FINANCIAL SERVICES AUTHORITY

SAINT VINCENT & THE GRENADINES

GUIDANCE NOTE: NO. 10

On

Risk Management and Internal Controls for Insurance Companies

Issued: October 7, 2021

INTRODUCTION

The conduct of insurance business in St. Vincent & the Grenadines is regulated under the Insurance Act, Chapter 306 of the Laws of Saint Vincent and the Grenadines, Revised Edition 2009 ("the Act"). Regulation and supervision of insurance business is exercised by the Financial Services Authority ("FSA"/ "Authority"), acting under the authority of the FSA Act, Act No. 33 of 2011. Additionally, the FSA has the duty, in collaboration with insurance companies, to promote and maintain high standards of conduct and management in the provision of insurance services.

In carrying out its core activities, an insurer will face a wide range of risks which are often interlinked and if not properly managed, could threaten the ability of the institution to achieve its objectives and sustain its viability. An insurer should therefore adopt a holistic approach to adequately identify, measure, control and monitor these risks.

The primary responsibility for sound and prudent management of an insurer rests with its Board of Directors ("Board"). The Board is responsible for ensuring that the insurer has in place, effective systems and functions to address the key risks it faces. The Authority requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls. The systems and functions should be adequate for the insurer's objectives, strategy, risk profile, and the applicable legal and regulatory requirements. They should be adapted as the insurer's business and internal and external circumstances change.

PURPOSE

These Guidelines have been developed to outline the FSA's expectation on what is required of the insurer's Board and senior management in the implementation of an effective risk management and internal control programme.

These Guidelines further aim to ensure that insurers are managed in a sound and prudent manner by having in place systems for identifying, assessing, monitoring, and mitigating the risks that affect their ability to meet their obligations to policyholders. These systems, together with the structures, processes and policies supporting them, are referred to in this guideline as the insurer's risk management framework.

Additionally, these Guidelines set out factors that the Board and management of an insurer should consider when establishing and implementing a framework for risk management and internal control. In addition, the Own-Risk Survey previously issued by the Authority, must be completed by all insurers as part their overall risk management strategy, and submitted to the Authority on an annual basis.

SCOPE OF APPLICATION

These Guidelines apply to all insurance companies operating in the State. The Guidelines are not intended to be prescriptive, nor do their broad applicability mean a "one-size-fits-all" approach to risk management and internal controls. An insurer's risk management and internal control framework should be flexible, proportionate to its risk profile and tailored to the nature, size, scale, scope of its operations and complexity of its business activities.

The Authority's guidance is of general application and seeks to take account of the diversity of institutions that are licensed under the Act, and as such there may be need for these Guidelines to be revised over time.

RISK MANAGEMENT-BOARD AND SENIOR MANAGEMENT RESPONSIBILITY

Risk management is an integral part of effective management and an essential part of good corporate governance. Risks can result from factors, both external and internal.

The Risk Management process in an organisation is influenced by the organization's:

1. mission, vision and objectives;
2. products and services; and
3. physical, environmental and regulatory conditions.

Risk Management is the practice of systematically identifying, understanding and managing risks encountered by an organisation. The Board of an insurer is ultimately responsible for risk management and internal controls and effectiveness of same. The Board is also responsible for endorsing policies and procedures developed by senior management for these areas.

RISK MANAGEMENT FRAMEWORK

An insurer should have a sound strategy to manage risks arising from its core activities. This includes the preparation of a risk register to catalog all identified risks and ensure regulatory compliance. The insurer should first determine its risk tolerance, i.e., the level of risk that it is able and prepared to bear, taking into account its business objectives and available resources.

An effective risk management framework to address risks arising from core activities such as product development, pricing, underwriting and reserving, asset-liability management, investments, reinsurance and claims handling, should include the following:

- **Risk Identification**

  To be effectively managed, risks must be clearly defined and proactively identified. The risk management system should take into account all reasonably foreseeable and relevant material risks to which the insurer is exposed, both at the insurer and the individual business unit levels. This includes current and emerging risks.

  Proper risk identification focuses on recognizing and understanding key risks inherent in the insurer's business activities, or key risks that may arise from external factors. Significant new or changed activities and products that may increase an existing risk or create a new type of exposure should be subject to appropriate risk review and be approved by the Board and Senior Management.

- **Risk Assessment**

  Insurers should assess material risks both qualitatively and, where appropriate, quantitatively. Appropriate consideration should be given to a sufficiently wide range of

outcomes, as well as to the appropriate tools and techniques to be used. The interdependencies of risks should also be analysed and taken into account in the assessments.

- **Risk Monitoring and Review**

  Risk should be monitored on an on-going basis to track adherence to risk appetite, policies, standards, procedures and processes. The risk management system should include early warnings or triggers that allow for timely consideration of, and adequate response to, material risks. An insurer may decide to tolerate a risk, when it is acceptable within the risk appetite that has been set.

- **Risk Control and Mitigation**

  The insurer should implement necessary measures to control and mitigate the identified risks. In most cases, an insurer will control or reduce the risk to an acceptable level. Another response to risk is to transfer the risk to a third party. If risks are not within the acceptable risk appetite and it is not possible to control, limit or transfer the risk, the insurer should cease or change the activity which creates the risk.

- **Reporting**

  The overall assessment of risks and the related action plans should be reported to the Board and/or to Senior Management, as appropriate, using qualitative and quantitative indicators and effective action plans. The insurer's documented risk escalation process should allow for reporting on risk issues within established reporting cycles and outside of them for matters of particular urgency.

- **Risk Policies**

  The insurer's risk policies should be written in a way to help employees understand their risk responsibilities. They should also help explain the relationship of the risk management system to the insurer's overall corporate governance framework and to its corporate culture. The overall risk management policy of the insurer should outline how relevant and material risks are managed. Related policies should be established, either as elements of the risk management policy, or as separate sub-policies. At a minimum, these should include policies related to the risk appetite framework, an asset-liability management policy, an investment policy, and an underwriting risk policy.

  This framework should be adopted regardless of the size of the institution. 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 necessary.

RISKS FACED BY INSURERS

The business of insurance is based on dealing with uncertainty. Therefore, an insurer needs to consider a wide range of possible risks and the outcome that may affect the current and future financial position. The material risks to be covered by an insurer's risk management framework must, as a minimum, include:

- **Credit Risk** which arises when any counterparty of an insurer such as a borrower, policyholder, intermediary or reinsurer is unable or unwilling to meet contractual obligations of a financial nature when they become due.

- **Market Risk** which arises from changes in market prices. There are three distinct components to market risk. *Interest rate risk* arises from movements in market interest rates and is the result of timing differences in the re-pricing of an insurer's assets and liabilities. *Foreign exchange risk* arises from movements in foreign exchange rates and their impact on the financial assets and obligations of an insurer. *Pricing risk* arises from movements in the market value of equity and real estate investments in response to changing economic conditions.

- **Insurance Risk** consists of two interrelated components. The first component is product design and pricing risk which arises from the exposure of financial loss from transacting insurance business where the costs and liabilities assumed in respect of a policy or policy type exceed expectations in pricing the policy. The second component is underwriting and liability risk which is the exposure to financial loss resulting from the selection of risks to be insured as well as the transfer of risks through reinsurance.

- **Operational Risk** which arises from problems in the performance of business functions and processes resulting from deficiencies or breakdowns in internal controls, technology failures, human error, dishonesty or natural catastrophes.

- **Cybersecurity risk** is a growing concern for the insurance sector. Insurers collect, store and manage substantial volumes of confidential information on policyholders. Due to these reservoirs of data, insurers are prime targets for cyber-attacks which may cause disruption to services. Cybercriminals can also use information obtained for criminal activity. In addition, given the significance of the insurance sector to the financial sector, interruptions of insurer's systems due to cybersecurity incidents may have far-reaching implications that can threaten financial stability.

- **Liquidity Risk** arises from an inability to have the necessary funds on hand to meet obligations such as claims payments as they come due. This is a particularly important risk for a non-life insurer because the timing and magnitude of future claim payments is very unpredictable.

- **Legal and Regulatory Risk** which arises from an insurer's non-compliance with applicable laws, rules or regulations.

- **Strategic Risk** arises from an insurer's inability to implement business strategies required as a result of changes in competition and the business environment.

- **Concentration Risk** arises from an uneven distribution of exposures in terms of counterparties or products.

- **Reputational Risk** arises from negative public opinion and the adverse impact this might have on the customer base and revenues of an insurer.

It is important that insurers and their Boards have an appreciation and understanding of the risks the company faces and make appropriate decisions to manage those risks.

Insurers should be able to identify all material risks, financial and non-financial, that they face, assess their potential impact and implement policies to manage them effectively. These policies should take into consideration the insurers relative complexity, size and risk exposure.

INTERNAL CONTROLS

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

An internal controls system consists of all the policies and procedures adopted by the management of an insurer to assist in identifying, assessing, managing, and controlling the risks involved in the company's business activities thereby achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business.

The purpose of internal controls is to verify that inter alia:

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

- transactions are only entered into with appropriate authority;

- assets are safeguarded, accounting and other records provide complete, accurate, 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.

The internal controls system should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported (both internally and externally), and compliance with laws, regulations, supervisory requirements and the insurer's internal rules and decisions. It should be designed and operated to assist the Board

and Senior Management in the fulfilment of their respective responsibilities for oversight and management of the insurer.

The internal controls system of an insurer shall be required to provide assurance from a control perspective that the business is being operated consistently within the strategy and risk appetite set by the Board, agreed business objectives, policies and processes and applicable laws and regulations.

An effective internal controls system typically includes:

- **Segregation of duties**

  Segregation of duties is one of the most effective internal controls. Effective segregation of duties represents a vital component of any organization's internal control system. This includes, amongst others, having sufficient distance between those accountable for a process or policy and those who check if such a process or policy and appropriate control exists and is being applied. Segregation of duties controls are designed to help prevent employees from committing errors or engaging in fraudulent activity.

- **Policies, procedures and processes**

  Written policies and procedures act as the standards for an organization's operations. Specifically, policies outline what tasks need to be done. Procedures complement policies by explaining how and when those tasks should be completed, as well as who should be primarily responsible for completing them. Well-defined policies, procedures and processes provide a basis for an insurer to analyze how to get from their existing state to a target state. By outlining current requirements, operations, interdependencies, risks and controls, they can help identify gaps and opportunities for improvement, including the appropriate controls.

  Documented policies and procedures should also be subject to review on a regular basis to ensure that they maintain their effectiveness to support the insurer's business activities.

- **Information and communication**

  The information and communication component of internal controls involves the process of gathering and disseminating information throughout the organization. Effective information and communication will include business systems that gather information related to internal controls and management that uses this information to support employees in doing their job. It should also be apparent through employee handbooks and orientation processes, that employees receive communications related to ongoing control efforts periodically throughout their employment.

- **Monitoring and review**

  Monitoring is the ongoing feedback mechanism that ensures that internal control systems that are effectively designed remain that way. Effective monitoring includes ongoing testing

of existing control activities and procedures to follow, when business processes change. The system of internal control should be periodically reviewed by management. By performing a periodic assessment, management assures that internal control activities have not become obsolete or lost due to turnover or other factors. Internal control activities should also be enhanced to remain sufficient for the current state of risks.

- **Reporting**

  The Board, with the assistance of the audit committee, should regularly receive and review reports on internal controls and be informed about how the reviews giving rise to the reports have been undertaken. The reports from management should provide a balanced assessment of the effectiveness of the system of internal controls in the areas covered. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact they have had, could have had, or may have on the organisation, and the actions being taken to rectify them.

- **Control Functions**

  As part of the effective systems of risk management and internal controls, insurers should have control functions, including for risk management, compliance, actuarial matters and internal audit. Control functions add to the governance checks and balances of the insurer and provide the necessary assurance to the Board in the fulfilment of its oversight duties.

  The existence of control functions does not relieve the Board or Senior Management of their respective governance and related responsibilities.

AUDIT AND INDEPENDENT REVIEWS

The audit committee should conduct an annual review of the effectiveness of the organizations' internal control and risk management systems. The committee should define the process to be adopted for this review. The annual review exercise should consider the issues dealt with in the reports reviewed during the year, together with additional information necessary to ensure that the Board has taken account of all significant aspects of internal control.

The control functions should be subject to periodic review either by the internal audit function (for control functions other than internal audit) or an objective external reviewer.

RISK MANAGEMENT AND INTERNAL CONTROLS QUESTIONNAIRE

The Authority will closely monitor the insurer's adherence to best practices of risk management and internal controls. The Own-Risk Survey to be completed by each insurer will be used as part of the Authority's off-site monitoring process. It is the intention of the Authority to review the documentation and processes which formed the basis of the responses to the survey.

COMMENCEMENT

This Guidance Note shall come into effect this 7th day of October, 2021.

Issued by:

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