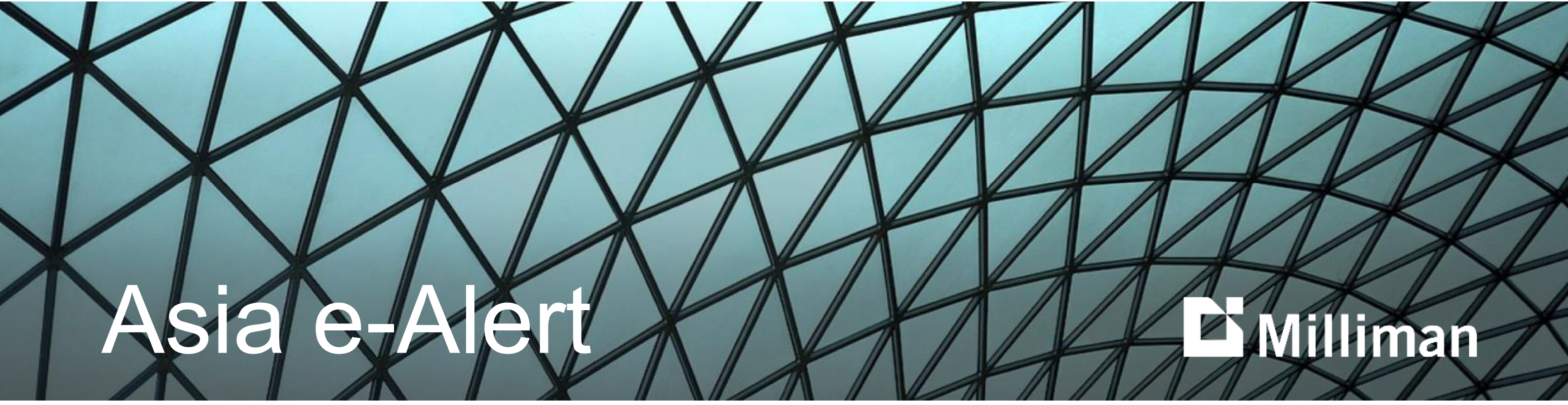


Hong Kong RBC – Consultation on draft ERM Guideline and ORSA reporting requirements

Introduction

On 8 May 2018 the Insurance Authority (IA) released the draft Guideline on Enterprise Risk Management (ERM Guideline) as part of the Pillar 2 – qualitative requirements under the Hong Kong Risk-based Capital (HKRBC) regime. The IA has stated that the main objective of the ERM Guideline is "*to nurture a strong risk culture in the insurance industry that would be reflected in the values, attitudes and norms of business behaviour*".

Key points of focus:

- Pillar 2 implementation timeframe
- Proposed ERM framework and ORSA reporting requirements
- Interaction with existing guidelines
- Potential implications of ERM Guideline

The ERM Guideline was drafted taking into account feedback from the Industry Focus Groups (IFGs) and the latest relevant Insurance Core Principles (ICPs) promulgated by the International Association of Insurance Supervisors (IAIS).[1]

Insurance companies have been invited to submit feedback on the ERM Guideline and reporting requirements of the Own Risk and Solvency Assessment (ORSA) by 6 July 2018. The ERM Guideline is targeted to be finalised by late 2018 and to take effect 1 January 2020.

FIGURE 1: IMPLEMENTATION TIMEFRAME

2018 2H	2019 1H	2019 2H	2020	2021
▪ Executive buy-in ▪ Gap analysis ▪ Resources identification	▪ Systems and processes design ▪ Data collection ▪ Methodologies and decisions	▪ Refinement of systems ▪ User testing	▪ Implementation of ERM framework ▪ Preparation of ORSA	▪ Submission of ORSA Report

In this e-Alert, we provide an overview of the ERM framework and ORSA reporting requirements proposed in the ERM Guideline and discuss potential implications.

Application of ERM Guideline

THREE-TIER GROUP-WIDE SUPERVISORY APPROACH

A three-tier group-wide supervisory approach (GWS approach) has been proposed in the ERM Guideline with the aim to effectively achieve group-wide supervision. Authorised insurers that are part of a group are classified into three tiers, subject to different ERM and ORSA requirements. (Refer to Figure 3 for details.)

FLEXIBILITY FOR COMPLIANCE

The IA has proposed the adoption of a principle-based approach that allows authorised insurers to deviate from the ERM Guideline if specific circumstances apply.

The principle of proportionality is also advocated whereby authorised insurers could coordinate their ERM framework and ORSA appropriately, taking into account the nature, scale and complexity of risks associated with their business operations.

Overview of ERM framework

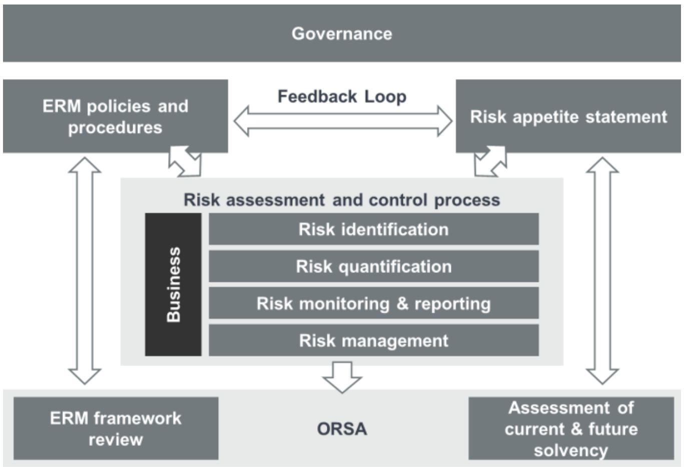
The IA has defined ERM for solvency purposes in the ERM Guideline as "*the coordination of risk management, strategic planning, capital adequacy, and financial efficiency in order to enhance sound operation of the authorised insurer and ensure the adequate protection of policy holders*".

ESTABLISHING AN ERM FRAMEWORK

An authorised insurer is required as per the ERM Guideline to establish an ERM framework with sufficient governance to ensure safe and sound operations, where the ERM framework is "*the process of identifying, assessing, measuring, monitoring, controlling and mitigating risks in respect of the insurer and, if applicable, the group to which it belongs*". An illustrated example of an ERM framework is shown in Figure 2.

[1] Refer to the latest ICPs adopted by IAIS at: link.

FIGURE 2: ERM FRAMEWORK



The following key elements are noted in the ERM Guideline for an authorised insurer to consider in designing a robust ERM framework:

- Forward-looking assessments, with a time horizon consistent with the nature of risks (normally covers at least three years).
- Clear and well-documented risk management policies and procedures reflecting the nature, scale and complexity of the risks associated with the business operations.
- Well-defined roles and responsibilities of the board of directors (Board), risk committee, senior management and risk management functions. For instance, the Board has the ultimate responsibility to establish and oversee an effective ERM framework and to shape the risk culture with senior management.
- A Board-approved risk appetite statement that articulates the risk types and limits that the insurer is willing to take.
- Use of stress and scenario testing relevant to business operations to assess the risk profile and impact on capital requirements and resources under different circumstances.
- Requirements under ERM framework, including annual ORSA Report, are set out in Figure 3.

ORSA REPORTING REQUIREMENTS

All authorised insurers which are subject to the ERM Guideline are required to perform an ORSA at the individual entity (solo) level at a minimum, and to submit their ORSA Report annually to the IA within four months after the end of each financial year.

Additionally, Tier 1 and Tier 2 insurers[2, 3] should also perform an ORSA on a group-wide and sub-group-wide basis, respectively. (Refer to Figure 3 for details on ORSA requirements for insurers of different tiers.)

In line with the IA proposed timeline (see Figure 1), the first ORSA Report is required to be submitted to the IA in 2021 for the financial year ending on or after 31 December 2020. It should cover at least:

- A risk appetite statement
- Year-on-year key changes in the ERM framework
- Stress and scenario testing results (based on the scenarios listed in Actuarial Guidance Note 7 (AGN7) issued by the Actuarial Society of Hong Kong (ASHK))
- A business continuity analysis
- A business failure analysis (e.g., reverse stress testing approach)
- A recovery plan

ERM FRAMEWORK REVIEW

As recommended in the ERM Guideline, the effectiveness of the ERM framework/ORSA should be reviewed regularly. A feedback loop mechanism should be adopted to ensure continued and timely remedial actions or improvements to the ERM framework/ORSA.

In particular, for Tier 1 authorised insurers,[2] the ERM framework should be reviewed by an independent party at least every three years, in order to review whether the ERM framework remains fit for purpose. The review results should be incorporated into the ORSA Report.

FIGURE 3: REQUIREMENTS UNDER ERM FRAMEWORK

		AUTHORISED INSURERS		
	NOT PART OF A GROUP	TIER 1[2]	TIER 2[3]	TIER 3[4]
CORPORATE GOVERNANCE AND ERM REQUIREMENTS	SOLO LEVEL	SOLO LEVEL + GROUP LEVEL	SOLO LEVEL + SUB-GROUP LEVEL	SOLO LEVEL
ORSA REPORT SUBMISSION TO THE IA	SOLO LEVEL	SOLO LEVEL + GROUP LEVEL	SOLO LEVEL + SUB-GROUP LEVEL	SOLO LEVEL
PRESCRIBED CAPITAL REQUIREMENT	SOLO LEVEL	SOLO LEVEL + GROUP LEVEL	SOLO LEVEL	SOLO LEVEL
PRIOR NOTIFICATION TO THE IA OF GROUP EVENTS AND INTRA-GROUP TRANSACTIONS	NOT APPLICABLE	MATERIAL TO INSURER + OVERALL GROUP	MATERIAL TO INSURER + SUB-GROUP	MATERIAL TO INSURER

[2] Tier 1 refers to insurance group(s) subject to home supervision of the IA on a group-wide basis.

[3] Tier 2 refers to authorised insurer(s) being part of a wider group (sub-group) which is significant to the Hong Kong insurance market but not subject to home supervision of the IA on a group-wide basis.

[4] Tier 3 refers to authorised insurer(s) being part of a wider group and neither Tier 1 nor Tier 2.

Interaction with existing guidelines

The ERM Guideline is to be read in conjunction with the existing Guidelines (GLs) and Actuarial Guidance Notes (AGNs) issued by the IA and ASHK, respectively, including but not limited to, GL3 (anti-money laundering and counter-terrorist financing), GL10 (corporate governance), GL13 (asset management), GL17 (reinsurance) and AGN7 (dynamic solvency testing).

Potential implications

RESOURCE MANAGEMENT

As mentioned in the ERM Guideline, authorised insurers need to ensure that they have suitable and sufficient resources to establish, implement and regularly review the ERM framework, develop appropriate models/design systems for assessments of risk and capital adequacy and perform an ORSA on a regular basis. In particular, insurance companies will need to take into account other demands, including business-as-usual work, IFRS 17 implementation, the Second Quantitative Impact Study (QIS 2), and transition to the new RBC framework.

RISK QUANTIFICATION

One of the key considerations for insurers embedding a robust ERM framework is to implement forward-looking assessments, with a time horizon consistent with the nature of the insurer's risks. Over time this may require some insurers to enhance their risk quantification capabilities to include forward projections and to be able to quantify impacts of emerging risks such as cyber risk.

EMBEDDING A RISK CULTURE

The Board has the ultimate responsibility to establish and oversee an effective ERM framework and to shape the risk culture with senior management. Best practice observed in embedding a strong risk culture ensures clear and open communication channels established across the insurer's operating structure and function lines. Embedding an enterprise-wide risk culture requires strong and consistent Board and senior management sponsorship.

Milliman has recently published a research report regarding global best ERM practices, *"Enterprise risk management: Global best practices and key challenges in Asia"*. It examines the evolution of the risk function among Asian life insurers and highlights the global best practices in implementing a robust ERM framework.

If you have any questions about this e-Alert or would like to discuss this further, please contact any one of our consultants.

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