A new risk governance model for the insurance industry
Part 1: The case for improvement
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Origins and components of the three lines of defense

Any discussion about organizing and governing risk management in a financial services company typically includes the “three lines of defense” model. Although there is some difference of opinion, there is generally agreement that the term was first applied to financial services in a 2003 paper published by the then UK industry regulator, the Financial Services Authority.

Likewise, there are different interpretations of each of the three lines’ roles and which functional departments fit into each line. The first line consists of those who undertake risk, typically described as the “business functions.” Sometimes the first line is described as the functions that own and manage risks. Often this line is said to be “accountable” for risk. The second line consists of those responsible for risk controls and compliance. This includes the risk department, the compliance department, and others. Sometimes the second line is described as the functions that “oversee risk.” Often “independent challenge” describes the second line’s responsibility. The third line is internal audit, though some versions also include external audit and the board audit committee. “Independent assurance” defines its role.

Regardless of how successful this model has been over the last fifteen years – and opinions differ – it is useful to consider how it might need to change considering how the insurance industry and its risks have changed over the past decade and will continue to change.
The risks facing the insurance industry are different than they were when the three lines model was new and they continue to change.

Forces reshaping industry needs
The risks currently facing the insurance industry are different than they were ten or fifteen years ago and they continue to change. The existential threat that disruptive technologies pose looms much larger now than traditional risks like credit, market and insurance.

Last month we surveyed over two dozen board members and CROs on risk strategy and organization topics. When we asked what they thought would most likely present the next significant risk to their industry, over 40 percent chose “a major strategic disruption (for example, significant and rapid change in customer purchase and service expectations due to technological innovations)” Only a third chose “another financial crisis.”

Strategic risk has assumed a new level of prominence among board members and CROs.

Concurrent with this shift to strategic risk, the nature of the traditional risks have themselves changed, particularly in the life sector. A number of factors, including continued low interest rates, changing buyer preferences, and more robust risk measurement and management have moved much of the industry away from market-risk taking, thus shifting the traditional risk set more toward insurance risks. In the same survey, nearly 20 percent saw “a catastrophic insurance event” as the next significant risk.

With these fundamental changes to insurers’ risk profiles, the approach to addressing and managing the new risk profile will need to change too.

A second shift our survey revealed was toward greater emphasis on using risk to improve company performance. Over 70 percent of respondents agreed that, over the last several years, insurers’ risk management activity has tended to focus on solvency and regulatory uses. When we asked where risk management should focus in the future, virtually all respondents said a better understanding of risk to improve the company’s risk-adjusted performance. In fact, over 80% “strongly agreed” with this statement, the most significant level of convergence in the entire survey.
Insurers are placing greater emphasis on using risk to improve company performance.

Recent M&A activity reflects this shift. Insurers are acting on their enhanced knowledge of the diverse risk/return profiles across their businesses to sort businesses into more homogeneous component parts. In some cases, this amounts to separating into different companies. Sometimes portfolios with a particular risk profile, like variable annuity, find a better home with a different type of risk taker with a different perspective on a portfolio’s risk/return opportunities.

This move toward using risk in performance management doesn’t imply that insurers should diminish or abandon solvency and regulatory uses. Companies and their CROs now have enough bandwidth to do both. This is the third shift that we observe.
ERM has matured to the point where most CROs don’t have to create a framework but instead make better use of what they’ve already built.

As recently as ten years ago, ERM was still in its formative stage. During those years, insurers devoted much effort and many resources to developing and testing basic concepts and building a workable infrastructure to deliver economic capital metrics. That effort has now borne fruit. As a result, CROs can reorient their budgets. Rather than spending to create the framework, they can apply that expenditure to making better business use of what they have built.

It is also noteworthy that, during those formative years, senior and business unit management developed a greater understanding and feel for how their metrics work. Observing how these metrics’ have operated over time and in different economic and business circumstances has increased management’s level of comfort and buy-in. Though acceptance may not always be complete and unconditional, enough support exists to begin deploying these metrics to better manage the business.
Where does three lines fall short in the evolving world?

Not surprisingly the three lines of defense model focuses on defense. Its description of roles and responsibilities accord well with an implicit assumption that the task at hand is to keep risks under control. The businesses are the first to engage with risks and are accountable for controlling their on-boarding or avoidance. The second line reviews and challenges the first line’s actions. And the third line independently assesses that these controls are functioning properly.

Less clear is who’s responsible for 1) searching out and assessing new emerging risks and opportunities, 2) identifying disruptive technologies and other existential threats to the business model and 3) assessing these impacts on the enterprise and the potential strategies that insurers could use in anticipation of them.

Similarly, there is no guidance for a proactive, offensive posture seeking risk adjusted performance improvement. What role might different parts of the insurer play in addressing this at the micro opportunity level and the diversified enterprise wide level?

Introducing “new” risks, like the strategic impact of disruptive technologies and a greater focus on usage of risk knowledge for performance improvement raises the question of whether a one-size fits all model is adequate. The three lines of defense model makes no distinction between different types of risk. Certainly this fits when the focus is on known risks measured via a clear metric, like credit risk measured by a VAR based formula. But should the same organizational functions have the same defined roles when the risk is emerging technologies and their task is to assess their positive or negative impact on credit or other risk-taking activities?
The three lines of defense model makes no distinction between different types of risk.

Lastly, other parts of the risk management tool kit have been developing over the last 15 years. As we note above, risk based metrics are now common and widely accepted. Risk appetite statements also have advanced, not only in terms of acceptance and usage but also in terms of rigor and precision. For the insurance industry, more formal model risk management is a new and widely utilized risk mitigant. Consideration also needs to be given to where models – especially advanced ones related to AI-type decisions – and model risk management fit into a governance structure.

Next steps

Very few, if any, models can expect to remain static for over 15 years. And the three lines of defense model is no exception. It’s time to consider new and emerging risks, the application of risk metrics to business performance as well as to solvency measurement, and new tools and techniques that are now part of the ERM landscape. In our next paper, we’ll look at how the three lines of defense model can improve to better meet the insurance industry’s evolving needs.
For more information

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