Submission to Central Bank of Ireland on Risk Appetite Discussion Paper (2014)

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1. Introduction

I appreciate the opportunity to comment on the Central Bank's Risk Appetite Discussion Paper. The views expressed in this submission are my own; they are not representative of any of the companies of which I am a director.

By way of background, I am an Independent Non-Executive Director of four regulated financial institutions, three of them life assurance companies and the fourth a reinsurance company. I sit on the Risk Committees for all four, chairing two of them. My entire career has been spent in finance/ actuarial/ risk management roles. I have discharged the roles of Appointed Actuary and Independent Actuary in Ireland; and Appointed Actuary, Actuarial Function Holder and With Profits Actuary roles in the UK. I served as President of the Society of Actuaries in Ireland from 2005 to 2007.

All the financial institutions of which I am a director are subsidiaries of international financial services groups, which brings me to the core of my submission, namely the absence from the paper of any reference to the special considerations that apply when the institution is a subsidiary. This is a serious omission, since the vast majority (well over 90%) of financial institutions regulated by the Central Bank of Ireland are subsidiaries. For subsidiaries, the considerations in relation to risk appetite are quite different from those appropriate for parents or for stand-alone institutions.

2. The Linkage between Strategy and Risk Appetite for Subsidiaries

The key theme of the paper is the close linkage between risk appetite and organisational strategy: *"The central message of this paper is that risk appetite must be considered with strategy because they are so deeply interlinked. The board is responsible for both." (page 1)* This is true at the parent company level, but not necessarily for a subsidiary. In fact, many (probably the majority) of financial institutions established in Ireland have been given very specific business strategies by their parents. Examples in life assurance, the area with which I am most familiar, include:

- subsidiaries transacting variable annuity (VA) business only;
- subsidiaries transacting gross rollup business in the UK;
- subsidiaries offering unit linked single premium products in Italy.

For such companies, the board and management have little to gain by spending time on questions such as what risks the organisation wishes to take or to avoid, as the Central Bank advises on page 13. They are told by their shareholder/ parent which risks to take. The board then decides how much capital it needs and how the risks should be managed. This very different perspective on the relationship between strategy and risk appetite should determine the Central Bank's approach when reviewing risk appetite statements for subsidiaries, not the theoretical perspective set out on page 13 of the discussion paper.

It is clear from the above that statements in the discussion paper such as:

- *"The risk appetite of an organisation must express the strategy of that organisation through desirable and undesirable risk exposures." (page 3);* and
- *"Even though this implies that risk appetite and strategy are interlinked, it is clear that one does not lead the other; risk appetite and strategic planning occur and evolve in parallel." (page 5)*

are of little relevance for the vast majority of Irish financial institutions. As explained above, for such institutions, strategy and risk appetite do not evolve in parallel: strategy is determined by the parent and risk appetite follows from that.

This begs the question as to what the board of the subsidiary should do if it is unhappy with the strategy set down for it by the parent. It may seek additional capital or implement additional controls if the risks are amenable to such measures, but what if the board is not satisfied that the risks can be either mitigated or controlled? I would have liked to have seen the paper explore such real world dilemmas facing boards of Irish financial institutions.

3. Disseminating a Single Definition of Risk Appetite

Section 5.2 of the discussion paper starts: *"An essential starting point for establishing a RAS should be clearly defining a single view of what risk appetite means for the <u>organisation as a whole</u>, how it will be used and what the expectations of the board in relation to risk appetite are. The board should agree and document a <u>single definition</u> of risk appetite, risk tolerance and risk limit for use <u>across all business units</u> in the organisation."* (my underlining)

For a group with a number of branches and subsidiaries across different territories and product areas, these two statements make eminent sense. The terms *"organisation as a whole"* and *"all business units in the organisation"* encompass both branches and subsidiaries.

In my experience, Group boards often do as the Central Bank advises. They articulate a single view of what risk appetite means for the organisation as a whole and how it will be used. There follows a cascading effect throughout the organisation, including subsidiaries.

Problems arise however when we try to define the subsidiary as *"the organisation as a whole"* and pretend that the parent doesn't exist when considering risk management in the subsidiary. This seems to be the approach that the Central Bank advises for subsidiaries. It is unrealistic to ignore the parent company's central role in defining what risk appetite means, how it will be used, and what the expectations are in relation to risk appetite for the subsidiary.

It would have helped if the paper had teased through the implications of the two statements quoted at the start of this section for boards and risk committees of subsidiaries.

4. Other Distinguishing Features of Subsidiaries

There are a number of other distinguishing features of subsidiary financial institutions that merit discussion but have not been considered in the paper:

- Access to additional capital is normally less of a constraint in a subsidiary than in a parent or stand-alone institution, particularly if the capital is used to support sales of a product that is

capital intensive but inherently profitable. An interesting question is the extent, if any, to which boards of such subsidiaries can rely on the parent's assurances that capital will be made available as and when required, with the residual risk that sales may have to be curtailed if the capital is not made available when required.

- Arguably, where a financial services group has a number of regulated subsidiaries, good risk management from a group perspective is for each subsidiary to retain the minimum amount of capital allowed by its local regulator, with any excess being held at the centre. This increases the fungibility of capital and makes it easier for the parent to allocate capital to subsidiaries as required.
- Furthermore, the benefits of diversification mean that the group's solvency cover is considerably better than the average solvency cover of individual subsidiaries, even if there is no excess capital at the centre.

Finally, I find figure 2 on page 9 confusing. It might make more sense if the axes are reversed.

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