FINANCIAL SERVICES
COMMISSION

# GUIDELINE NO. 2

# GUIDELINE ON INTERNAL CONTROL AND RISK MANAGEMENT

**(This guideline is issued pursuant to section 53 of the Financial Services Commission Act, and comes into effect on March 1, 2013.)**

## 1.0 INTRODUCTION

1.1 Insurers[1] must be prudently managed. The prime responsibility for the sound and prudent management of an insurer rests with the Board of Directors of the insurer. Corporate governance refers to the rules and procedures put in place within a corporation for the management and control of its business and affairs and the Board should set the policies for corporate governance in the insurance company. Risk management and internal controls systems are an integral part of a corporate governance framework and although the risk management and internal control systems and practices may differ depending on the size and complexity of the insurer, and the nature of the insurer's risk exposures, the fact remains that those controls are needed. This guideline sets out factors that the board of directors and the management of an insurer should consider when establishing and implementing risk management and internal control systems and procedures. In addition, the Guideline contains an Internal Controls and Risk Management survey that must be completed by all insurance companies and submitted to the Financial Services Commission. Thereafter, the company is required to complete the survey and submit to the Commission once every two years.

The Commission's approach to the supervision of insurance is becoming increasingly risk-based. This means that the Commission, to the extent possible, identifies, assesses, prioritizes, and minimizes the likelihood of events or circumstances occurring with might prevent the Commission from achieving its objectives. Further to this the Commission assesses the risks posed by an insurer by gaining an understanding of a licensed insurer's operations, the risks it faces and how it deals with these risks. The consideration of the governance and the decision-

[1] Insurer means a company carrying on insurance business and, except where otherwise stated, includes all the members of an association of underwriters that is registered as an insurer registered under the Insurance Act CAP. 310, Exempt Insurance Act CAP. 308A and Financial Services Commission Act, 2010-21.

making and control processes of an insurer is a key component of this assessment process. This approach to supervision is in contrast to a transaction-oriented review.

1.2 While the Commission aims to provide clarity as to its approach on implementation of guidelines, this guideline cannot be exhaustive. The Commission will do its best through this and other guidelines to set out information about its regulatory approach and expectations regarding a registered insurer's risk management and internal control systems.

1.3 The Commission's guidance is of a general application and seeks to take account of the diversity of institutions that may be licensed under the Insurance Act CAP. 310, Exempt Insurance Act CAP. 308A and Financial Services Commission Act, 2010-21 and as such there may be a need for the Guidance to be revised and developed over time.

## 2.0 APPLICATION

2.1 This guidance applies to all insurers registered under the Insurance Act CAP. 310, Exempt Insurance Act CAP. 308A and Financial Services Commission Act, 2010-21.

2.2 In managing its affairs, an insurer should have regard to the principles of good risk management and internal controls. Taking into account the size, nature, complexity and risk profile of the business of the licensed insurer, the Board must exercise its judgement in determining the nature and scope of the risk management and internal control systems and practices that are necessary. It is the responsibility of the Board to ensure that this survey is completed as accurately as possible.

2.3 As part of its supervisory process, the Commission will look for indications that, overall, processes or procedures for effective risk management and internal control systems are in place, that they are appropriate to the individual insurer, and that they are operating effectively. The Commission will formulate its judgment on the effectiveness of an insurer's risk management and internal control systems based on a variety of indicators inclusive of completion of the survey. The degree of applicability and weighting of individual elements in this guidance will depend on the size, nature, complexity and risk profile of each insurer. For example, the Commission recognizes that insurers which only insure or reinsure the risks of their owners and are part of the same organization may pose less risk to the public than other insurers or reinsurers, and that it may be appropriate for the risk management and internal control policies and procedures for these entities to be less complex than for other insurers.

## 3.0 RESPONSIBILITY OF THE BOARD OF DIRECTORS

3.1 The Board of Directors, along with management, is responsible for suitable prudential oversight of the risk management and internal control systems, strategies and policies.

Insurers should review their policies and practices regularly to ensure that they remain appropriate in light of changing circumstances and in light of how policies and practices have performed.

3.2 The risk management policies set by the Board should be carried out by the management of the company. Development and implementation of an adequate and sound system of internal controls is normally the responsibility of management. The Board of Directors, however, is ultimately responsible for ensuring that such a system is established and maintained.

## 4.0 RISK FACED BY INSURERS

4.1 Nine risks have been identified as being particularly important in the operation of insurance companies.

4.1.1 Credit risk - which arises when any counter party such as a borrower, policy holder, reinsurance company, or broker is unable or unwilling to meet contractual obligations of a financial nature when they become due.

4.1.2 Interest rate risk - which arises due to movements in interest rates and is the result of timing differences in the re-pricing of an insurance company's assets and liabilities. This risk is of particular importance for life insurance companies due to the long term profile of their liabilities.

4.1.3 Foreign exchange risk - which arises from movements in foreign exchange rates and their impact on the financial assets and obligations of the insurance company. Reinsurance contracts are usually denominated in foreign currencies such as US dollars while premium and claims payment transactions between a local insurance company and its customers are denominated in local currency. A sudden shift in exchange rates can therefore have a significant impact on company profitability.

4.1.4 Product design and pricing risk - which arises from the potential of selling an insurance policy where the value of the liabilities assumed on the policy or policy type, exceed the premium revenue received from the policy. This is of particular importance for insurance companies because they must set premiums on policies based on expected future claims.

4.1.5 Underwriting and liability risk - which arises from the selection of risks by the insurance company and the transfer of a portion of these risks through reinsurance. Section 12 (1) (e) of the Insurance Act Cap 310 speaks to the requirement of an insurance company to maintain adequate reinsurance arrangements. For general insurance companies, the transfer of risks through reinsurance is particularly important. General insurance companies must consider the design of their reinsurance strategy to ensure that their reinsurance contracts, in fact, cover the underwriting risks to which they may be exposed.

4.1.6 Operational risk - which results from deficiencies or break downs in internal controls, technology, human error and dishonesty. This risk, of course, is not unique to insurance companies.

4.1.7 Liquidity risk - which arises from an inability to have the necessary funds on hand to meet obligations as they come due. This is a particularly important risk for a general insurance company because the timing of required claim payments is very unpredictable.

4.1.8 Legal, reputation and regulatory risk - which arise from a company's non-compliance with laws, regulations, industry best practices, corporate governance best practices, or ethical standards. In the insurance industry, a loss of reputation or a loss of public confidence is often fatal for a company.

4.1.9 Strategic risk - which arises from a company's inability to implement business strategies required as a result of changes in competition and the business environment.

4.2 It is important that insurance companies and their Board of Directors have an understanding and appreciation of the risks the company faces and make appropriate decisions to manage those risks.

4.3 Insurers should be in a position to identify all material risks, financial and non-financial, that they face, assess their potential impact and have policies in place to manage them effectively. These policies should be catered to the insurer relative complexity, size, and risk exposure. The insurer should establish an appropriate tolerance level or risk limit for material sources of risk.

## 5.0 IMPLEMENTATION OF INTERNAL CONTROL AND RISK MANAGEMENT PROCEDURES

5.1 A formal risk management process should be adopted and implemented by the insurance company. This process should be written, documented, and approved by the Board of Directors. The primary components of a sound risk management process include policies, procedures and practices that:

- Clearly delineate lines of responsibility for managing risk;
- Set in place adequate systems for measuring risk;
- Create appropriately structured limits on risk taking;

- Establish effective internal controls; and
- Describe comprehensive and timely risk monitoring and reporting.

5.2 A system of internal control is critical to effective risk management and as such insurance companies should ensure that they have adequate internal control processes in place to supplement the risk management program.

5.3 Internal controls refer to a control system within an organisation which oversees the proper conduct of its business and affairs. Internal controls encompass the policies, processes, culture, tasks and other aspects of an insurer that support the achievement of the insurer's objective. A sound internal control system facilitates the efficiency of operations, contributes to effective risk management, assists compliance with applicable laws and regulations, and strengthens capacity to respond appropriately to business opportunities.

5.4 Among other matters, the purpose of internal controls is to verify that:

- The business of an insurer is conducted in a prudent manner in accordance with policies and strategies established by the Board of Directors;

- Transactions are only entered into with appropriate authority;

- Assets are safeguarded;

- Accounting and other records provide complete, accurate, verifiable and timely information; and

- Management is able to identify, assess manage and control the risks of the business and hold sufficient capital for these risks.

- Duties and responsibilities are clear and there is appropriate delegation of authority;

- Decision-making procedures are clear and;

- There are internal checks and balances.

5.5 The internal and external audit, actuarial and compliance functions, as applicable, are part of the framework for internal control, and should test adherence to the internal controls as well as to applicable laws and regulations. Again the Commission reiterates that the Board of Directors has ultimate responsibility for ensuring the risk management and internal controls are adequate.

## 6.0 INTERNAL CONTROLS & RISK MANAGEMENT SURVEY

6.1 The Commission will monitor closely the insurance company's adherence to best practices of risk management and internal controls. The survey attached is to be completed by each insurer and will be used to monitor off site by the Commission. During the course of an on-site inspection, it is the intent of the Commission to review the documentation and process which formed the basis of the responses to the Survey. We do not believe that transitional arrangements will be required on an industry-wide basis as the expected impact from the guideline on the operations of the company should be minimal.