2014 EAAC TAIPEI TAIWAN

18TH EAST ASIAN ACTUARIAL CONFERENCE

12-15 October 2014

Taipei International Convention Center in Taipei Taiwan

Enterprise Risk Management

How much risk do you want to take?

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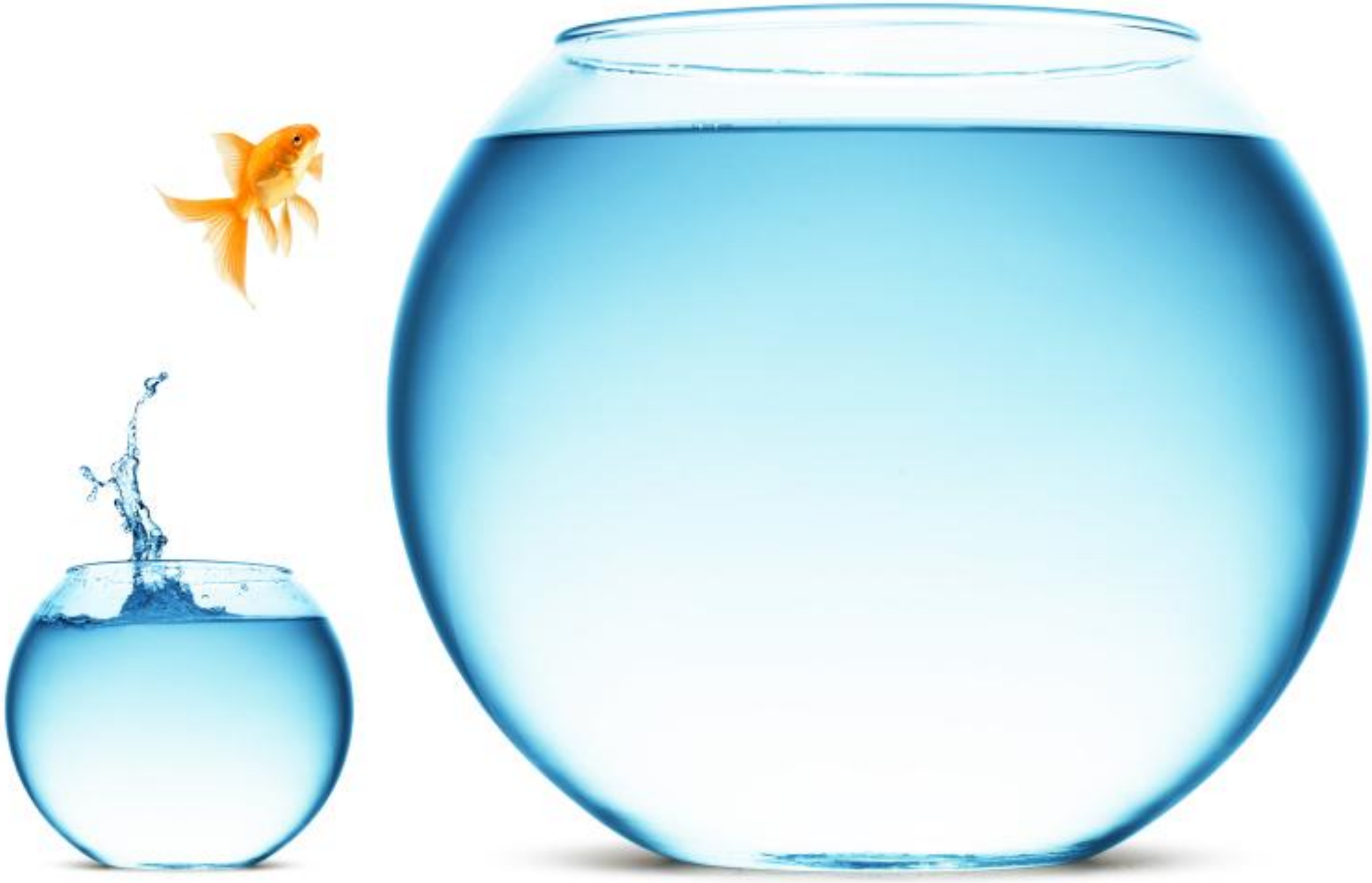
Agenda

1. Introduction
2. Developing an ERM framework
3. Defining and integrating Risk Appetite
4. Risk Appetite and Risk Culture
5. Closing



Introduction

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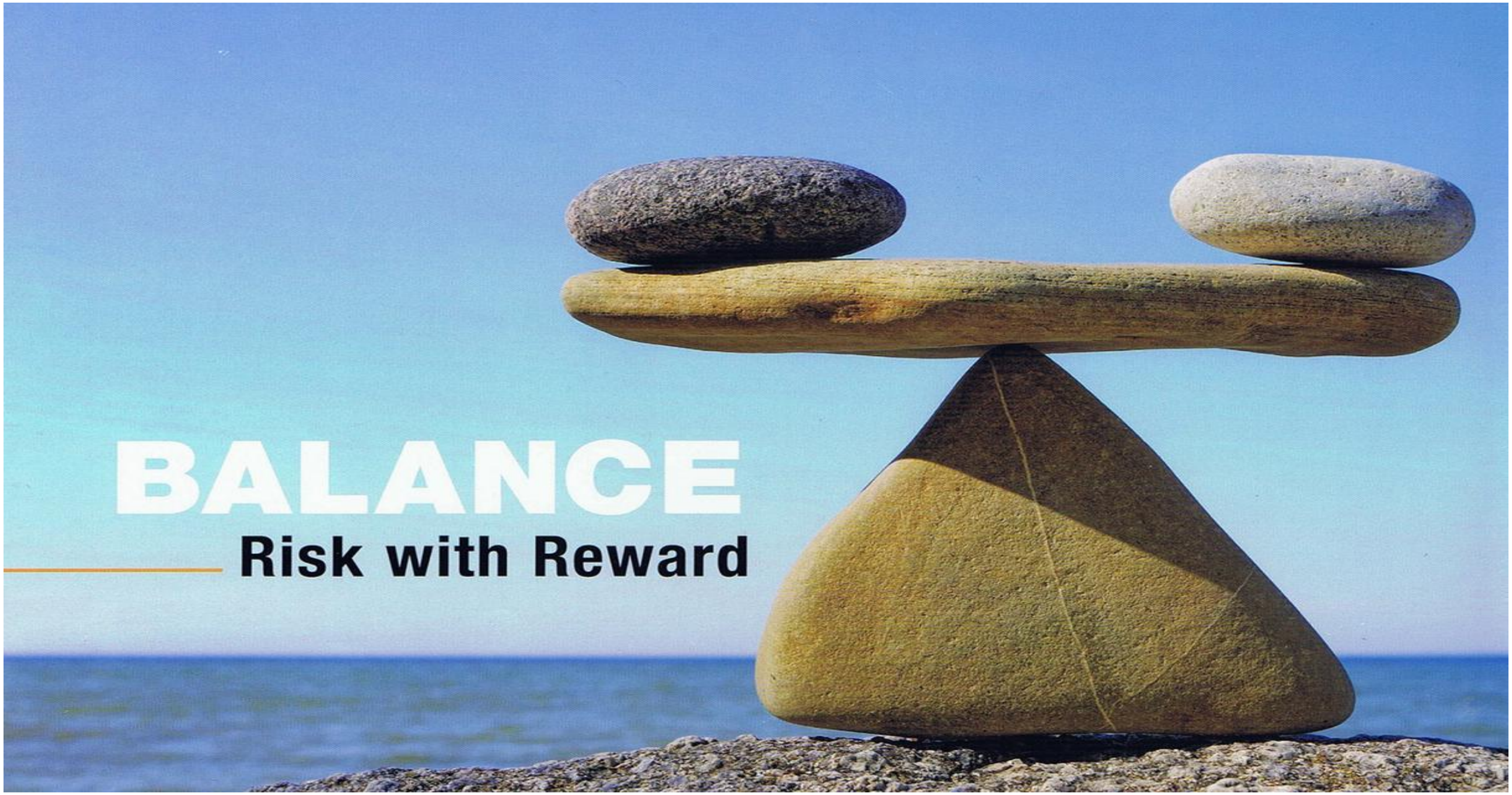
What is risk?

RISK: The effect of uncertainty on an organisation's objectives

Source: ISO 31000 (2009)

What is risk management: understanding your risks

What is risk management: balancing risk and reward

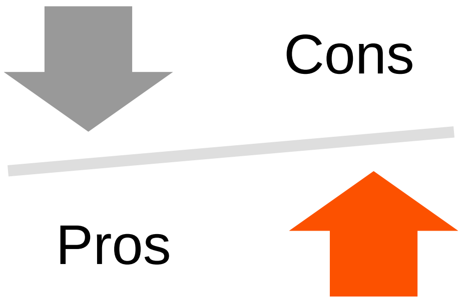


Good risk management allows companies to align risk and reward with business strategy and proactively take advantage of opportunities and protect the downside

What does ERM aim to do?

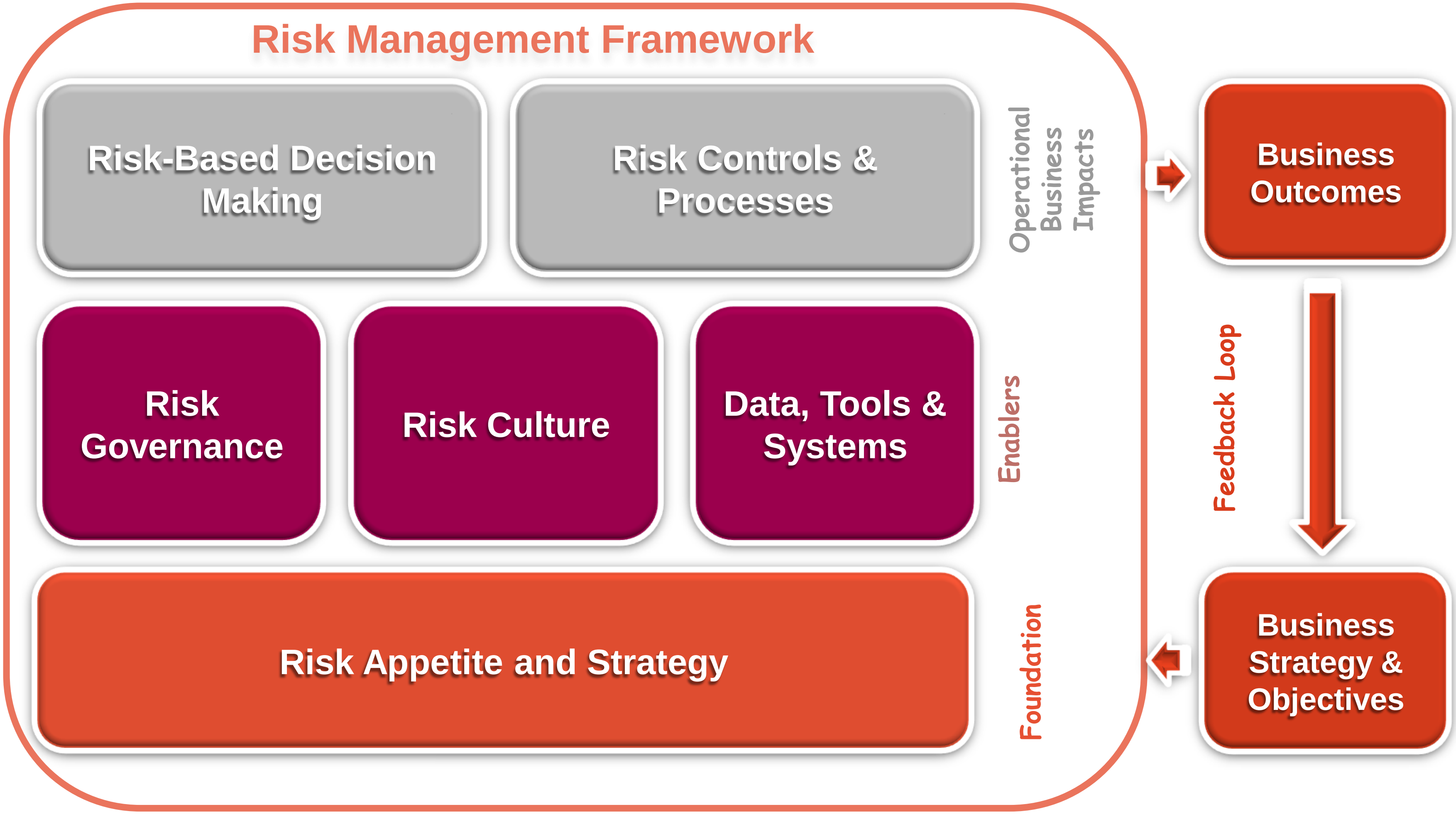
Traditional risk management	**Enterprise risk management**
• Risks viewed as a series of single elements, or silos • Each risk stands alone and is not related to the others	• A comprehensive view and consistent analysis of institutional risks • Striking the right balance between risk and return
Optimising management of each risk individually	**Optimising different risks in the context of the company's strategic objectives**

- Identifying and managing risks that could impact the overall strategic plan and mission of the company
- Thinking about the possibilities and using what-if analysis to identify risks and opportunities
- Analysing activities, initiatives and opportunities, taking into consideration both the potential upside and downside impacts
- Improving the analytical rigour applied to strategic decisions and proactively monitoring and managing risks on a day-to-day basis



Developing an ERM framework

The core components of the ERM framework



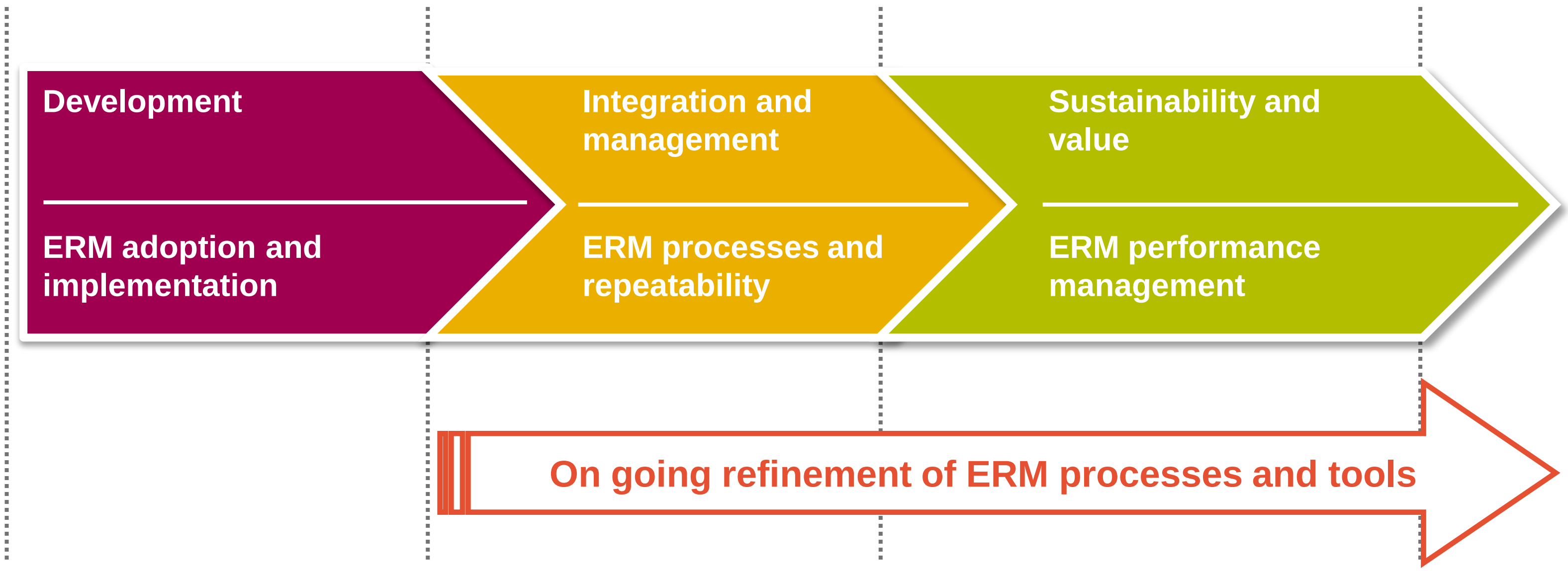
Risk management is not about limiting risks, but about understanding and controlling risks

Taking risks provides opportunities

ILLUSTRATIVE

An ERM roadmap

Defining, developing and implementing an ERM program



Drive progress

On-going

Plan

Realistic timing

Refresh regularly

Integrate

Celebrate progress

Defining and integrating Risk Appetite

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What is a risk appetite framework?

- **An overarching framework for the conduct of the business**
  - Specifies the risks to which XYZ does and does not wish to be exposed
  - Defines a process for managing risks by means of risk measures and other methods
- **Defined formally by the Board to provide guidance to management**
- **Provides a means of communicating the Board's views / expectations on risk**
  - Certain day-to-day risk management activities may be delegated to the senior management
- **Does not seek to address the detail of policies, procedures, etc**
  - Aim is to define sufficiently the overall risk framework, objectives and headline metrics in order to enable the risk appetite to cascade down to the business
- **Defines how the company's key risks will be measured and monitored**

What are the motivations for having a risk appetite?

To ensure a firm's Board exercises sufficient oversight over the risks incurred

- Define a common language
- Guide decision making
- Evaluate opportunities
- Constrain or limit risk taking
- Provide triggers or warnings

What does a risk appetite framework look like?

Which risks?	How much risk?
Risk strategy The company's overall philosophy towards risk/return-requirements for achieving its objectives.	
Risk preferences Risks the company wants to take to achieve its objectives, with the expectation of creating value. And those it wants to avoid.	**Risk tolerances** Quantitative expression of the amount/volatility of risks the company will tolerate.
Risk attractiveness Tactical assessment of risks in the preference set, reflecting current conditions.	**Risk limits** Operational limits and controls; granular and easy to monitor.

Risk appetite monitoring and reporting

Escalation and action plans

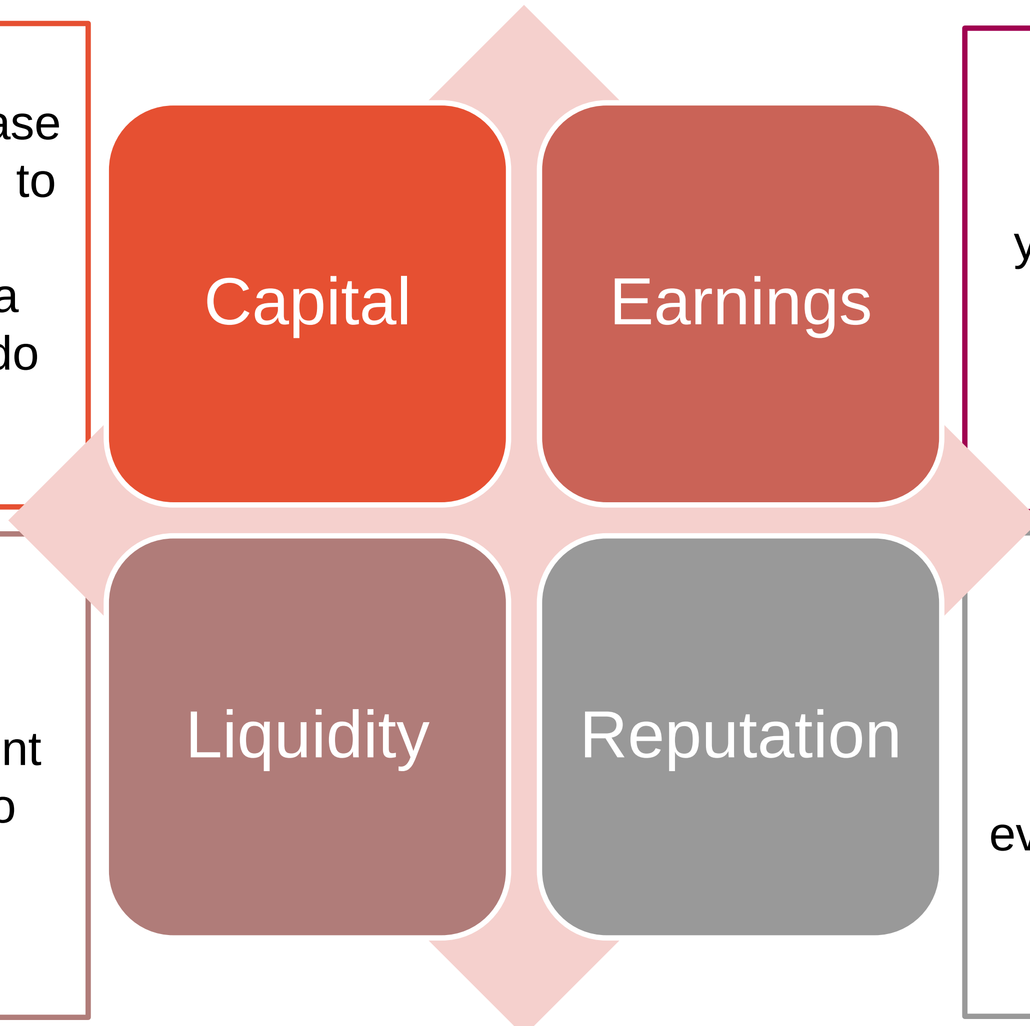
A company's risk appetite should be objective, tangible and actionable

ILLUSTRATIVE

Risk metrics should be aligned with the metrics used to steer the business

How much of your capital base are you willing to lose?
How much of a capital buffer do you want to hold?

Do you want stable profits?
How much can your profits vary over the business planning horizon?



Under what conditions are you willing to have insufficient liquid assets to meet cash outflows when they are due?

What is the company's tolerance for actions and events that might damage its reputation?

Examples of risk appetite statements – AIA

"The amount of risk taken by AIA in the ordinary course of its business will be sufficient to meet its customers' reasonable requirements for protection and benefits while ensuring that the level and volatility of shareholder returns are in line with a broadly-based risk profile appropriate to an Asia ex-Japan focused life insurance company."

- **Regulatory capital:** *"We have no appetite for regulatory non-compliance and as such will ensure that we hold sufficient capital to meet our current statutory minimum solvency in all but the most extreme market conditions."*
- **Financial strength:** *"We will ensure the Group's ability to meet all future commitments to our customers, both financial obligations and in terms of the promises we make to them. We will maintain sufficient capital to support a Financial Strength Rating that meets our business needs."*
- **Liquidity:** *"We will maintain sufficient liquidity to meet our expected financial commitments as they fall due."*
- **Earnings volatility:** *"We will seek to deliver reported operating earnings consistent with expectations and will implement policies, limits and controls to contain operational risks, risk concentrations and insurance risks within reasonable tolerances."*

Source: AIA Group Annual report 2013

Examples of risk appetite statements – Prudential

"Prudential defines and monitors aggregate risk limits based on financial and non-financial stresses for its earnings volatility, liquidity and capital requirements.

Earnings volatility: the objectives of the limits are to ensure that:

a) the volatility of earnings is consistent with the expectations of stakeholders;
b) the Group has adequate earnings (and cash flows) to service debt, expected dividends and to withstand unexpected shocks; and
c) earnings (and cash flows) are managed properly across geographies and are consistent with funding strategies.

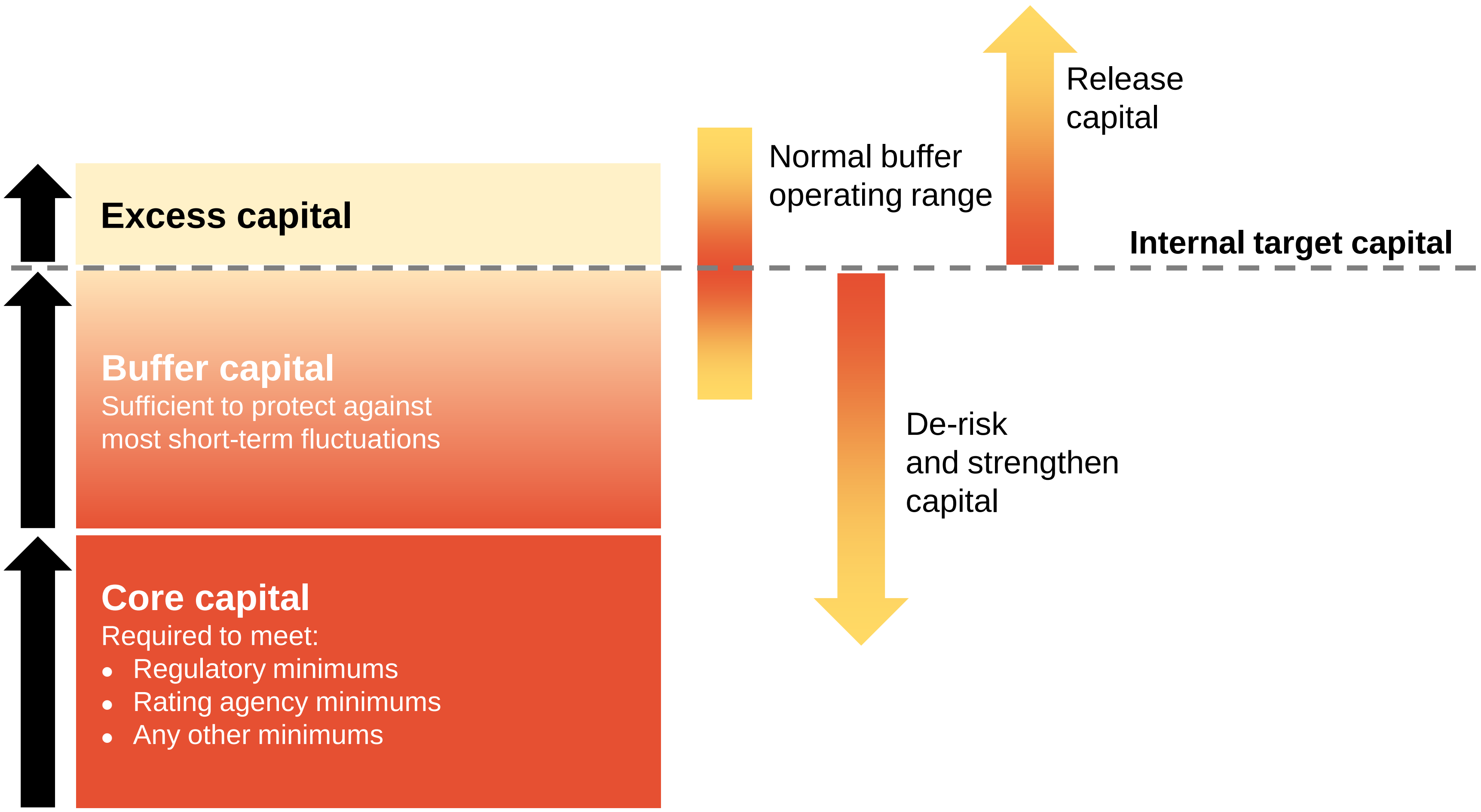
Liquidity: the objective is to ensure that the Group is able to generate sufficient cash resources to meet financial obligations as they fall due in business as usual and stressed scenarios.

Capital requirements: the limits aim to ensure that:

a) the Group meets its internal economic capital requirements;
b) the Group achieves its desired target rating to meet its business objectives; and
c) supervisory intervention is avoided."

Source: Prudential plc Annual report 2012

Regulatory RBC is a key capital metric and acts as a constraint on required capital



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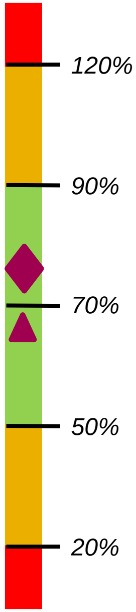
Risk reports should be designed to ensure key issues are escalated effectively

Capital

Capital buffer as a percentage of regulatory capital



Acceptable range

Trigger breached, management action required

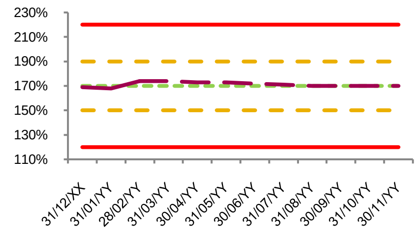
Threshold breached, possible regulatory intervention

Current position

Previously reported position

Solvency position

Key figures	*$m*
Sum of risk-based internal required capital	*525*
Diversification	*-75*
Available capital	*783*



Commentary

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Capital risk appetite

Capital by risk type

	Target	***Current***	***% Total***	***Trend***
Equity	*79*	*75*	*14%*	
Interest rate	*133*	*125*	*24%*	
Credit spread	*135*	*150*	*29%*	
Default	*26*	*25*	*5%*	
Life insurance	*100*	*95*	*18%*	
Non-life insurance	*55*	*50*	*10%*	
Expense	*5*	*5*	*1%*	
Total (with diversification)	***460***	***450***		

Commentary

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Earnings risk appetite

	Target	***Current***
IFRS profit YTD	*XX*	*YY*

Commentary

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Liquidity risk appetite

	Target	***Current***
Liquidity ratio	*XX*	*YY*

Commentary

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Reputational risk appetite

	Target	***Current***
New business premiums	*XX*	*YY*
New business value	*XX*	*YY*
Customer satisfaction	*XX*	*YY*

Commentary

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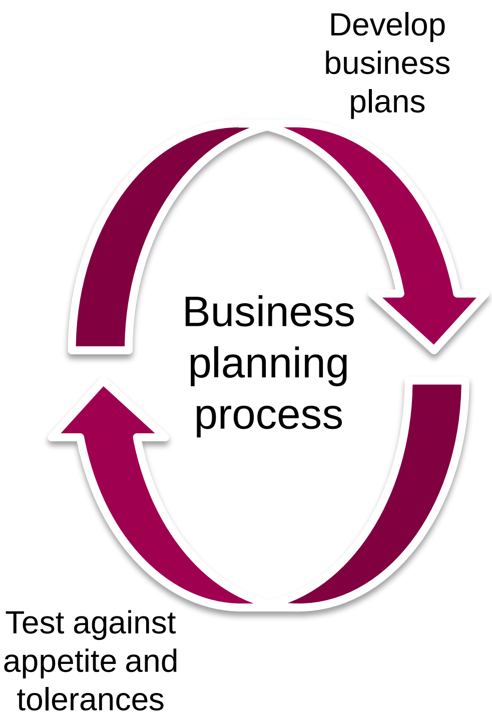
Companies are integrating risk information into the business planning process

Strategic perspectives set at Board level

Business strategy

Risk appetite
- Risk preferences
- Risk tolerances

Business plans developed using an iterative process

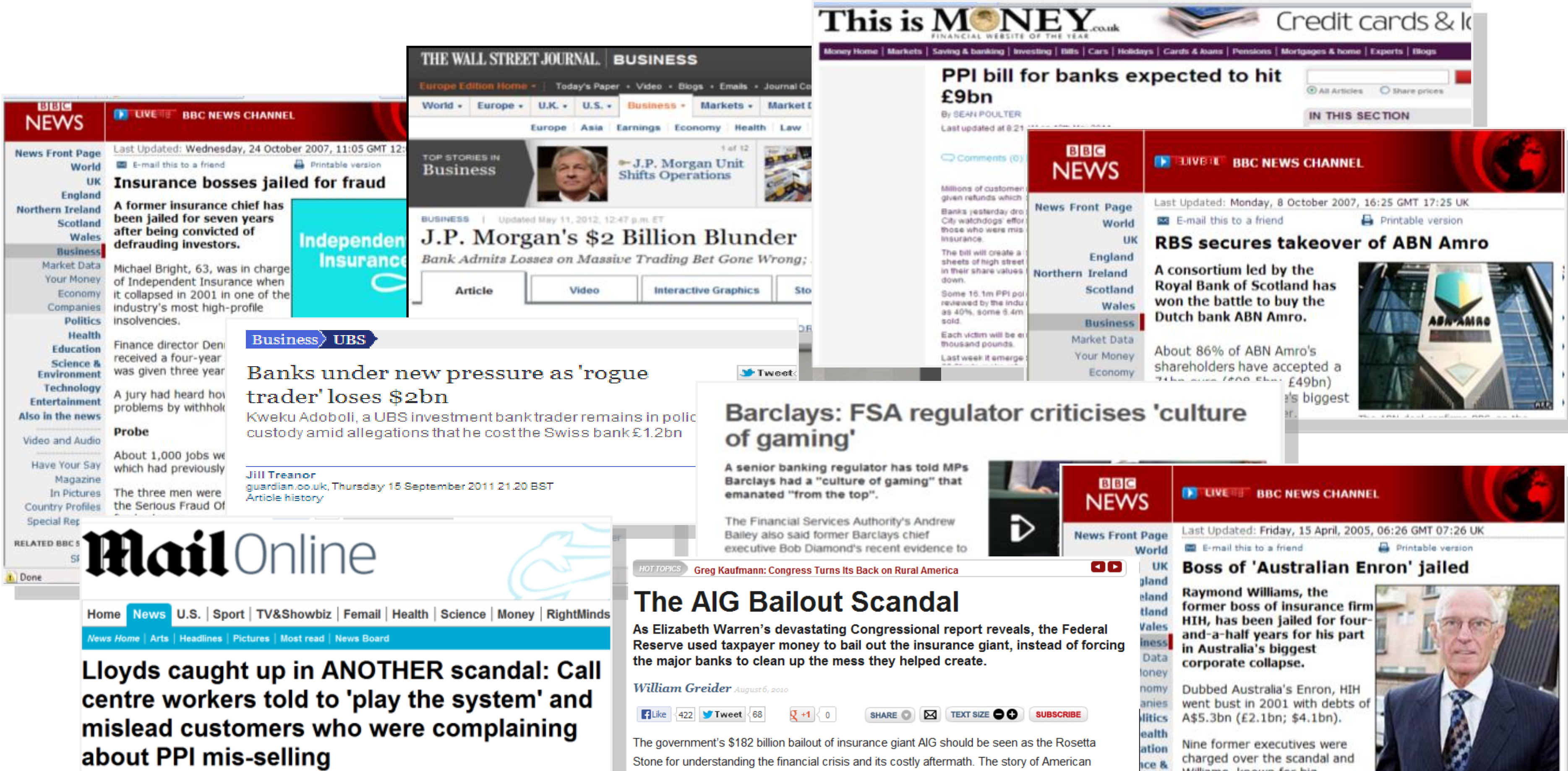


Performance and risk monitored against targets and limits

- Value created
- Capital efficiency
- Liquidity coverage
- Solvency ratio
- Limit usage

Operationalising risk appetite requires a strong risk culture

Why are risk management and risk culture important?



*"Most institutions have a set of values to which they ascribe however, in many cases there is clearly a gap between what they claim to believe and do, and what they actually do. These values also tend not to be aligned or lived by the employees **meaning the firm does not practice what it preaches**…"* H. Sants, FSA CEO, 17th June 2010

What is risk culture?

"Risk culture can be defined as individual and group **behaviour** within an organization that **determines** the way in which the company **identifies, understands, discusses** and **acts** on the risks the organization confronts and takes."

Source: "Reform in the Financial Services Industry: Strengthening Practices for a More Stable System." Institute of International Finance, 2009

"Risk-management culture is the **degree to which risk and risk management are important considerations** in all aspects of corporate decision making."

Standard&Poor's, 2005

Risk culture drives risk management practices

What characterises a good risk culture?

“***Committed leadership***”

“Horizontal ***information sharing***”

“***Vertical escalation*** of threats and fears”

“Continuous and constructive ***challenging*** of the organisation’s ***actions*** and ***preconceptions***

Incentives that ***reward thinking*** about the ***whole organisation***”

“***Active learning*** from mistakes”

“An effective ***governance*** structure”

“management ***objectives*** linked to ***risk management*** objectives”

Reform in the Financial Services Industry: Strengthening Practices for a More Stable System
Institute of International Finance, 2009

Closing

Risk appetite is the foundation of an effective risk management framework

Closely linked to strategy and business planning

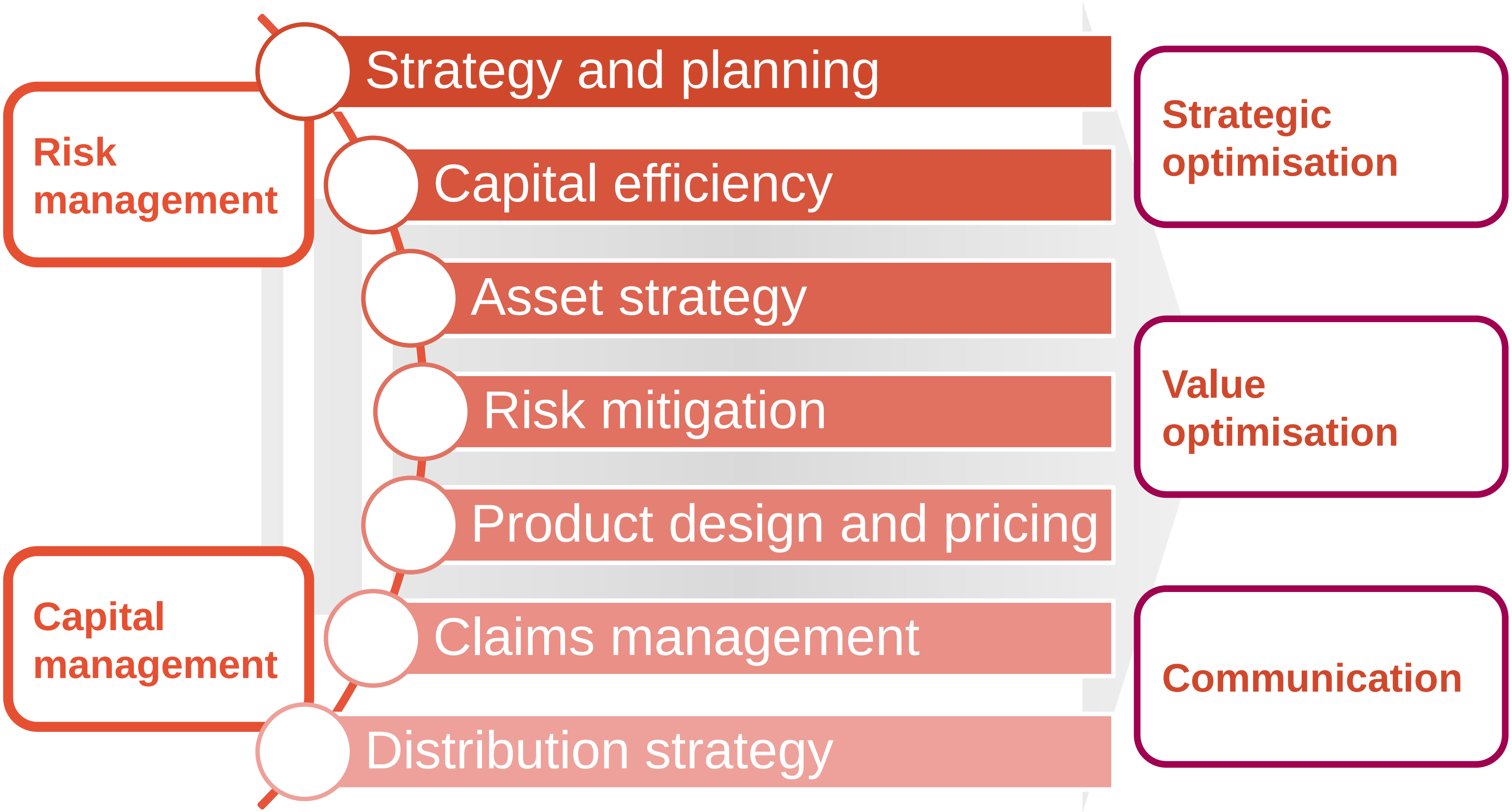
Clearly communicated

Underpinned by a strong risk culture

Used to monitor and assess the risk profile of the company

Developing an integrated risk appetite framework will take time

Effective risk and capital management unlocks opportunities to improve business performance



Questions

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