arises for a number of reasons, mainly:

- Technological limitations whereby many insurers continue to be burdened with legacy systems, with many operating in isolation of one another
- An under-investment in efficient IT platforms generally that are capable of delivering fast and reliable risk data and information for analysis
- An overwhelming volume of key risk indicator (KRI) material presently being supplied which causes difficulty in producing, measuring and then using reliable risk reports for better business decision-making purposes.

What is required to enhance the risk systems and technology used by many insurers to achieve greater value and reduce time on risk reporting?

As a first step, the functionality and efficiency of the risk systems need to be reviewed and tested against the actual business needs. The target operating model built should be using efficient technology to ensure timely and accurate delivery of Risk MI. To achieve these outcomes, risk, actuarial and accounting systems need to be compatible with each other and aid economic capital, solvency and other business decision critical outputs. Filtered KRIs and reporting criteria would then need to be built into the risk system to achieve optimal performance. The improvement in risk systems can then enable risk teams to perform stronger, more insightful analysis that drives better decision-making.

Additionally, modelling systems will not only need to identify the key risks to sustaining the business plan and meeting business objectives, they should be able to model predictive views of where the business may be heading under a variety of scenarios. Historically, insurers have not necessarily focused enough on the relationship between risk, capital, and performance, with the focus often being backward-looking rather than predictive.

Building a functional model that generates relevant insight into the organization's risk framework requires having the right data for business analytics. Determining accurate, reliable, and consistent data, and designing appropriate systems and controls for data throughout the business is necessary. Ideally, key economic data (including linkages between other important data sources such as lapses) will be absorbed, exchanged, reported, analyzed, and reconfigured in such a manner that the insurer will have a view into market movements as they develop, enabling management to quickly choose an appropriate course of action to address multiple contingencies. This is particularly relevant given clear linkages are needed to align culture, people, processes, and technology across geographies and time while addressing key solvency areas including capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues.

5. Reporting mechanisms

Similar to the operating risk systems, reporting mechanisms – both for internal and external purposes – are presently underperforming for many insurers. For example, Risk MI data and feedback loops to aid risk reporting between the business and second line review functions are vague. A lack of alignment in these controls often remains unclear and reporting processes invariably impact the efficiency of the ORSA review and in producing other capital and financial metrics.

What can be improved?

To ensure value-enhancing mechanisms can be established for reporting purposes, clearly understanding the expectations from key stakeholders regarding critical MI data and analysis – such as from the risk committee – is helpful to ensure alignment of the outputs. This is particularly relevant, as much of the reporting is generated in the first line, both for financial and operational risk. Submissions to risk committees will be a combination of first and second line analysis and views, and submissions to governance committees will reflect the risk perspective, such as planning. The process of analysis and review is as important to maintaining the risk framework as the reports themselves. This reflects the role of risk in the second line as reviewers/challengers/analysts rather than originators. Reliable reporting methodology and measurement of data is required in appropriate and consistent formats to ensure alignment across all business units. Such fundamentals assist to establish internal reporting criteria measures for capital and solvency metrics linked to financial performance outcomes. In turn, such consistency should provide for more efficient and faster external reporting needs to be met to key stakeholders such as analysts, rating agencies, regulators and consumers.

What are the implications for insurers?

- In the future, risk functions are going to have to justify the cost of risk management – from both a commercial and a compliance perspective.
- While many risk functions have made significant progress, driven largely by compliance considerations in some markets, they now need to step back and align the commercial and compliance perspectives.
- The capabilities for this new world are in no way different, but there will need to be a significant change in attitude and therefore in culture.
- Embedding an efficient and coherent risk framework will be fundamental to this, as well as ensuring that technology and reporting are well structured and aligned to business needs.
- Perhaps the biggest challenge will be working out how to measure cost and value so as to demonstrate this to stakeholders – this will be far more challenging than simply demonstrating effectiveness, which will be viewed as a given.

How KPMG can help?

Through our extensive expertise in enterprise risk management, KPMG has helped clients globally define, develop and implement risk transformation programs aligned to the business needs. Should you have any questions relating to the issues raised in this article, or questions relating to your firm's specific needs, please speak to your local KPMG contact or one of our subject matter experts listed.

Contact us

Global Insurance Leadership Team

Frank Ellenbürger
Global Head of Insurance and EMA Coordinating Partner
KPMG in Germany
T: +49 89 9282 1867
E: fellenbuerger@kpmg.com

Simon Donowho
ASPAC Coordinating Insurance Partner
KPMG in China
T: +852 2826 7105
E: simon.donowho@kpmg.com

Laura Hay
Americas Coordinating Insurance Partner
KPMG in the US
T: +1 212 872 3383
E: ljhay@kpmg.com

Frank Pfaffenzeller
Global Insurance Audit Lead
Partner, KPMG in Germany
T: +49 89 9282 1027
E: fpfaffenzeller@kpmg.com

Gary Reader
Global Insurance Advisory Lead
Partner, KPMG in the UK
T: +44 20 7694 4040
E: gary.reader@kpmg.co.uk

Tim Roff
Global Actuarial Lead
Partner, KPMG in the UK
T: +44 20 7311 5001
E: tim.roff@kpmg.co.uk

Hugh von Bergen
Global Insurance Tax Lead
Partner, KPMG in the UK
T: +44 20 7311 5570
E: hugh.von.bergen@kpmg.co.uk

Mary Trussell
Partner
KPMG in the UK
T: +44 20 7311 5461
E: mary.trussell@kpmg.co.uk

Authors

Paul Bishop
Global Head of Insurance Finance & Risk Partner
KPMG in the UK
T: +44 20 780 261 4970
E: paul.bishop@kpmg.co.uk

Rob Curtis
Global Insurance Regulatory Lead
KPMG in the UK
T: +44 20 7694 8818
E: rob.curtis@kpmg.co.uk

Key Contacts

Antonella Chiricosta
Partner
KPMG in Italy
T: +39 068 097 11
E: achiricosta@kpmg.it

Michael Crawford
Partner
KPMG in the UK
T: +44 20 7311 1446
E: michael.crawford@kpmg.co.uk

Juan De Ipiña Garcia
Director
KPMG in Spain
T: +34 629 740 835
E: jdeipina@kpmg.es

Michael Dermody
Partner
KPMG in Australia
T: +61 2 9335 8141
E: mdermody@kpmg.com.au

Nick Dexter
Partner
KPMG in the UK
T: +44 20 7311 5443
E: nick.dexter@kpmg.co.uk

Roger Gascoigne
Partner
KPMG in Central and Eastern Europe
T: +420 2221 23481
E: rogergascoigne@kpmg.com

Carl Groth
Director
KPMG in the US
T: +1 973 912 4873
E: chgroth@kpmg.com

Gábor Hanák
Director
KPMG in Central and Eastern Europe
T: +361 887 6639
E: ghanak@kpmg.com

Viviane Leflaive
Partner
KPMG in France
T: +33155686227
E: vleflaive@kpmg.fr

Douglas Lecocq
Principal
KPMG in China
T: +852 2978 8282
E: douglas.lecocq@kpmg.com

Luciene T Magalhaes
Partner
KPMG in Brazil
T: +55 11218 33144
E: ltmagalhaes@kpmg.com.br

Brid Meaney
Partner
KPMG in the UK
T: +44 20 7311 5470
E: brid.meaney@kpmg.co.uk

Dr. Peter Ott
Partner
KPMG in Germany
T: +49 89 9282 1839
E: pott@kpmg.com

Neil Parkinson
Partner
KPMG in Canada
T: +1 416 777 3906
E: nparkinson@kpmg.ca

Thomas Rauschen
Senior Manager
KPMG in Germany
T: +49 511 8509 5058
E: trauschen@kpmg.com

Jeroen van Wageningen
Partner
KPMG in the Netherlands
T: +31 20 656 2409
E: vanwageningen.jeroen@kpmg.nl

kpmg.com/socialmedia

Designed by Evalueserve.
Publication name: Insurance risk and capital transformation: Moving beyond compliance to value-enhancing performance
Publication number: 130038
Publication date: April 2013