Risk management and regulation – the boardroom perspective
Agenda

1. Regulatory requirements vs. “best practices” for risk and governance

2. Some risk management and governance case studies
   a) Past – ORSA
   b) Present – Operational risk
   c) Future – Market conduct
   d) Future – Global insurance capital standard
   e) Future – Risk culture
Regulatory requirements vs. “best practices” for risk and governance
Drivers for improvement in ERM and governance

After several waves of corporate scandals, corporate boards and leaders have implemented stronger governance and oversight practices

- More independence in oversight
- More intensive board activity – active oversight and monitoring, vs. approval
- Constructive challenge

Change is not complete but an evolution; example is the fragmentary state of enterprise risk management practices
Drivers for improvement in ERM and governance

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- Constructive challenge

Change is not complete but an evolution; example is the fragmentary state of enterprise risk management practices

For financial institutions, regulatory change has both raised expectations and added pressure to change more quickly
Canadian regulatory drivers

- Canada received “good grades” on its financial system after the global financial crisis of 2008 – credit due to regulation and supervision, but also management and sound economy
  
  **Are there gaps?** Supervision of multi-national groups is an acknowledged gap – international regulatory and supervisory trends will not go away
  
  **Need to be more imaginative about what might go wrong “next time” – and there will be a next time!**

- Supervision and governance:
  
  **OSFI has been driving further improvements in governance and risk management practices**
  
  **No accident that OSFI initiatives have an international flavour - OSFI and provincial regulators are active participants through IAIS and other forums in developing international standards**
Canadian regulatory drivers

- No global regulation as such— but increasingly regulators work together:
  - “regulatory colleges” for co-ordinating regulation of multinational insurers
  - EU concept of “equivalence” to Solvency II for some other jurisdictions
  - Enhanced requirements for larger FIs: those deemed “too-big-to-fail”, systemically important, internationally active, etc.

- While Canada is not seeking equivalence to Solvency II, the Canadian regulatory framework is largely aligned with the Insurance Core Principles (ICPs) developed by the IAIS (International Association of Insurance Supervisors)
  - Rapid adoption of Own Risk and Solvency Assessment (ORSA)
  - Greater commonality in regulatory capital – both in approach and in details
  - Early signs of greater focus on market conduct
  - Assessment of the Canadian FS framework by the IMF - against the ICPs

- Provincial regulators also are beginning to adopt OSFI guidelines more broadly
At a glance: global regulatory outlook

- Supervisors increasingly look beyond the regulated insurer to the wider group and holding company operations.
- Systemic concerns are not abating and additional G-SIIs are likely to be named, with increasingly intrusive requirements. Expansion to domestically significant insurance operations is likely to follow.
- Insurance critical functions are viewed as part of essential services which must be maintained or run down in an orderly fashion. Insurers will need to invest more in resolution and contingency planning as a result.
- Boards must be able to demonstrate that their risk governance procedures, especially in regards to risk culture, permeates all levels of operations, sales and management.
- Conduct regulation will continue to increase and will be expanded to product design, marketing and incentive policies.
General themes

- Regulatory requirements are not done yet
- Global regulatory initiatives have a way of turning up in Canada
- Large company requirements eventually affect everyone
Risk management and governance case studies

Past – ORSA
The ORSA experience so far

- Requirement introduced with a very short runway - OSFI indicated that they recognized that there would likely be gaps and development areas in year 1 ORSA reports

- Canadian ORSA requirement closely aligned with the EU approach

- ORSA as a process – the report is just an output

- Applied to all insurers
  - Including branches of foreign companies
  - No exemption for small insurers
  - Guideline stated principles applicable to all, expected to be “scaleable” to smaller and less complex insurers
  - Some provinces adopting for provincial companies

Management establishes processes and controls → “3 lines of defence” model → Senior management oversight and reporting → Board oversight, with periodic independent reviews
The ORSA experience so far - 2

- Likely due to “first time through” pressures, the year 1 ORSA process was less than ideal in many cases
  - Emphasis on getting a report done
  - “Of course we do that!” – difficult to demonstrate for many processes
  - Limited opportunities for board oversight at the start and throughout the process – for many, it was more like “board approval” than “board oversight”

- Most insurers completed a first report with some things on the “to do” list
  - Future improvements in forming own view of capital needs
  - Improved risk identification and management processes
  - Reporting and oversight processes
  - Integration with planning and management processes
  - The ORSA reports have been a great “thermometer” for getting an understanding of the state of current risk management and governance practices!
# ORSA Maturity Assessment
## Canadian Insurers – 2014 reports

<table>
<thead>
<tr>
<th>Category</th>
<th>Lagging</th>
<th>Developing</th>
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<td>Alignment to Business Planning</td>
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**Legend:**  
- Worst in Class  
- Average  
- Best in Class
ORSA Development Roadmap
Roles, Process, Documentation and System

- Continue Board education and the development of detail, depth and frequency of the Board oversight process
- Firms need to develop the management and board routines around ongoing monitoring of ORSA, and a “production environment” risk management system:
  - Key metrics reporting
  - Relationship to ongoing stress testing
  - Risk monitoring, risk appetite, emerging risks
  - Development of supporting systems
  - Frequency, format and documentation
  - Responsibility for management and board oversight
  - Approach to validation and verification

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Synchronize the ORSA cycle with reviews of other decisions and monitoring processes

- Timetable for risk appetite, strategic planning, capital and business planning
- Make ORSA review a building block – reflect the logical dependencies

Require documented consideration of risk in business decisions
The (largely separate!) processes in 2014

Typical business as usual (BAU) reporting and planning cycle

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Typical 2014 ORSA development process

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<tr>
<th>Last year?</th>
<th>Jan</th>
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<tbody>
<tr>
<td>Project plan, workshops</td>
<td>Project plan</td>
<td>Assess and retrofit existing policies and reports</td>
<td>Quant analysis of capital</td>
<td>Review and redraft</td>
<td>Final ORSA</td>
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<tr>
<td>Gap analysis</td>
<td>Board input</td>
<td>Develop “missing pieces”</td>
<td>Drafting of ORSA report</td>
<td>External review</td>
<td>Board approval</td>
<td>File KMR</td>
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### What does “better” look like?

**Embedding risk and ORSA in BAU processes**

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<td>DCAT</td>
<td>Q3 reports</td>
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<td><strong>Risk monitoring</strong></td>
<td>Q4 risk and capital reports</td>
<td>Q1 risk and capital reports</td>
<td>Q2 risk and capital reports</td>
<td>Q3 risk and capital reports</td>
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<tr>
<td><strong>ORSA reporting</strong></td>
<td>Update risk appetite, risk assessment, projections</td>
<td>Updated ORSA</td>
<td>Board approval</td>
<td>File KMR</td>
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- **Regular risk reporting aligned with the reporting cycle**
- **Develop a dashboard to facilitate continuous reporting and monitoring**
- **Align risk reviews and the completion of ORSA with strategic and business planning cycle**

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The ORSA experience so far – year 2?

- Has the ORSA in fact moved ahead this year?
  - Any progress in integrating ORSA with other reporting, monitoring and planning processes?
  - Any evidence of board monitoring of ORSA through the year? Or is it just another OSFI filing approval?
  - Any evidence of greater, active board oversight of risk assessment? The whole ORSA process?
Risk management and governance case studies

- Present – Operational risk
### Some Examples of Common, But Usually Unreported Operational Risk Events

<table>
<thead>
<tr>
<th>LOSS CATEGORY</th>
<th>DESCRIPTION</th>
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<tbody>
<tr>
<td>Theft and Fraud</td>
<td>• Fraudulent claims – fabricated events by fraud rings; exaggerated claims.</td>
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<td>• Unreported deaths for annuities and pensions.</td>
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<td>• Jumbo commissions on fraudulent life policies.</td>
</tr>
<tr>
<td>Unauthorised Activity</td>
<td>• Internal collusion with external claims or other service providers.</td>
</tr>
<tr>
<td>Suitability, Disclosure and Fiduciary</td>
<td>• Failure to comply with training and sales practices requirements by sales force.</td>
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<tr>
<td></td>
<td>• Failure to provide adequate selection and oversight of sales force.</td>
</tr>
<tr>
<td>Clients, Products and Business Practices</td>
<td>• Failure to apply underwriting or claims settlement standards.</td>
</tr>
<tr>
<td></td>
<td>• Over-rides of underwriting or claims settlement standards.</td>
</tr>
<tr>
<td>Clients, Products and Business Practices</td>
<td>• Errors in product design or pricing.</td>
</tr>
<tr>
<td>System Failures</td>
<td>• Interface errors between billing and receivable systems.</td>
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<td></td>
<td>• System configuration errors affecting complex computations.</td>
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<td></td>
<td>• Loss of data.</td>
</tr>
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</table>
## Operational Risk – Regulatory Guidance

<table>
<thead>
<tr>
<th>DATE</th>
<th>SOURCE</th>
<th>PUBLICATION</th>
</tr>
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<tbody>
<tr>
<td>Superceded</td>
<td>OSFI</td>
<td>Sound business and financial practices framework for life insurers. Proposed but not introduced for P&amp;C insurance.</td>
</tr>
<tr>
<td>May 2006</td>
<td>OSFI</td>
<td>Corporate Governance at TSA (The Standardized Approach) &amp; AMA (Advanced Measurement Approach) Institutions</td>
</tr>
<tr>
<td>Ongoing</td>
<td>Solvency II</td>
<td>Models for measuring capital required, including specific amounts for operational risk</td>
</tr>
<tr>
<td>June 2011</td>
<td>BCBS</td>
<td>Principles for the Sound Management of Operational Risk</td>
</tr>
<tr>
<td>June 2011</td>
<td>BCBS</td>
<td>Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches</td>
</tr>
<tr>
<td>August 2011</td>
<td>OSFI</td>
<td>Memo to Banks referencing BCBS - Principles for the Sound Management of Operational Risk: “OSFI believes that the principles outlined in the 2011 paper establish sound practices that are relevant to all deposit-taking institutions, and expects institutions to take account of the nature, size, complexity and risk profile of their activities when assessing their practices against the updated principles in the Principles paper in the course of normal compliance reviews. Institutions should develop a plan to remedy any deficiencies that come to light during their assessments.”</td>
</tr>
<tr>
<td>September 2012</td>
<td>OSFI</td>
<td>OSFI issued Life Insurance Regulatory Framework, indicating that future life insurance capital requirements will be introduced that include specific margins for operational risk.</td>
</tr>
<tr>
<td>Summer 2015</td>
<td>OSFI</td>
<td>Draft guideline issued for federal financial institutions.</td>
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Issued August 2015

Comments closed October 9, 2015

OSFI has indicated that full implementation of the Guideline by FRFIs will be expected no later than one year from the date that it becomes effective

Applicable to all FRFI’s other than branch operations of foreign banks and foreign insurance companies

Draft Guideline communicates OSFI's expectation that FRFIs establish and maintain an enterprise-wide framework of operational risk management controls

Addresses four principles that:

- Are consistent with the framework set out in OSFI's Supervisory Framework and Corporate Governance Guideline
- Are designed to promote best practices
- Reflect international standards
Principle 1: Operational risk management is fully integrated within the FRFI’s overall risk management program and appropriately documented

Elements of a documented framework for operational risk:

- Efficient corresponding documentation
- Describe approach to manage OR
- “Three lines of defence model”
- Clear accountability and ownership
- Risk assessment and reporting tools
- Application to FRFI enterprise-wide
- Review of relevant policies
- Independence of key functions
- Governance structures used to manage OR
- Approach to establish and monitor risk appetite
Principle 2: Operational risk management serves to support the overall corporate governance structure of the FRFI…and develop and utilize an operational risk management statement

- Develop and maintain a risk appetite statement for OR that:
  - Articulates the nature, types and approximate exposure levels of OR
  - Is succinct, clear, and include a measurable component. Purpose of requiring measurable component is to give an indication of the level of OR which is considered acceptable within the FRFI, and level of OR events that need to be escalated to Senior Management and/or Board.
  - Board of Directors and Senior Management should regularly review for appropriateness and reasonableness
  - Is aligned within a FRFI’s broader corporate governance framework
Principle 3: …A “three lines of defence approach”…serves to separate the key practices of operational risk management and provide adequate independent overview and challenge.

– Draft Guideline states that appropriate accountability for management of OR is essential
– “Three lines of defence” is one way to achieve such accountability
– Draft Guideline does not expressly state that other structures are permitted as alternatives
– Role and responsibilities of each line of defence is explained
– There may be some overlap between 1st and 2nd lines of defence, but the 3rd line of defence must remain independent
– How this is operationalized in practice (in terms of organizational structure) will depend on business model and risk profile of FRFI
### Organizational and reporting structures for managing risk and performance measurement

#### Key features

- Detailed design of roles, responsibilities, key interfaces and reporting infrastructure for a selected model
- Linkages between risk management performance and your performance measurement strategy
- Alignment of HR policy to selected individual’s specific responsibilities for risk management

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<tr>
<td>BUSINESS OPERATIONS</td>
<td>OVERSIGHT FUNCTIONS</td>
<td>INDEPENDENT ASSURANCE</td>
</tr>
<tr>
<td>• Established risk and control environment</td>
<td>• Risk, Compliance, Finance, Policies and procedures, Strategic management</td>
<td>• Internal, External Audit, Provide independent challenge and assurance</td>
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#### Benefits

- Building a robust organization model for risk will ensure:
  - Clarity of roles and responsibilities of all parties involved in the risk management process
  - Interfaces are understood
  - Reporting infrastructure is defined
- Linking risk management performance to business targets and personal contracts increases overall levels of commitment to improving risk management effectiveness
Principle 4: ... ensure comprehensive identification and assessment of operational risk through the use of appropriate management tools ...

- Operational risk taxonomy
- Risk and control assessments
- Change management risk and control assessments (not just ICOFR!)
- Internal operational risk event collection and analysis
- External operational risk event collection and analysis
- Risk and performance indicators
- Business process mapping
- Scenario analysis and stress testing
- Quantification/estimation of operational risk
- Comparative analysis
Food for thought

– Will the nature, size, complexity and demonstrated risk of a FRFI shape the approach to operational risk management?

– What is the expectation of smaller, less-complex institutions with demonstrated low operational risk profiles having to implement all components of the Draft Guideline?

– Is the Draft Guideline representative of another major set of risk management and governance expectations imposed on FRFIs by OSFI?

The Draft Guideline is intended to consolidate existing guidance and thus simplify the governance process for FRFIs

FRFIs will likely find that it significantly expands rather than streamlines their obligations in respect of risk management
Risk management and governance case studies
Future – Market conduct
Market conduct issues – some questions

- Do international influences stop with OSFI, or is the provincial level “next”?  
  - Continued development of IAIS (International Association of Insurance Supervisors) Insurance Core Principles (ICPs)
  - ICPs are not just about governance and solvency!
  - What happens when regulators comply with IAIS Insurance Core Principles?

- Is *caveat emptor* dead?
Do international influences stop with OSFI, or is the provincial level “next”?

What is in the ICPs affecting market conduct? Some examples:

<table>
<thead>
<tr>
<th>ICP 18 - Intermediaries</th>
<th>ICP 19 – Conduct of Business</th>
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<tbody>
<tr>
<td>Role in promoting public trust and confidence in the insurance sector – ensuring customers are sufficiently informed before buying</td>
<td>Ensure customers are treated fairly, before a contract is purchased, through to fulfillment of contract obligations</td>
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<tr>
<td>Licensing and supervision</td>
<td>Policies and procedures for product development and marketing, providing clear information on rights and obligations</td>
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<tr>
<td>Professionalism and competence standards</td>
<td>Ensuring fair treatment is embedded in governance, management, processes and organization culture</td>
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<tr>
<td>Disclosures – terms and conditions with customers; relationships with insurers they represent; compensation</td>
<td>Ensuring product suitability to customer circumstances, managing reasonable expectations of customers</td>
</tr>
<tr>
<td>Responsibilities regarding conflicts of interest – includes remuneration incentives</td>
<td>Ensuring high quality advice, and management of conflicts of interest</td>
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UK developments – the shape of things to come?

“We expect you to identify the target audience and design a product that meets their needs … to test the products to make sure they can deliver fair outcomes looking to see how the product would fare under different scenarios, to see if it will do what it says on the tin. To have a robust approval process in place before your products are on sale. And finally, that you monitor the product to see who is buying it and how it is performing. This is not just about selling it and moving on, but taking an interest in how it is actually working in practice”

Martin Wheatley, Managing Director, FSA 2012

- FCA, part of the replacement of the FSA, focuses on market conduct
- Previous TCF (Treating Customers Fairly) initiatives considered not robust enough
  - Issues raised by regulators – renewals priced higher than new business; “strong” terms and conditions that work against claims by the customer; wrongful selling
  - Who do you actually sell to? Are the products suitable for them?
  - Lens is “what is a good customer outcome?”
  - Insurers – how to prevent or anticipate future problems
A 1998 survey showed:

- The 50 US State regulators had a combined 440 examiners (i.e. staff years) focused on Market Conduct
- On average, less than 6% of a US State regulator’s budget was allocated to Market Conduct examinations
- Federal level CFPB organization did not yet exist in the US

Approximately 15 years later:

- The CFPB organization alone has over 500 staff years in its budget
- State regulators placing high focus on Market Conduct with increasing staff and budgets

Source: Pressure Index (from KPMG 2015 International Survey)
Examples of material market conduct failures and their corresponding impact on institutions:

- **Insurer (UK):** Failed to take steps to ensure that its customers were being treated fairly. FCA was of the view that customers were taking out accident insurance products they did not understand. Fine/loss: £8.3 million

- **Top 5 Bank (US):** Deceptive marketing and unfair billing practices. Fine/loss: $727 million

- **UK Banks:** Selling payment protection insurance products, which were either not needed, already covered or not disclosed. Fine/loss: £ many billions (fines and restitution)

- **Top 10 Bank (US):** Violations by subsidiaries at every stage of the consumer experience from applications to paying off debts. Fine/loss: $112.5 million (fines and restitution)

- **Bank owned insurer (UK):** Breached rules on handling customer complaints. Fine/loss: £2.1 million

Why is Conduct Risk important to the regulator?
Where will Canadian regulation and supervision go?

- Not every development in Europe inevitably crosses the ocean (recall the prohibition on gender-based rating in the EU) … but ……
  - Canadian regulators are active participants in IAIS, are aware of the ICPs, and may increasingly adopt the ICPs, and
  - It only takes one!

- What is higher risk of attracting scrutiny?
  - Product suitability – particularly for highly profitable products
  - Quality of oversight of sales and distribution – use of metrics and rigorous processes
  - Consideration of customer outcomes
Why is Conduct Risk important for insurers?

If Conduct Risk is not managed effectively, it could result in the following:

- Firms have a poor reputation
- Customers face barriers to complaining or making claims
- Products are sold to customers they were not intended for
- Customers are generally discontented with the financial services industry
- Customers do not understand products in the market
- The regulator has to use more intrusive powers to intervene
- Customers do not get a fair deal
IMF did Detailed Assessment of Observance of ICPs on Canada

Some observations on compliance with ICP 18 Intermediaries:

- Overall assessment: “largely observed”
- Authorities advised to:
  - Establish proportionate governance expectations…focused on achieving fair treatment outcome for policyholders
  - Ensure that FSCO has adequate resources for effective supervision of intermediaries

Some observations on compliance with ICP 19: Conduct of Business

- Overall assessment: “partly observed”
- Empower FSCO to issue enforceable rules on product development and promotion, and
- Require insurers and intermediaries to conduct needs analysis before providing advice and meet policy obligation
- Review adequacy of supervisory resources of FSCO for regulatory policy
“In other words, we’re not just asking: Is this product compliant? Does it tick every legal box?

But actually: is the outcome good? Is the market competitive? And is fair treatment of consumers designed into products and culture?”

UK FCA, July 2013
Risk management and governance

Future – Global insurance capital standard
Insurance Capital Standard - Overview

- Proposed Market-adjusted Valuation Approach
- Further field testing of GAAP with Regulatory adjustments
- Potential development of consistent and comparable Margin over Current Estimate (MOCE)

Market Adjusted Valuation Approach

- Deterministic: Factor-based and Stress Testing
- Stochastic Modelling
- Key Categories of risk: Insurance risk, Market risk, Credit risk, Operational risk

Capital Resources Tier 1 / 2 Capital

- Capital resources must meet specific criteria in order to be qualifying
- Limits are applied

Measuring Risk E.g. Stress Testing

Insurance Capital Standard

- Expected to be used as Prescribed Capital Requirement (PCR)
- One-year time horizon

ICS Capital Requirement

Ratio = qualifying capital resources / capital requirement
Insurance Capital Standard
– Liability Valuation Approach

- IAIS proposes a market-adjusted valuation approach
  - broadly reflects where global developments on insurance accounting standards are heading and converging (IFRS4 Phase2, Solvency II)
- Alternatively, GAAP with regulatory adjustments approach being considered
  - Development through further field testing
- Open questions still remain, which is being discussed through the consultation period:
  - Development and treatment of the MOCE
  - Market Adjusted approach vs. GAAP with Adjustments approach
  - Confidence Level. Data to be collected at 99.5% VaR & 90% TVaR over a one-year time horizon.

Source: KPMG International, February 2015
### Quality of Capital

<table>
<thead>
<tr>
<th>Tier 1 Financial instruments for which there is no limit</th>
<th>Tier 1 Financial instruments for which there is a limit</th>
<th>Tier 2 Paid-Up financial instruments</th>
<th>Tier 2 Non-Paid-Up financial instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common/ordinary share capital</td>
<td>Non-cumulative perpetual preferred shares</td>
<td>Approval from supervisors</td>
<td>Approval from supervisors</td>
</tr>
<tr>
<td>Fully paid up</td>
<td>Fully paid-up</td>
<td>Callable on demand by IAIG</td>
<td>Callable on demand by IAIG</td>
</tr>
<tr>
<td>Most subordinated</td>
<td>Perpetual</td>
<td>When called, meets criteria for</td>
<td>When called, meets criteria for</td>
</tr>
<tr>
<td>Perpetual</td>
<td>Redeemable by issuer with approval after minimum of 5 years</td>
<td>inclusion in Tier 1 or Tier 2 paid up capital</td>
<td>inclusion in Tier 1 or Tier 2 paid up capital</td>
</tr>
</tbody>
</table>

#### Quality of Capital: Subordination; Availability; Loss absorbing capacity; Permanence; Absence of encumbrances and/or mandatory servicing costs.

Intangible asset items including goodwill and DTA’s excluded from Tier 1 capital; however, proportion (realizable component) of its value may be added back into Tier 2 capital.

Tiering approach similar to some jurisdictions, such as Canada, though for others it could be new concept.
Insurance Capital Standard - Measuring Risk

**Capital requirement:**

- Approaches to determine capital include factor based models, stress testing and stochastic modelling
  - Factors and stresses to reflect the targeted level of confidence
  - Discussion of varying factors/stresses by product, geographical region, asset class also being considered

- Recognition of diversification benefits both within and between types of risks may be allowed for in the ICS
  - Approaches may include assuming complete dependency of risks by adding all charges together (conservative) or combining risks through an assumed correlation matrix

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<table>
<thead>
<tr>
<th>Risk/Sub-risk</th>
<th>Potential approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Factor-based</td>
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<tr>
<td>Insurance risks</td>
<td></td>
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<tr>
<td>Mortality</td>
<td></td>
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<tr>
<td>Longevity</td>
<td></td>
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<tr>
<td>Morbidity/disability</td>
<td></td>
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<tr>
<td>Lapse</td>
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<tr>
<td>Expense Risk</td>
<td></td>
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<tr>
<td>Premium</td>
<td></td>
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<tr>
<td>Claim reserve</td>
<td></td>
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<tr>
<td>Catastrophe</td>
<td></td>
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<tr>
<td>Market risks</td>
<td></td>
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<tr>
<td>Interest rate</td>
<td></td>
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<tr>
<td>Equity</td>
<td></td>
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<tr>
<td>Real estate</td>
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<tr>
<td>Currency/FX</td>
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<tr>
<td>Asset concentration</td>
<td></td>
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<tr>
<td>Credit risk</td>
<td></td>
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<tr>
<td>Operational risk</td>
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</tr>
</tbody>
</table>

Canadian Regulatory Environment
OSFI – Current state and Vision

**Required Capital (MCCSR for Life)**
- Primary regulatory tool to measure capital adequacy.
- Main Risk Categories – Insurance, Market, Credit, f/x and seg fund guarantees.
- Add-on to CALM reserves
- MCCSR ratio equal to Available Capital / Required Capital.
  - 120% - Minimum – margin to account for operational risk.
  - 150% - Supervisory target – additional margin to account for other risks, such as strategic and reputation.

**Internal Capital Targets & ORSA**
- Internal Capital Targets (A-4)
  - Effective June 2011
  - OSFI Expectation is MCCSR Ratio greater than 150%
- ORSA (E-19)
  - Effective 2014
  - Integrates risk management with capital ratio targets

**Vision / Framework (2018)**
- Better reflect each company's risk profile and risk management practice.
- Total Asset Requirement (TAR) = Best Estimate Liability (BEL) + Solvency Buffer
- Overall, solvency buffer is calibrated to withstand adverse conditions at a degree of confidence of CTE (99) over a one-year time horizon plus a terminal provision.
## Comparison of OSFI Vision to IAIS ICS
- **Core Principles closely aligned**

<table>
<thead>
<tr>
<th>OSFI Core Principles used in development of Capital Framework</th>
<th>IAIS Principles used for the development of ICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contain methodologies that can be objectively and consistently applied by all insurers</td>
<td>Incorporate consistent valuation principles (Principle 1) Comparability of outcomes across jurisdictions (Principle 5)</td>
</tr>
<tr>
<td>To include all relevant cash flows from on-balance sheet assets and liabilities and off-balance sheet activities</td>
<td>To take into account assets, liabilities, non-insurance risks and off-balance sheet activities (Principle 4)</td>
</tr>
<tr>
<td>Includes individual measures of required capital for insurance, credit, market and operational risk at a specified confidence level over a defined time horizon</td>
<td>Reflect all material risks (Principle 4) Required capital to be based on appropriate target criteria, which underlie the calibration (Principle 10)</td>
</tr>
<tr>
<td>Risk mitigation strategies – for e.g. reinsurance and hedging – should be reflected</td>
<td>ICS promotes sound risk management (Principle 6)</td>
</tr>
<tr>
<td>Methodology for aggregating required capital of individual risk should consider the dependencies and interactions within and between risks</td>
<td>Appropriate balance between risk sensitivity and simplicity (Principle 8)</td>
</tr>
<tr>
<td>Concepts / Approach</td>
<td>OSFI Life Insurance Capital Framework</td>
</tr>
<tr>
<td>---------------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td><strong>Accounting Basis</strong></td>
<td>Anticipating IFRS 4 Phase II</td>
</tr>
<tr>
<td><strong>Solvency Measure</strong></td>
<td>Available capital / Required capital Calibrated at the supervisory target level (CTE(99)) over a 1-year time horizon with a terminal provision</td>
</tr>
<tr>
<td><strong>Discount Rates</strong></td>
<td>Potential future IFRS discount rates. Currently using specified Discount Rates</td>
</tr>
<tr>
<td><strong>Aggregation and Diversification</strong></td>
<td>Currently variance-covariance. Aggregation within risks, across risks and across lines of business and portfolios</td>
</tr>
<tr>
<td><strong>Risk Mitigation</strong></td>
<td>Should be a real reduction in risk, for e.g. reinsurance. Should consider effects of other related risks, e.g. legal, regulatory, operational</td>
</tr>
</tbody>
</table>
OSFI Vision


- Measure of solvency buffer is comparable to 150% MCCSR plus PfADs
- Solvency Buffer includes amounts for: Credit risk, Market risk, Insurance risk and Operational risk.
- Solvency Buffer also provides credits for: Diversification within and between risks, PAR and Adjustable business, Risk Mitigation strategies, such as reinsurance and hedging, which is reflected within each risk buffer calculation.
What do new capital standards mean to Canadian Insurers?

- Enhanced financial stability for local and global insurers and economy as a whole.

- Potential for two sets of capital standards - local and global.

- Key principles and concepts between Canadian framework and IAIS ICS relatively aligned.

- Canadian regulators are well-positioned to meet the new global capital reform.
  - OSFI is an active player in the IAIS regulatory initiatives.
  - OSFI anticipating implementation of new life capital requirements (QIS) by January 2018.

- For some markets, ICS capital requirement is not expected to have a significant impact.
Considerations and Implications for insurance companies

- Product development and pricing will need to consider the impact and interplay of new accounting treatment and regulatory and capital requirements.
- Biggest challenge is current economic environment
- Market and credit risk should be actively managed. Differentiated capital charges will be influencing companies' investment decisions
- Governance over the models and process will continue to become more and more important to ensure consistency and accuracy of results
- More frequent and urgent reporting requirements would bring challenges to current IT systems, including finance, actuarial and risk management
- Risk management creates real value and should be embedded in the business decisions
Risk management and governance case studies

- Risk culture
Risk Culture ... why is this an important topic?

Customer and public expectations are rising …

Shareholders and Boards demand greater transparency and security …

and regulators are scrutinising risk culture …

Group-wide supervisors should further explore ways to formally assess risk culture, particularly at G-SIIs.

Establishing a strong risk culture at financial institutions is an essential element of good governance.

International Association of Insurance Supervisors, Global Systemically Important Insurers: Policy Measures, July 2013
What do we mean by Risk Culture?

Institute of Risk Management

“the values, beliefs, knowledge, attitudes and understanding about risk shared by … the employees of an organization”

Financial Stability Board

“norms, attitudes and behaviours related to risk awareness, risk taking and risk management”

What does a good risk culture look like?

An effective risk culture … enables and rewards individuals and groups for taking the right risks in an informed manner

A good risk culture

… effective risk management, … sound risk-taking … emerging risks or risk-taking activities beyond the institution’s risk appetite are recognised, assessed, escalated and addressed in a timely manner
The agility and effectiveness of risk management has become increasingly critical. Organisations need to find a balance between commerciality and prudent risk management.

We have found that organisations typically fall into one of these categories:

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
</table>
| Aggressive | ■ Business decisions and sales are prioritised over Risk Management and Compliance.  
               ■ The organisation is at high risk of risk exposure. |
| Paranoid   | ■ Extremely strong controls around Risk Management and Compliance.  
               ■ Business is constrained by Risk and Compliance.  
               ■ Lack of commerciality due to rigid controls. |
| Negligent  | ■ Negative risk behaviours exist where there is a failure to act in accordance with the organisation’s policies, processes and procedures.  
               ■ Risk breaches are not deliberate, but are foreseeable. |
| Ownership  | ■ Business collaborates with Risk and Compliance to ensure minimum risk exposure.  
               ■ Business is accountable for and owns Risk management and Compliance. |

Experience has taught us that a culture of risk ownership is one where there is:

■ A well executed risk management strategy.
■ Leaders that role model good risk and compliance behaviour.
■ Performance management and reward systems that drive and reinforce compliance.
■ A Risk function that is aligned and engaged with the business.
■ All members of staff understand accountabilities and consequences.
What does a risk culture survey address and deliver?

- Escalation
  - There is a culture of fear of recrimination if individuals escalate risk and compliance issues.
  - Individuals are willing and able to immediately escalate any risk incident or compliance issue that they come across.

If the respondent provides a rating on the negative side of the scale, the survey seeks to understand the root cause of the poor behaviour.

If the respondent provides a rating on the positive side of the scale, the survey seeks to understand what is working well.

Why do you feel this is the case?
- Senior Management does not set the right tone at top
- Staff are not empowered to escalate
- Staff do not understand the implications of poor performance
- Process and policy framework is too bureaucratic
- Other (with verbatim feedback)

Responsive and Improvement

What the data is telling us:
- There is a culture of fear of escalation
- There are no positive consequences for escalation

- Individuals have been trained to escalate potential breaches or breaches and also raise risk events to that effect.
- Staff do escalate risk incidents but there is a tendency to only escalate financial loss related incidents. The near misses and operational incidents are not appropriately tracked.

- There is clear communication on the process of whistleblowing and escalation

44%

56%
The following analysis represents the relative position of the different countries against the 12 components

- **Risk Appetite**: AAA scored the lowest on almost every dimension compared to the rest of the organisation.
- **Role Modelling**: Scores for escalation are the lowest overall suggesting that staff find it difficult to escalate risk issues.
- **Engagement**: BBB scores particularly weak on risk appetite suggesting a need to clearly define and articulate the risk appetite for all individuals.

**Key:**

- Mean score for Organisation (XX respondents)
- Department AAA (AA respondents)
- Department BBB (BB respondents)
- Department CCC (CC respondents)
- Department DDD (DD respondents)
- Department EEE (EE respondents)
- Department FFF (FF respondents)

**Notes:**

- “There is no training on the consequences of our actions. Training is left at a theoretical level. It is not enough to just know the academic side.”
- “AAA scored the lowest on almost every dimension compared to the rest of the organisation.”
- “Scores for escalation are the lowest overall suggesting that staff find it difficult to escalate risk issues.”
- “BBB scores particularly weak on risk appetite suggesting a need to clearly define and articulate the risk appetite for all individuals.”
- “I would want to see managers taking risk seriously and in my opinion we are not there yet.”
- “Senior management is tolerant of any behaviour as long as good income comes in.”

“Senior Management are concerned about their control environment, however this fails to cascade down to the individuals doing it”

“We are driven by a culture of fear: the stick and not the carrot”

“Our Key Risk Framework triggers siloed behaviour”

“Senior Management are in touch with the management of risk in the business”

“Risk and control functions are consulted extensively by the Business”
## What do we usually find?

Through our work we have found some common pitfalls ...

<table>
<thead>
<tr>
<th>Theme</th>
<th>What have we found?</th>
<th>How do we fix this?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inconsistent behaviours and messages from leadership</td>
<td>Management often display behaviours contrary to what they expect from staff.</td>
<td>Leadership workshops to develop a common language and set of behaviours around risk management for the business.</td>
</tr>
<tr>
<td></td>
<td>Leadership creates a perception that risk management is inconsistently prioritised.</td>
<td>Deliver behavioural skills training for Leadership and Managers: ‘Good Risk Leadership’.</td>
</tr>
<tr>
<td><strong>Staff and Management are not held to account for risk management consistently through performance management (PM)</strong></td>
<td>The approach towards rewards and penalties, is not applied consistently.</td>
<td>Design PM approach ensuring KPIs for good risk management are reflected in all scorecards and are transparent and measurable.</td>
</tr>
<tr>
<td></td>
<td>Risk management is only a small part of individual scorecards.</td>
<td>Define clear consequences and incentives through the PM process for managing risk.</td>
</tr>
<tr>
<td></td>
<td>Profit takes priority over risk metrics.</td>
<td>Senior level behavioural and technical coaching to ensure they understand the need for easy escalation.</td>
</tr>
<tr>
<td><strong>Fear of recrimination when individuals escalate issues. Issues are therefore covered up and rarely solved</strong></td>
<td>There is a fear of escalation.</td>
<td>Risk incident assessment and feedback loop to ensure risk issues are understood and do not re-occur.</td>
</tr>
<tr>
<td></td>
<td>Similar risk incidents seem to be repeated across different parts of the business.</td>
<td>Design a detailed training strategy to develop behavioural capabilities in the second line of defence.</td>
</tr>
<tr>
<td><strong>Risk and Compliance functions are incapable of challenging other parts of the business</strong></td>
<td>There is no understanding of the root causes of risk issues.</td>
<td></td>
</tr>
</tbody>
</table>

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