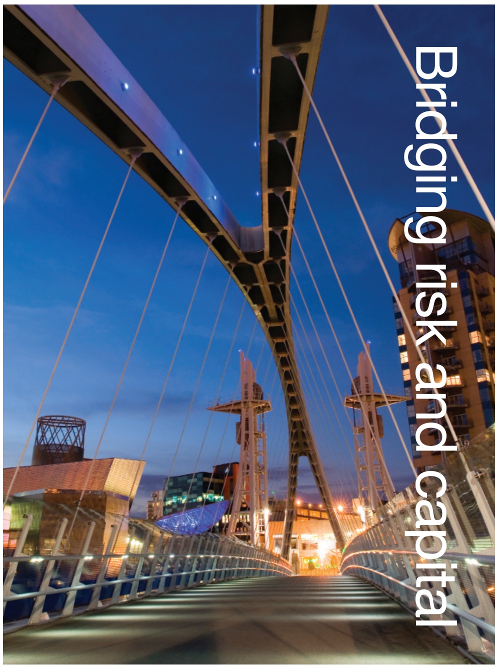
Minimum requirements on risk management of insurers (MaRisk VA) published: German insurers gain transparency on BaFin's expectations



With the amendment of the Insurance Supervisory Act (9th amendment in 2007) and the publication of the MaRisk VA in January 2009, Germany is already anticipating the implementation of the qualitative Pillar 2 requirements of the future Solvency II regime. The main consequences of the MaRisk VA are, firstly the convergence of the requirements with the banking regulation, and secondly, the effective monitoring and control of business processes; a risk-oriented cycle of monitoring, control and management of risks; increased documentation requirements; and the formalisation of the internal audit function.

On 22 January 2009, the German regulator, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) published its MaRisk VA circular on supervisory requirements for risk management of insurers (Rundschreiben über die aufsichtsrechtlichen Mindestanforderungen an das Risikomanagement von Versicherern, MaRisk VA). The circular provides a consistent basis and, to BaFin, a binding interpretation of the regulations in sections 64a and 104s of the German Insurance Supervisory Act which prescribe the adoption of appropriate risk management systems by insurers and predominantly insurance-focused financial conglomerates.

With the MaRisk VA, BaFin is aiming to clarify its expectations, laying the foundations for the consistent application of the rules by all German insurers. After an extensive consultation period, insurers are now fully aware of what needs to be done to bring their risk management systems up to the required standard. BaFin's requirements clearly anticipate the future risk-oriented Solvency II Pillar 2 regime but also stress the urgency of adopting economic approach to risk assessment.

The BaFin considers that effective risk management is essential for ensuring policyholder protection.

Holistic approach of MaRisk VA

Risk strategy defines strategic framework

- Consistency with business strategy, taking into consideration all business areas and all business risks
- Definition of objectives: risk categories, risk tolerance, source of risks, time horizon and risk-bearing capacity
- Analysis of effects and consequences on the operational business
- Adjustments depending on changes on the total risk-profile (to be reviewed at least once a year)
- "Strategy-audits"
- Reporting to supervisory board and discussion with the supervisory board

Appropriate organisational and operational framework

Organisational structure

- Clear segregation of duties
- Comprehensive oversight and responsibilities
- Organisational framework

Operational structure

- Business processes with significant inherent risks
- New business areas and new products
- Compensation/incentives and resource allocation
- Business development

Internal system of management and control

Concept of risk-bearing capacity

Consistent system of limits for limitation of risks

Risk-control process

- Integration in the management of the business
- Identification > analysis/ valuation > management and control > reporting

Risk reporting and internal communication

Quality assurance

Internal audit function

Internal control

Holistic approach of MaRisk VA

BaFin believes that the MaRisk VA requirements need be seen as a holistic approach driving the more effective oversight and control of business processes through a risk-oriented cycle of monitoring, control and management of insurers' risks. The circular underlines that, when using economic measures such as risk bearing capacity or calculation of technical reserves, insurers are obliged to assess whether internal functions and processes faciliate a significant improvement of the current risk management approach. All stakeholders should focus on how the assessment and design of their risk management systems can be improved, quantitatively, qualitatively and operationally.

Risk-strategy sets the strategic boundaries

Senior management has to define the risk strategy for individual business lines consistently with its overall business strategy. The resulting, granular risk strategy defines the strategic framework for the risk management approach. This risk strategy must not be determined statically: senior management needs to reassess it continuously and particularly when market conditions or specific risk profiles change significantly. Changes in the insurer's risk profile should lead to appropriate adjustments in the risk management framework. This continuous reassessment has to be both quantitative and qualitative in nature. In terms of the latter, the "strategy audit" should encompass consulting the internal audit function or the supervisory board, for example.

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Who is subject to MaRisk (VA)?

- Direct- and reinsurance undertakings with registered office in Germany including their national and foreign branches in the European Union and the European Economic Area
- Pension funds
- Insurance undertakings according to section 105 VAG
- Reinsurance undertakings according to section 121i VAG
- Insurance undertakings according to section 110d VAG
- Insurance holdings companies being parent to an insurance group according to section 1b Abs. 1 VAG
- Mixed financial holding companies according to section 104q Abs. 3 Satz 8 VAG

Appropriate organisational framework

Essentially, the segregation of incompatible duties and functions must be effected all the way up to the management board. This requires, for example, the segregation of duties for operational risk management and for risk control up to that level.

The operational structure must be clearly defined, covering all business processes with significant inherent risks, for example:

- Insurance business
- Calculation of technical reserves
- Asset management (including asset-liability management)
- Management of retrocession/reinsurance

The compensation system, and the reward of financial, personnel, material and technical resources, needs to be aligned with the objectives laid down in the business and the risk strategy. To encourage an open dialogue on risk, and indeed a risk culture, MaRisk VA advocates internal guidelines on informational requirements.

Internal system of management and control

Based on each business's overall risk profile, and the assessment of the insurers' risk-bearing capacity, the insurer's ability to cover all material risks must be determined. This exercise provides the basis for breaking down and allocating risk limits in relation to the most important business processes (and their risks). This allocation needs to be consistent with the business strategy and the risk strategy.

A comprehensive risk identification and assessment exercise, considering all risks inherent in relevant business processes, underpins the risk control process. This is followed by a preliminary, qualitative classification of risks on the basis of the insurer's individual defined standard ("reference scale"). Subsequently, all material risks need to be quantified using prescribed, fully-documented valuation standards (potential loss, probability of loss occurrence and correlation).

The management of identified risks, as well as the continuous surveillance for emerging risks by the risk control function, constitute additional elements of the internal system of management and control. The quality of the implemented processes needs to be reassessed continuously using a validation process.

Internal audit function

A well-functioning internal audit function plays a central role as an independent monitoring function and forms an essential component of an appropriate business organisation. For the first time in German insurance regulation, the MaRisk VA defines obligatory requirements on the organisation and the work of insurers' internal audit functions.

Internal control

The requirement to implement an internal control structure appropriate to the individual risks aims to guarantee the well-functioning of all components of the risk management system. The circular prescribes an assessment of the effectiveness of these controls at least once a year, as well as the assessment and prompt rectification of any identified control weaknesses.

Further information:

- Internetlink to (German PwC-site): "4. MaRisk (VA) Newsletter"
- Internetlink to (German PwC-site): "MaRisk für Versicherungen: Chancen auf dem Weg zu Solvency II"
- Internetlink to (German PwC-site): "Solvency II auf der Zielgeraden"
- Internetlink to (global PwC-site): "Countdown to Solvency II: Bridging risk and capital – December 2008 (4. Edition)"

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