

5 July 2013

Mr Neil Grummitt,
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Dear Neil

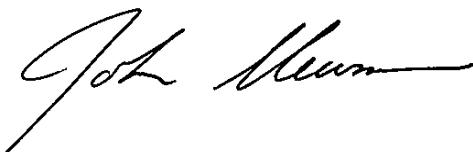
**Submission on APRA Discussion Paper
Harmonising cross-industry risk management requirements**

The Actuaries Institute is the sole professional body for actuaries in Australia. It represents the interests of over 4,100 members, including more than 2,200 actuaries. Our members have had significant involvement in the development of insurance regulation, financial reporting, risk management and related practices in Australia and Asia.

The attached brief note sets out the Actuaries Institute's submission in response to APRA's discussion paper on the harmonisation of risk management requirements across industries released for consultation on 9 May 2013.

Please do not hesitate to contact Melinda Howes, Chief Executive Officer of the Actuaries Institute (phone 02 9239 6106 or email melinda.howes@actuaries.asn.au) to discuss any aspect of this paper.

Yours sincerely



John Newman
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1 Summary

In its role as the prudential regulator of the Australian financial industry, the Australian Prudential Regulation Authority (APRA) has made various enhancements to risk management requirements in recent years.

On 9 May 2013, APRA released a discussion paper including a draft Prudential Standard CPS 220 – Risk Management, proposing a range of mandatory requirements in regards to risk management practices across industries. This discussion paper proposes harmonised risk management requirements for authorised deposit-taking institutions, general insurers, life insurers, single industry groups (level 2 groups) and conglomerate groups (level 3 groups). This new standard will not apply to superannuation.

The Actuaries Institute supports the overarching objective of the proposed standard to enhance risk management (essentially requiring an institution to have in place a risk management framework that addresses its ability to meet its obligations to depositors and/or policyholders), and agrees in principle with the aim of harmonisation, where appropriate, across industries.

The Actuaries Institute recommends some changes to the proposed prudential standard as outlined below.

2 Overall recommendations

Balance between prescription and principles

Our primary concern with the proposed standard is the high degree of prescription. While the basis put forward may be suitable for some (possibly many) institutions, for some institutions the requirements (which are very specific) would entail a significant change to operating models and business structure. As such we believe it would be better to adopt a more principles based approach within the standard, and leave details of the preferred (and optional) means to achieve those principles to a prudential practice guide (“PPG”). By using a principles based approach, there is greater scope for an individual institution to adopt practices and structures that are “appropriate to its size, business mix and complexity” whilst still demonstrating how these chosen practices and structures satisfy the principle requirements.

Whilst the Institute agrees with the aim of harmonisation across industries, we do acknowledge that material risks differ significantly by industry and it may be appropriate to include examples of the most relevant material risks for different industries in the PPG. For example, in general and life risk insurance, Asset Liability Modelling is a significantly more material consideration than liquidity as claimants can generally not change the timing of the cash liability unlike an ADI. A key risk for a general insurer is being able to manage the insurance cycle especially the ability to manage and estimate long tail reserves, long tail premiums and large natural catastrophe exposure/pandemics etc.

This approach would encourage financial institutions to focus on the most relevant risks for their organisations rather than adopting a compliance mentality potentially focusing too much on lower priority risks and thereby reducing risk management effectiveness.

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We understand that APRA is committed to ensuring that an institution's risk management framework is appropriate to its size, business mix and complexity however the level of prescription as currently set out in the standard risks imposing unreasonable costs on some smaller, less complex insurers, including branches of overseas insurers. We recommend APRA provides clear guidance on how it may accommodate smaller insurers so that they get a better understanding of how the new proposals may apply to them in practice.

Example – requirement for an independent CRO

APRA could use an existing feature from its prudential regulation to address the concern that the requirement for an independent CRO is onerous for small insurers. At present “small insurers” in GI are exempt from requiring an Appointed Actuary (“AA”), with APRA’s approval.

A similar system could be implemented for the independent CRO requirement. APRA could assess applications for exemption on a case by case basis, where institutions are below a certain size. Provided the institution has a relatively low risk business model and structure the exemption would be given.

This would preserve the main benefit of APRA’s proposed changes for larger, more complicated businesses.

CRO role

We understand APRA’s intention for the CRO to provide objective, unbiased challenge to business and reporting to the Board. It could be interpreted that the standard aims to achieve this by separating the CRO role from “first line” activities, and understanding the potential for conflicts to arise. While it may be appropriate in many cases to place a specific individual without any other responsibilities into a pure second line CRO role, there may be alternative ways of achieving the intention, such as enforced professional standards and professional codes.

Our discussions with you indicate that it is not the intention to divorce the CRO from frontline business decisions, and that the CRO has a key role to play in ensuring risk management is embedded in the business. Our concern is that some companies may interpret this differently and believe that they need to “water down” the role of the CRO by separating them from input to front line decision making. To prevent this we propose that the objectives of the risk function and the CRO role should be addressed by principles with further guidance provided in a practice guide. The practice guide should also clarify that the CRO role is not intended to duplicate or to recreate work conducted by the business, but to challenge the results with a focus on the risk elements. However, an institution should be allowed to have its risk area undertake some of the work directly where this is appropriate given the size of the company and it can be demonstrated that appropriate controls are in place.

In some institutions (for example in general insurance) it is possible that the AA operates as a pure second line of defence, in which case it could be deemed there is less inherent conflict of duties between the role of the AA and the responsibilities of CRO. However it is important to recognise the conflict that exists when the AA is required to review the risk management framework in the FCR. Even if the AA has a pure second line role, this conflict clearly already exists and needs to be managed. We therefore recommend it should be left to the individual institutions to consider the principles of to what degree the CRO and AA role are conflicted and to determine on consultation with APRA whether it is desirable to have a combined AA and CRO role.

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3 Focus of a principles-based prudential standard

We support the objectives as set out on the first page of draft CPS220. These objectives are stated as follows:

an APRA-regulated institution is required to have systems for identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating material risks that may affect its ability to meet its obligations to depositors and/or policyholders. These systems together with the structures, policies, processes and people supporting them, comprise an institution's risk management framework.

The Board of an APRA-regulated institution is ultimately responsible for having a risk management framework that is appropriate to the size, business mix and complexity of the institution or group and must also be consistent with the institution's strategic objectives and business plan.

Our comments with regard to the specific detail of CPS 220 and whether we believe they should be more the focus of a principles based prudential standard rather than prescription are as follows:

- The role of the Board (paragraph 12): We believe the eight detailed specifications look appropriate. We would point out with reference to point (g) that boards need to understand that there are limitations and uncertainties arising from situations where material judgement has been used without models as well as from models themselves.
- Risk management framework (paragraphs 20-26):

We support the points but believe that paragraph 24(e) should be removed as the standard should require that the relevant functions are carried out, not specify how it is implemented.

- Material risks (para 27): We believe this section looks appropriate, in terms of covering the breadth of risk types. Some useful industry-specific content has been lost with the proposed changes (e.g. reference to insurance concentration risks which are critical to many general insurers). A point could be added confirming that not all risks will be material to all organisations and that whilst all risks should be reviewed, focus should remain on the most material risks for the business.
- Risk appetite statement (paras 28-29): This includes a high level of detail, much of which would be more appropriate to include in a PPG. For example, the details of how risk appetite should be expressed (para 29(b)) will differ by institution given there is no universally accepted definition of the terms used. The requirements of para 29(c) may not be achievable for all risks and only represent one method of achieving the desired aim.

Paragraphs 23/29 can drive siloed risk thinking rather than more holistic Enterprise Risk Management and does not force consideration of correlations and/or diversifications which is not always appropriate. We believe in order for the Risk Appetite Statement to be an effective live document used by organisations to drive change the standard should not be too prescriptive so that the current operational risk appetite considerations can be balanced with long term compliance considerations of the organisations.

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- Risk management strategy, business plan, (paras 30-34): These paragraphs seem appropriate. However, we believe that specific wording of paragraph 31(e) that requires “all persons within the institution to have awareness of the risk management framework” could be reworded as there are realistically some employees who do not need to have a knowledge of the RMF beyond the very tight confines of their role.
- Policies and procedures (para 35). The role of risk management function is to assist the Board and senior management in the development of the policies and procedures set out in Para 35, to report on their implementation and any breaches or material deviations. We would not see their role as implementing those policies and procedures.
- Risk management function: (paras 37 – 41): We agree that there is a need for a part of the business to have the ability / capacity to monitor the risk management framework however we believe the details of paragraph 37 would be best moved to PPG.

Para 39: The CRO must be able to operate in an effective second line capacity if conflicts of interest are to be avoided or minimised. However we believe the second sentence in para 39 “The CRO must not be the Chief Executive Office, Chief Financial Officer, Appointed Actuary or Head of internal Audit” should instead be included in the PPG.

We agree with a mandated Board Risk Committee (BRC) but acknowledge that it can be combined with the Board Audit Committee (BAC). This reflects current practice in that many institutions operate a combined committee covering both responsibilities. One potential benefit of having separate mandates is to ensure that risk management receives suitable attention.

We agree the CRO should be in a position to challenge effectively and objectively. We agree the CRO should “report to” the BRC, and have free and unfettered access to the Board.

- Review of risk management framework (paras 43-46) - we believe this is appropriate.

4 Nature of CRO role

We believe there is a change in what some financial organisations currently perceive to be a typical ‘CRO’ role, working from within the business and how it is described in the standard. Many current CROs and their teams are involved in first line decisions such as allocating risk based capital, providing opinions as part of due diligence during acquisitions, providing support for aggregate management etc. In many cases, this CRO role has been very effective, in empowering people to integrate risk into their business with the CRO being considered one of the team.

The newly described Chief Risk Officer role rather than being considered part of the management team who can encourage risk management from within the business could be interpreted to be a challenging outsider whose role is to objectively challenge and then report up to the board appropriately. Although the CRO role as a second line of defence is important, we believe it is also important that the current risk culture established by engaging with the business to fully embed the risk management framework is not lost as a result of these

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changes. The CRO has a key role to play in ensuring risk management is embedded in the business. Our concern is that some companies may interpret this differently and believe they need to 'water down' the role of the CRO by separating them from input to front line decision making. Clear guidance is required to ensure that companies do not misinterpret the changes to mean that APRA desires such a change.

Responsibilities of the role

In order to assist institutions get a better understanding of the nature of the CRO role, we recommend a PPG is issued and could include information such as the following:

The CRO must have the ability to comment independently on the risk implications of business decisions in real time and how they align to the risk management framework. While the CRO should be appropriately independent of business decision making, the CRO should have visibility of decisions as they are being made, providing challenge where appropriate.

It is expected that the CRO will monitor whether the business maintains appropriately qualified resources and controls to manage each category of risk. The CRO is not required to actively manage any specific risk or be qualified in any specific category of risk, nor duplicate business activities. The resources available to the CRO must be sufficiently skilled in order to assist the CRO in their role of effectively challenging activities undertaken and decisions made by the business.

We recommend transitional arrangements be allowed where the CRO is currently combined with another role in order to have sufficient time to manage these conflicts of roles and structures and to work through the resulting people issues. Alternatively a transition period may apply after APRA publishes its guidance on expectations for CRO attributes. During this period the requirements may be relaxed.

Attributes of the CRO

As well as providing a better understanding of the role of the CRO, we believe it would be beneficial if APRA provided broad guidance on what the board could take into account when selecting a CRO in order to assist organisations determine suitable candidates for the role.

The guidance should not mandate particular practice backgrounds (e.g. actuarial, legal, audit, etc) for the CRO role however considerations a board could take into account could include:

- Experience levels (in risk management generally and/or in that particular industry),
- risk management qualifications,
- member of a recognised profession,
- ability to understand the risks of the particular organisation, and
- the ability to adequately question, challenge and communicate.

What is required from the CRO is likely to vary for different organisations. For instance a small, uncomplicated institution with few products and a simple organisational structure will differ from a large multinational selling a wide range of products in many countries. In the latter case, the key requirement for the CRO is an ability to provide sound general oversight of

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specific types of risk without necessarily being involved in the detail of each. This oversight also needs to consider the interaction between risk types and different areas of the business. The ultimate requirement will be for APRA to decide what is appropriate for each institution via its supervision program.

Restrictions on who can be CRO

Currently CPS220 states the CRO cannot be the CEO/CFO/AA/Head of Internal Audit. It is clear that it would be inappropriate for a CEO and CFO to take on the dual CRO role (due to the CEO's first line responsibility and the CFO's integration of first line activities). An AA role can sit across different lines of defence and in some cases it is less clear cut whether their work falls into the first or second line of defence.

A life insurance AA is typically heavily involved in a first line capacity with key decisions taken by the company (e.g. pricing, reinsurance program, investment strategy, etc.).

By contrast, a general insurance AA often operates in the second line of defence where they advise the business of the implications of decisions, effectively challenging the risk/reward trade off (similar to the way in which a CRO is expected to challenge) without being involved directly in the decision itself. Therefore, in some organisations it could be shown that as the AA is not involved in the business and is quarantined from first line activities, they would be suitable for a CRO role. However it is important to recognise the conflict that exists when the AA is required to review the risk management framework in the FCR. Even if the AA has a pure second role, this conflict clearly already exists and needs to be managed. We submit that the restriction on the CRO and the AA being the same role is better set out in a guidance note and should be considered by APRA on a case by case basis having regard to the organisation structure adopted by each company.

Interaction with AA

We appreciate the proposals are closely aligned with emerging international standards, but many countries, and certainly banks, do not have the AA role. To ensure that Boards and management have a clear view on who does what, it would be helpful if APRA could clearly articulate their expectations of the differing roles and responsibilities of the AA and CRO and how their roles may interact and complement each other in certain financial institutions.

An example of this interaction is with regard to the Risk Management Framework (RMF) where it is expected that the CRO would design and implement the RMF and the AA would comment on it. The Financial Condition Report is produced and presented to the Board by the AA and is expected to form a key component of the RMF. Although the AA may contribute to the development of the RMF ultimately the responsibility for it would be with the CRO. The CRO would also provide advice to the board but would cover risks at a higher level.

Example of problems from being prescriptive vs. principles-based

The proposed standard requires the CRO report to the CEO. For conglomerates, the CEO of a regulated entity may not be the same as the Group CEO. It is often the case that the Risk Function will not report into the subsidiary CEO, but will be independent and only report at

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the Group CEO level. It is suggested that this structure is appropriate as it satisfies the principle of independence for the risk function. The alternative would require multiple layers for the Risk Function as some would be independent at the subsidiary level, but not at the Group level if they report in to subsidiary CEO's. The Risk Function should still have the full level of access to the Board and Risk Committee of the subsidiary as required by the proposed standards. This is an example of where a principles-based approach would ensure the most appropriate reporting lines are established as opposed to a prescriptive approach that may not be appropriate for all situations.

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