

The role and function of insurance company board of directors' risk committees





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Introduction

PwC conducted a study of insurance company board of director' risk committees during the summer of 2015. Our findings are based on **interviews with 13 insurance company directors representing 16 different insurers**; a review of current regulatory developments in this area, including the NAIC's recently adopted Corporate Governance Annual Disclosure Model Act and Regulation (CGAD Act); and our general observations and discussions with insurance industry boards, senior management, regulators, and others.

Our principal observations are:

1. Adding a board risk committee at insurers is a relatively recent trend but one that we believe will continue. More boards are likely to add this committee. Companies also will continue to refine the duties of their risk committee through clarification (defining the risk committee's role in comparison to other committees) and compartmentalization (reducing the risk committee's oversight of other, non-risk activities).
2. Regulatory directives have encouraged this trend. Until recently, this influence has been stronger outside of the US but the Corporate Governance Annual Disclosure Model Act and Regulations (CGAD Act) may change that. Just as the NAIC's ORSA Model Act has accelerated development of ERM functionality for many insurers, the CGAD Act may have the same impact on insurers' corporate governance, especially in the medium and smaller size segments.
3. Demands on directors to stay current on reports management provides, many of which may be driven by regulatory obligations, are leaving them with less time for proactive thinking about emerging and strategic risks. Addressing this imbalance will be important for insurers looking to get the most value out of their risk committees.

We also summarize key regulatory developments and present conclusions and recommendations after reporting on the interviews we conducted.

Findings from interviews

The focal point of this study is the risk committee. We looked at how the committee relates to the full board and to other committees. We asked about some specific risk related management activities to ascertain how risk committee oversight is divided between and among the risk committee, the board, and other committees. We asked about the impact of regulation and how the risk committee apportions its time between different activities.

Interviewees were board members at life and P&C insurers operating in the US. Most of the companies are in the top 25 in their sector. As directors are frequently on the boards of more than one insurer, we also gained some insight into smaller insurers, as well as a perspective on insurers and regulatory regimes outside of the US (notably Canada and the EU).

While we followed an interview guideline (which we include as an appendix at the end of this report), we encouraged interviewees to shape the discussion around topics of particular interest to them. Sometimes, this led to not asking some questions in the guidelines, but it provided the benefit of hearing directors' perspectives on matters of especial importance to them.

As regards the delegation of responsibility between the board and the risk committee (or any committee for that matter), we found a statement in the July 2015 document "Corporate governance principles for banks" by the Basel Committee on Banking Supervision of the BIS ("BIS") that describes this well:

"The board may delegate some of its functions, **though not its responsibilities**, to board committees where appropriate" (emphasis ours).

Directors were very clear that even though the risk committee and other board committees took on some tasks and duties to assist the full board, the full board retains ultimate responsibility for decisions. Although as we will see below there are some differences in the full board's level of involvement in specific tasks or duties.

Of the 16 companies represented in this report, three did not have risk committees, seven had risk committees identified as such and the remaining six had risk committees identified as some combination of risk and other functions like finance, investment, or compliance – for example, the “Finance and Risk Committee.”

Of the three companies that did not have risk committees, two indicated that they were discussing creating one in the future. The issue did not come up in discussions related to the third company without a risk committee.

Of the 13 companies with risk committees, five are less than five years old. Although we did not always receive precise information on when the older committees were formed, we expect few if any of the eight risk committees were formed more than ten years ago.

Interviewees always mentioned the audit committee in response to the question “what other committees are also responsible for risk.” For the three companies without a risk committee, the audit committee is responsible for either all or some risks. When directors described the development of their risk committee, they almost always noted that it was an outgrowth of the audit committee.

Interviewees from five of the 13 companies with a risk committee also noted that the investment committee also has a role in risk management. For two of these companies, risk and investment are part of the same committee. For the other three, the investment committee has some manner of involvement related to investment related risks.

Finally we note that the compensation/remuneration committee usually has oversight over the risk related to senior management compensation programs.

All respondents reported good relationships between the various committees with overlapping risk roles. There frequently were overlapping memberships (e.g., the chairman of audit committee also is a member of the risk committee) and joint or “open” meetings (i.e., interested board members can attend a committee’s meetings even if they are not a member of that committee). In instances where directors reported recent changes in committee roles or structure, the trend was toward more compartmentalization, whereby the committees would concentrate on all risks and risk only rather than also having non-risk duties. A number of directors made the point that, while there

was a benefit of different committees looking at an issue, this need not come at the expense of clarity about where the primary responsibilities lie. In particular, they also said that **good risk oversight benefits from clear accountability for one committee**; this helps prevent risks from falling through the cracks or confusion about where responsibility for any particular emerging risks would fall.

While recognizing that the board has ultimate responsibility for decisions about risk, we were interested in determining if the degree of delegation of risk-related tasks differed by type of tasks. Of the six different tasks we discussed, defining the risk appetite is where the full board’s role seemed strongest and most direct. On the other hand, model risk management and stress testing are the two responsibilities for which boards seem to be least directly involved.

Risk management framework and policies and the ORSA were two responsibilities for which results were mixed, but the importance of the full board’s role in final approval was often cited. Risk identification, measurement and monitoring generally were tasks for which the board relied heavily on the risk committee. However, some respondents mentioned that the full board was more engaged in identifying emerging risks than measurement or monitoring.

As regards the interaction of the risk committee or board with regulators, responses were markedly different depending on whether the regulators were from the states or elsewhere. Interviewees commenting on jurisdictions other than the states indicated that regulations in those jurisdictions typically required interactions between committee chairs or board chairs and the regulator.

None of the interviewees indicated that interaction with US state regulators was a formal obligation and most of them indicated that interaction between them and regulators did not occur. However, when it did occur, it was informal and directors uniformly reported that interaction was beneficial for both their company and the regulator. Moreover, interviewees who referred to interactions with their supervisory colleges (which are being formed for Internationally Active Insurance Groups) also reported that they were mutually beneficial.

Of note is the fact that the meetings described above were with senior regulatory officials. This contrasts with typical US state regulatory interactions, which interviewees said are at the examiner and analyst level.

By comparison, meeting with senior regulatory officials allowed directors to have a more open and informative peer to peer dialogue.

The final question in our interview guide was about the allocation of risk committee time across various activities. While we were not able to ask this question in all interviews (as conversations sometimes moved toward and focused on other topics), we did develop a profile from about half of the respondents. On average 45 percent of risk committee time is devoted to reviewing and discussing risk reports that management provides, 40 percent is devoted to deep dives into particular risks or risk topics, 5 percent on blue-sky thinking or free-form discussions about risk, and 10 percent on risk and strategy. There was some variation, particularly between risk reports and deep dives, but results were consistent across respondents. **Also consistent was the fact that most interviewees said they wished they had more time to spend on emerging risk and risk and strategy.**

We also discussed two other matters that the questionnaire guideline did not directly address:

- CRO – Although the nature of the chief risk officer role is not a subject of this study, the role clearly is a major component in an insurer’s risk management and governance framework. A number of interviewees made comments and asked questions about the CRO role. One interesting question was about how prevalent this functional role is in the industry. In response, we compiled information on 50 insurers consisting of the 16 covered by this survey, rounded out by the top writers in both the life and P&C sectors. 42 (84 percent) had an identified CRO role (i.e. an executive whose title consisted of or contained the phrase “chief risk officer”), seven (14 percent) had a CRO-like role but not the title “CRO.” The title often included ERM as in “VP and head of ERM.” **Only one company appeared not to have a CRO or similar role.**
- Committee size – There was also some discussion of the typical number of members on a risk committee. We started by looking at the size of the full board. We were able to obtain this information for 14 of the 16 companies in this study; the average size of the board at these companies was 12. Of the 13 companies with a risk committee, we were able to obtain the number of committee members for 10; the average size was between five and six.

Review of regulatory developments

- *NAIC Guidance* – Of the regulatory guidelines that we reviewed, the one that is directly relevant to all insurers operating in the US is **the NAIC’s Corporate Governance Annual Disclosure Model Act and Regulations**. Although the CGAD Act makes clear that “nothing in this act shall be construed to prescribe or impose corporate governance standards,” the regulations describe the expected contents of the CGAD report. And in so doing, the CGAD Act provides insight into what regulators expect to observe when an insurer describes its corporate governance.

The Act anticipates that various committees of the board will have been established. And, while no specific reference is made to any particular committee, (because risk related topics are accorded significantly more attention than other topics) it would be reasonable to assume that one of the committees expected to be established is a risk committee.

The CGAD Act expects that the distribution of responsibilities between the board and committees is well defined and documented through “bylaws, charters, informal mandates, etc.”

The Act requires a description of “the processes by which the Board, its committees and Senior Management ensure an appropriate amount of oversight to the critical risk areas impacting the insurer’s business activities.” This description should include a discussion of how “the Board is kept informed of the insurer’s strategic plans, the associated risks, and the steps that Senior Management is taking to monitor and manage those risks.”

Also of note is the stipulation that the CGAD should include “a description of the general objectives of significant compensation programs” and that that description should “include sufficient detail to allow the Commissioner to understand how the organization ensures that compensation programs do not encourage and/or reward excessive risk taking.” Though it does not require it, per se, the Act suggests that a discussion of the board’s role in overseeing management compensation programs and practices may be included.

- *Basel Committee* – At the other extreme of applicability to US insurers (which is to say it is not compulsory for any insurer) is the BIS corporate governance principles for banks (BIS principles). Nonetheless, the BIS principles provide a very thoughtful and well developed perspective that insurers and their boards would benefit from considering. In particular, they devote considerable attention to the role and duties of a risk committee. They make clear that **the purpose of the risk committee, like other committees, is “to increase efficiency and allow deeper focus in specific areas.”**

The BIS principles require a risk committee for systemically important banks and strongly recommend a risk committee for others based on size, risk profile or complexity. The risk committee should be distinct from the audit committee, but it may have “other related tasks.”

The risk committee is responsible for:

- Advising the board on the overall current and future risk appetite;
- Overseeing senior management’s implementation of the risk appetite statement;
- Reporting on risk culture; and
- Overseeing the CRO.

The committee’s work should include oversight of the strategies for capital and liquidity management as well as for all relevant risks, including operational and reputational risks.

The board, with senior management and the CRO, should establish risk appetite. The board should oversee adherence to the risk appetite statement, risk policy and risk limits. The BIS principles provide some elaboration on how this oversight is to be effected: namely, through an effective risk management function under the direction a CRO. The CRO, in turn, reports to senior management and the risk committee (or the board) on all of these items.

- *Office of the Superintendent of Financial Institutions (OSFI) Canada* – The third set of regulatory guidelines we studied are applicable to some insurers operating in the US. However, what makes the OSFI guidelines on corporate governance of particular interest is that it defines with considerable precision the governance

structure that insurers – and all federally-regulated financial institutions (FRFIs) – are expected to follow.

The OSFI guidelines make clear that the duty of the risk committee of the board is to “oversee the risk management of the FRFI.” The guidelines stipulate that the risk committee “should have a sound understanding of the types of risks to which the FRFI may be exposed and of the techniques and systems used to identify, measure, monitor, report on and mitigate those risks.”

Additional expectations of the risk committee are clearly spelled out; for example, it should:

- Seek assurances from the CRO that the oversight of the risk management activities are “independent from operational management, are adequately resourced, and have appropriate status and visibility throughout the organization;”
- Receive timely and accurate reports on significant risks and exposures;
- Provide input to the approval of material changes to the insurer’s strategy and risk appetite; and
- Be satisfied with the manner in which material exceptions to policies and controls are identified, monitored, measured and controlled.

It is noteworthy that some risk related oversight is specifically assigned to the board. Namely:

- The board should approve the risk appetite framework, and
- The board should seek assurances from senior management that controls are operating effectively and that risk positions are in compliance with delegated authorities and limits.

The guidelines also make clear that the entire board, not just the risk committee, should have open and ongoing dialogue with the CRO.

- *ComFrame* – The IAIS’s Common Framework is expected to apply to the 50 or so Internationally Active Insurance Groups, many of which will be domiciled in the US.

While Comframe does not categorically require a risk committee, it makes an interesting statement in this regard:

“The Governing Body [board] is generally expected to establish committees ... These committees should exercise adequate oversight over, among other things audit, compliance, risk management and remuneration ...”

It goes on to say:

“Where the Governing Body does not establish committees, it is expected to demonstrate to the group-wide supervisor that the Governing Body as a whole can effectively carry out the functions with sufficient attention and depth.”

Comframe devotes considerable attention to the risk management function, the role of the CRO, and the expectations of the board related to risk. Unfortunately, apart from stating a clear preference for establishing a risk committee, it provides little in the way of clear delineation between the duties of the risk committee and the duties of the board.

If readers are interested in learning more about these regulatory regimes, then we recommend they review the following documents (all of which are available online):

- BIS Guidelines Corporate governance principles for banks, July 2015
- IAIS Comframe revised draft June 2104
- NAIC Corporate Governance Annual Disclosure Model Act and Regulations 4th Quarter 2014
- OSFI Corporate Governance, Sound Business and Financial Practices January 2013

Conclusions and recommendations

Taken together, our interview results, regulatory review and industry perspective lead us to the following conclusions and recommendations:

- **Demands on boards will continue to grow.** These demands will be particularly acute in the area of risk management. Forming a risk committee with a primary focus on risk and risk related responsibilities seems like the best way to deal with these demands. While other committees also have natural and meaningful roles to play related to risk, having a single focal point makes clear that there is no room for existing or emerging risks to fall through the cracks.
- **Risk reporting will continue to become more robust and elaborate,** in large part because of regulatory demands. Risk committees will need to work with their CRO and other senior management to distill these reports into their essential elements. In this way they can ensure they have sufficient time available for more inquisitive and strategic dialogue.
- While all interviewees reported involvement in model risk management, we were particularly impressed with the similar points two directors made on **the central importance of models and model risk management** in an insurer’s ERM framework. We agree that this an important area that the industry needs to continue to address in a thoughtful manner. Focus should include value add to shareholders and other stakeholders – not just compliance with regulatory demands.
- Although we raised stress testing as a risk related activity, this didn’t turn out to be a major topic of discussion. This may be because we had many other topics to discuss and limited time to do so. Nonetheless, we believe **stress testing is an important part of insurers’ ERM frameworks** that we expect will be receiving more attention in the future. Most emerging regulatory regimes are putting more emphasis on stress testing, and we believe the benefits to management and boards from increased risk insight are significant.



Appendix

Appendix

Background

1. The objective is to provide insurance companies and their boards with insight into industry trends in the role and functioning of a board risk committee
2. The core information will be gathered from telephone interviews with insurance company board members; supplemented with related information from regulatory requirements or guidelines
3. It is expected that approximately 10 to 15 interviews would be conducted. Emphasis will be on the top 25 insurers in life and P&C. Interview results and interviewee identities will be kept confidential. Initially, the survey report will be shared only with participants.
4. Interviews expected to cover both insurers with and without risk committees
5. Completion of the work and distribution of the survey report is targeted for fall 2015

Interview guide

Risk Committee mandate and history

1. Clarify/confirm interviewee's role: chair of RC, member, other
2. How long have you had a risk committee? How many members? If no risk committee, is it being considered?
3. Does the committee have a charter; what would you describe as the committee's key objective? If no risk committee, is risk oversight a key objective of one or more other committees?
4. Were you involved in the establishment of the risk committee, can you comment on why it was created and how its charter was developed?
5. Does the risk committee cover all risks or are other committees responsible for some risks?

Relationship with full board and other committees

1. If other committees are also responsible for risks, can you comment on what these committees are and what specific risks they are responsible for?
2. How would you describe the relationship between the risk committee and the full board?
 - a. The risk committee provides initial review, assistance and advice to the board, but the board is ultimately responsible for all risk matters.
 - b. The risk committee has final authority on some matters related to risk and the full board has final authority on others.
 - c. The risk committee has final authority on all matters related to risk.
3. How would you characterize the audit committee's role related to risk and the risk committee? Do the audit committee and risk committee have members in common?
4. Would you say the relationships/sharing of responsibilities are working well across committees and between the risk committee and the board? Can you see opportunities for improvement?

Role related to specific activities and outcomes

How would you characterize the role of the RC related to each of these activities, would you describe it as: (a) not involved, (b) involved to review but not final approval (in this case, does the full board approve or no one?) or (c) review and final approval

1. Risk management framework and policies
2. Risk identification process, including emerging risk monitoring
3. Risk measurement processes
4. Defining the risk appetite
5. Risk reporting, measuring performance against the risk appetite and overseeing resolution of breaches
6. ORSA

7. Model risk management
8. Stress testing, especially approval of stress scenarios to be tested

Regulatory expectations

1. Does the chair or full RC meet with regulators routinely, ad hoc or not at all?
2. In what way do you feel emerging regulatory demands have had the greatest impact on risk oversight by the RC and full board?
3. Are you expecting increased requirements to be imposed; can you elaborate?

Allocation of time

1. How many times per year does the RC meet?
Approximately how long is each meeting?
2. Thinking of the RC's annual expenditure of time, how much is devoted to:
 - a. Reviewing and discussing materials provided by management
 - b. "Deep dives" into specific risk related topics
 - c. "Blue sky" discussion of emerging risks
 - d. Discussions of the company's strategy and risk related to that strategy
 - e. Other topics

For more information

For a more in-depth discussion of risk committee function and roles, please contact

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