

RISK MANAGEMENT GUIDELINES
FOR
INSURANCE COMPANY, 2076



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TABLE OF CONTENTS

1. PRELIMINARY.....	3
2. OVERVIEW.....	3
3. OBJECTIVES	3
4. THE DIMENSIONS OF RISK MANAGEMENT.....	4
5. RISK MANAGEMENT FRAMEWORK.....	7
6. THE MANAGEMENT OF INSURANCE RISK	12
7. THE MANAGEMENT OF CREDIT RISK.....	25
8. THE MANAGEMENT OF LIQUIDITY RISK.....	26
9. THE MANAGEMENT OF MARKET RISK	27
10. THE MANAGEMENT OF OPERATIONAL RISK	28
11. ENFORCEMENT.....	31

1. PRELIMINARY

This "Risk Management Guidelines for Insurance Company, 2076" has been issued by Beema Samiti, in exercise of the power conferred to it by Section 8D of the Insurance Act, 2049 to insurance company in order to provide guidelines on principles related to risk management and to ensure effective management of possible risks faced by the insurance company. The Risk Management Guidelines 2076 applies to all licensed insurance company including reinsurance company operating in the Nepali insurance industry.

2. OVERVIEW

In general terms, risk management is the assessment and quantification of the likelihood and financial impact of events that may occur in the customer's world that require settlement by the insurance company; and the ability to spread the risk of these events occurring across other insurance underwriters in the market. Risk management involves managing to achieve appropriate balance between realizing opportunities for gains while minimizing losses. Risk management work typically involves the application of mathematical and statistical modelling to determine appropriate premium cover and the value of insurance risk.

Beema Samiti requires insurance company to have, as part of its overall corporate governance framework, effective systems of risk management. This guideline has been prepared taking into consideration the international practices and the guidance provided by The International Association of Insurance Supervisors (IAIS). The guideline does not replace the existing regulations and guidelines. It is not intended to be so comprehensive that it covers each and every aspect of risk management activity but it provides minimum standard for the risk management to be met by insurance company. The insurance company may establish a more comprehensive and sophisticated framework than that outlined in the guideline. This is entirely acceptable as long as all essential elements of the guideline are fully taken into account.

3. OBJECTIVES

The objective of this guideline is to ensure that insurance company 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. The objectives of issuing this guideline are:

- 3.1 To ensure that an insurance company are run and managed in sound and prudent manner.
- 3.2 To ensure that an insurance company have the system for identifying, assessing, monitoring and mitigating risks.
- 3.3 To ensure that an insurance company have in place the policy and procedures for managing risks.
- 3.4 To ensure that the board and top level management are responsible for managing risks.

4. THE DIMENSIONS OF RISK MANAGEMENT

4.1 Importance of Risk Management

Taking risk is an integral part of financial intermediation and insurance business. However, failure to adequately assess and manage risks may lead to losses endangering the soundness of individual insurance company and affecting the stability of the overall financial system. Weak risk management is often identified along with weak internal governance as an underlying cause of insurance company' failure. There is a strong link between good corporate governance and sound risk management. It is an essential part of helping the insurance company to grow and promote sustainability and resilience.

The setting of an appropriate risk strategy and risk appetite/ tolerance levels, a holistic risk management approach and effective reporting lines to the management and supervisory functions, enable insurance company to take risks knowingly and treat risks where appropriate.

4.2 Risk Culture

A sound and consistent risk culture throughout an insurance company is a key element of effective risk management. Every insurance company shall develop an integrated and institution-wide risk culture, based on a full understanding of the risks it faces and how they are managed, considering risk appetite and tolerance.

The risk culture of an insurance company shall be developed through policies, communication, training of staff regarding their responsibilities for risk, and

examples of appropriate risk behavior. Risk culture and its impact on effective risk management shall be a major concern for the board of directors and senior management. A sound risk culture should encourage effective risk management, promote sound risk-taking and ensure that risk-taking activities beyond the insurance company's risk appetite are recognized, assessed, reported, and addressed in a timely manner.

The Board of insurance company shall be responsible for achieving desired risk culture. The risk culture can be strengthened through:

- Creating a healthy and congenial environment which encourages employees to raise the issue when observing new or excessive risks
- Clarifying the range of acceptable risks using a risk appetite statement and various forms of communication and training;
- Matching incentives with objectives and clarifying how breaches in policies/procedures will be addressed.

4.3 Risk Capacity, Risk Appetite and Risk Tolerance

Risk capacity is the maximum amount of risk an insurance company is able to bear considering its available financial resources. Risk appetite describes the absolute risks an insurance company is open to take *a priori*, considering its exposures and business activities, its business objectives and its obligations to stakeholders.

Risk tolerance relates to the maximum amount of risks an insurance company is ready to tolerate above its risk appetite. Risk tolerance shall be based on the use of series of risk limits and indicators that serve as early warning mechanisms to alert management of threats to strategy and objectives.

4.4 Risk Governance and Organization

Risk governance refers to the structure, rules, processes, and mechanisms by which decisions about risks are taken and implemented. It covers the questions about what risk management responsibilities lie at what levels and the ways the board influences risk-related decisions; and the role, structure, and staffing of risk organization. Risk governance should follow the three-lines-of-defense-model.

4.4.1 The first line of defense provides that the business and operation units of the institution have in place effective processes to identify, assess, measure, monitor, mitigate, and report on their risks.

4.4.2 The second line of defense relates to the appropriate Internal Control framework put in place to ensure effective and efficient operations, including the following;

- Adequate control of risks;
- Prudent conduct of business;
- Reliability of financial and non-financial information reported or disclosed (both internally and externally);
- Compliance with laws, regulations, supervisory requirements, and the institution's internal policies and procedures.

4.4.3 The third line of defense consists of the insurance company's internal audit which performs independent periodic reviews of the first two lines of defense, provides assurance and informs the two first lines of strengths and potential weaknesses.

4.5 Risk Assessment

Risk assessment is the overall process of risk identification, analysis, and evaluation. Risk identification is the starting point for identifying the nature, sources and cost of risk, areas of impacts, events, causes, and potential consequences. Attention should be given not only to existing risks but also to those arising from new activities.

Risk analysis involves developing and understanding of the risk that will help make the decisions most appropriate for risk treatment. Risk analysis involves measuring risk by considering consequences of an unfavorable event and likelihood of such event occurring. Factors that affect consequences and likelihood shall also be identified.

Risk evaluation helps in making decisions, based on the outcomes of the risk analysis, in particular to inform senior management. It mainly involves comparing the level of risk found during the analysis process with the insurance company's risk appetite, risk tolerance and regulatory limits.

4.6. Risk Treatment

After the risks are assessed, insurance company shall choose the best option to eliminate or mitigate unacceptable risks. Risk treatment options are not necessarily mutually exclusive or appropriate in all circumstances. Options could be to:

- Avoiding the risk by deciding not to start or continue with the activity that gives rise to the risk.
- Accepting and retaining the risk by making informed decision and having plans for managing and funding the consequences of the risk if it occurs.
- Reducing the likelihood of the risk through staff training, changing procedures, or by reducing the impact through diversifying credit portfolio, setting up off-site data backup etc.

4.7. Risk Control and Monitoring

The most important ways for insurance company to address risks is to put in place adequate risk control mechanisms: establishment and communication of risk limits through policies, standards and procedures that define responsibilities and authority. It also helps the concerned parties know when the risk becomes unacceptable and align their actions and behaviors with the insurance company's set risk appetite, risk tolerance and strategy. The Insurance company's monitoring and review processes should encompass all aspects of risk management process for the purposes of:

- Detection of changing risk sources and factors within and outside the institution,
- Obtaining further information to improve risk assessment,
- Ensuring that controls are effective and efficient in both design and operation,
- Analyzing and learning lessons from events, trends etc., and
- Identifying emerging risks.

5. RISK MANAGEMENT FRAMEWORK

The risk management framework outlines the stepwise guidelines which an insurance company should follow in order to address the risks associated with its fundamental business actions.

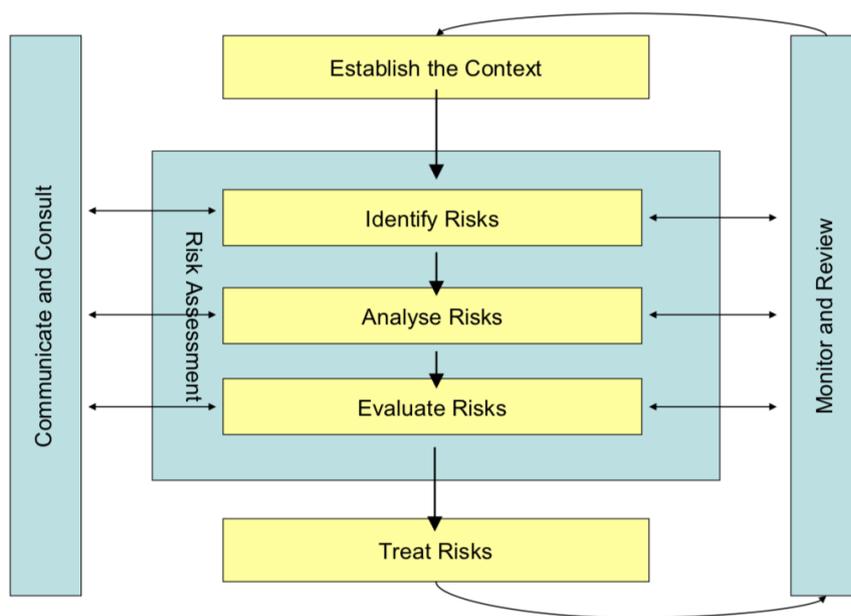


Figure 1: Risk Management Framework

5.1. Establish the Context

The foremost step in risk management is to ensure that the key objectives are clarified to certify there is a common understanding of what the risk management is aiming to achieve. There are several issues to consider in establishing the risk management context which are legislation, standards and policies, stakeholders to be impacted and specialist professional or other relevant knowledge. This provides a resilient basis for the identification of the risks.

5.2. Risk Identification

The risk management framework should require routine identification of all reasonably foreseeable and relevant material risks and risk interdependencies for risk management as appropriate to the authorized insurance company. An insurance company must have effective indicators to point out the risks generated while performing its principle activities. For instance, risk indicators should act as a whistleblower against relevant and material risks such as liquidity risk, operational risk, emerging risk, market risk and so on.

5.3. Risk Analysis/Quantification

An authorized insurance company should have sophisticated policies and procedures on risk analysis or quantification. It should assess the level of risks on a sufficiently regular basis, in terms of the potential impact and the probability of occurrence, using appropriate forward-looking techniques. Risk quantification is fundamental for measuring and explaining the nature, scale, severity and complexity of the relevant risks. A simple qualitative approach might involve classifying risks along these lines:

Illustration 1

Risk Rating		
Risk Level	Risk	
0	Very Low	No risk
1	Low	Minimal risk
2	Moderate	Moderate
3	High	Significant
4	Extreme	Very Significant

Illustration 2

Risk Summary		
Risk Type	Risk Scores	Area of Concern
Solvency		
Financial Performance		
Insurance (Claim and Reserving)		
Insurance (Pricing/Underwriting)		
Insurance (Reinsurance)		
Credit		
Liquidity		
Market		
Operational		
Strategic		
Legal and regulatory		

5.4. Risk Evaluation

The risks identified and measured must be compared against the insurance company risk classification benchmarks to decide on the importance to be assigned to address each of the risks and hence, provide appropriate responses. The primary objective of evaluating risks is to make decisions on which risks need treatment and the priority for treatment.

5.5. Treatment/Mitigation

Insurance company should formulate and implement necessary procedures to control and mitigate the identified risks. Risk treatment involves a cyclical process of assessing current controls, deciding whether the residual risk levels are tolerable, generating a new risk treatment (if not tolerable) and assessing the effectiveness of that treatment. The type and level of risk treatment will depend on the significance of the risk and its impact on the procurement objectives. The actions can be considered as a directive for accepting or retaining the risk, avoiding the risk, transferring the risk, exploit the risk and reducing the consequences and/or likelihood of occurrence. Also, risk treatment measures include setting appropriate standards and limits to the insurance core activities.

5.6. Monitor and Review

Insurance company need to monitor the risks through effective monitoring system and the effectiveness of treatments throughout the application of insurance procurement or core activities. The nature of risk can change throughout the course of the procurement and it is likely that the risk management process may need to be repeated or revised to ensure appropriate action is taken. Proper monitoring helps to ensure that risk standards and limits are complied with as intended and any deviation is duly approved and documented.

5.7. Communication and Consultation

Suitable communication and consultation with internal (within insurance company) and external stakeholders (e.g. regulator, relevant ministries) throughout the risk management process promotes a common understanding of stakeholder interests, risks identified and the process for managing them. A consultative approach with stakeholders will bring together different areas of expertise in the risk management process. For instance, appointed actuary (recommended as per Life Insurance Actuarial Valuation Directive 2076) could be consulted for confirming the validity of advice from the appointed actuary.

5.8. Active Board of Director and Senior Management Oversight

The introduction of risk management and ensuring its ongoing effectiveness shall come from the top level of the insurance company. As the board of directors has been

entrusted with the ultimate responsibility for the risks taken by the insurance company, it shall define the risk appetite and risk tolerance, and set risk strategies. It is responsible for understanding the nature of risks significant to the institution and for ensuring that management is taking necessary steps to implement those strategies and manage accompanying risks.

While the overall responsibility for risk management is recognized to rest with the board of directors, it is the duty of senior management to transform the strategies into appropriate operational policies, procedures, and processes for effective risk management. Top management shall be aware of the insurance company's risk profile on an ongoing basis and shall regularly report it to the board or a board level committee for review.

5.9. Risk Management Function and Committees

Insurance company must have an independent risk management department. As necessary, it may have separate risk management divisions or units within the risk department for overseeing each key risk area. The main functions of the department/units include the following:

- managing the process for developing risk policies and procedures,
- coordinating with business users to prepare functional specifications,
- preparing and forwarding risk reports, and
- assisting in the implementation of all aspects of the risk function.

The Insurance company must have risk management committee pursuant to Section 14 (2) b of the Corporate Governance Directive 2075 issued by Beema Samiti. Depending upon the size and complexity of the insurance company, other committees and subcommittees may be set up for monitoring and controlling risks.

Policies and Procedures

The board of directors and senior management must formulate and implement risk management policies and procedures to deal with various risks that arise from the insurance company's business and operational activities. The Insurance company's policies and more detailed procedures should provide guidance for the day-to-day

implementation of broad risk strategies, and generally should include limits designed to shield the institution from imprudent and unwarranted risks. The management body should review risk policies, procedures, and limits in a timely manner and update them when necessary. Further, independent assurance from internal audit about the efficacy of these policies should also be obtained.

5.10. Management Information System (MIS)

Effective MIS is necessary for adequate risk monitoring and reporting. When MIS can generate key risk indicators in the form of accessible reports in a timely manner, then risk managers can monitor the risk levels continuously and inform senior management and board as necessary or as required. The MIS should be able to produce reports in accordance with regulatory requirements. In addition to regular reporting, there should be a system to address any exceptions observed. Further, there should be an explicit procedure regarding measures to be taken to address such deviations.

6. THE MANAGEMENT OF INSURANCE RISK

6.1. Overview of Insurance Risk

Insurance risk relates to the likelihood that an insured event will occur, requiring the insurance company to pay a claim, beyond either its original expectation during the pricing of the insurance product, or its risk appetite, such as in the case of natural catastrophes. Some insured events have a much lower insurance risk than others. For example, the expected claim experience from household insurance is more predictable, and thus less risky, than the expected claim payment on single insured risks such as commercial buildings. Similarly, claims with more measurable losses are less risky. For example, the damage to a motor vehicle under an auto insurance is more measurable (and thus less risky) than the medical cost or other liability amount incurred during the same auto accident. Claims that are likely to be paid over a long period of time (such as those resulting from professional indemnity insurance) is riskier than personal accident insurance. In case of life insurance, critical illness rider is riskier than endowment insurance. The relative risks are reflected in varying levels of capital which the insurance company needs to hold. The higher the risk, the greater amount of capital is required to support those risks.

Insurance risks may arise from any of the core activities of an insurance operation: pricing, underwriting, claims handling, and reinsurance.

6.2. Organization Structure

Insurance company should adopt a risk management structure that is commensurate with their size and the nature of their activities. The organizational structure should reflect effective management oversight and execution of risk management and control processes. The Board of Directors is ultimately responsible for the sound and prudent management of an insurance company. The Board shall approve the risk management strategy and risk policies pertaining to core activities that give rise to insurance risk. It should ensure that adequate resources, expertise and support are provided for the effective implementation of the entity's insurance risk management strategy, policies and procedures.

6.3. Strategies, Policies and Procedures

Insurance company shall have a sound strategy to manage risks arising from its insurance activities. Based on its risk profile, an Insurance company shall establish an appropriate insurance risk management strategy, considering the board established risk appetite including internal and regulatory solvency requirements. It shall determine its risk tolerance, considering its business objectives and available resources. The entity shall periodically review its insurance risk management strategy taking into account its own financial performance, changes to its operations or business objectives, and market developments. The strategy shall be properly documented and effectively communicated to all relevant staff.

Risk policies shall set out the conditions and guidelines for the identification, acceptance, monitoring and management of insurance risks. These policies should be helping to explain the relationship of the risk management system to the entity's overall governance framework and to its corporate culture. The policies shall, at a minimum, cover the following:

- the identification, measurement and communication of key risks to the Board;
- amount of risk that insurance company is able to take, and the frequency of review of risk limits;

- the roles and responsibilities of the respective units and staff involved in acceptance, monitoring and management of insurance risks;
- the principles and criteria relating to pricing, underwriting, claims handling and reinsurance management, as well as the approval structure relating to these activities including authority to approve deviations and exceptions; and
- the management of concentration risk and exposures to catastrophic events, including limits, reinsurance, portfolio monitoring and stress testing.

Insurance company shall establish appropriate procedures and processes to implement its insurance risk policies in the form of controls, checks and monitoring mechanisms. These shall be documented and set out in sufficient details to provide operational guidance to staff. These procedures shall be periodically reviewed and updated to take into account new activities, changes in systems and structural changes in the market.

Insurance company shall have in place proper and effective reporting systems to satisfy the requirements of the Board with respect to reporting frequency, level of detail, usefulness of information and recommendations to address issues of concern. The head of risk management function shall have the authority and obligation to inform the Board promptly of any circumstance that may have a material effect on the risk management system of the entity.

6.4. PRODUCT DEVELOPMENT

Product development is the process of working out the features of a product to be marketed to customers in accordance with the insurance company' business objectives. This includes enhancements or variations to existing products. The product development process generally involves conducting environment scans, understanding customers' needs, developing and refining proposals, obtaining the requisite approvals, implementing the approved proposals and conducting post-implementation reviews.

6.4.1. Risk Identification and Measurement

The insurance company should analyze the information collected to identify emerging trends, and the associated opportunities and threats they may pose to

the insurance company' business. The insurance company should document its analysis of the potential influence of the market environment and emerging trends on the level of risks and profitability of the product being developed.

6.4.2. Risk Control and Mitigation

The insurance company should verify that the proposed product is consistent with their risk strategy and policies. It should also scrutinize assumptions made in product proposals about likely consumer behavior and market reactions and verify these assumptions where appropriate.

The insurance company should ensure that the premium and compensation structure for intermediaries are consistent between products of similar features/duration and distribution channels so as to minimize possible lapse and re-entry or churning, and channel conflicts. This is particularly relevant for life insurance business.

The insurance company should ensure that the product proposals include the following information to assist the Board or senior management in making informed decisions:

- scope and level of coverage proposed for the product including options and guarantees, if any;
- risk exposure limits (which can be defined by premiums, sum insured, probable maximum loss or other risk measures and may also include interim limits to manage new product growth);
- reinsurance protection;
- pricing methodology;
- delegation of authority for underwriting and claims;
- underwriting and claims assessment criteria;
- investment strategy;
- projection of sales, expenses, profitability and solvency under different scenarios to test the sensitivity of results to different operating conditions. For example, life insurance products often contain guarantees, particularly on investment performance, which can significantly add to the risks written;
- distribution method; and

- ability of existing or proposed administrative systems and processes to handle the new or enhanced product.

The insurance company should ensure that the potential risks identified are adequately addressed under a risk management framework that would cover the key issues when introducing a new product, such as clarity of contract wordings, accuracy and transparency of promotional materials, skills and expertise of the distribution channels, etc. Where such a framework is not in place, the insurance company should ensure that the product proposal itself has adequately addressed the relevant risks identified.

The insurance company should ensure that there is proper documentation of the detailed product proposal, the product approval authority levels, the decisions made by the authorized personnel or committee as well as the rationale and follow-up actions. In particular, when a decision has been made by the appropriate approval authority to accept a proposal which does not meet the risk tolerance or profit objectives of the insurance company, the approval and rationale for such a decision should be clearly documented.

The insurance company should have clearly articulated procedures for withdrawal and re-pricing of existing products when pre-determined criteria are triggered, such as when it is no longer economically viable to sell the product.

6.4.3. Risk Monitoring and Review

The insurance company should put in place a structure setting out the reporting lines and roles of business units and personnel involved, and procedures and risk indicators to monitor the product implementation and performance after its launch.

These may include:

- comparing between key performance indicators and business plan, and actual versus expected results;
- monitoring adherence to the insurance company' policies and procedures as well as regulatory requirements;
- monitoring changes in risk profiles and analyzing loss experience (particularly large and catastrophic losses);

- monitoring changes in policyholder's behavior leading to higher lapse rates or deteriorating claims experience; for example, prolonged economic recession causing more policyholders to lapse/surrender their life insurance policies or to submit fraudulent property related claims;
- monitoring changes in the investment and economic environment which may affect the performance of the portfolio;
- monitoring the number and nature of complaints;
- monitoring changes in tax, regulatory reserving and capital requirements; and
- conducting internal audit reviews and actuarial reviews.

6.5. PRICING

The pricing of an insurance product involves the estimation of claims, operational and financing costs and the income arising from investing the premium received. The pricing process typically comprises collecting data on the underlying risks to be covered, determining the pricing assumptions and the base rate, setting the final premium rate, and monitoring the review of the appropriateness of pricing.

6.5.1. Risk Identification and Measurement

Insurance company shall identify the probable scenarios which may lead to its revenue from premiums and investment income being insufficient to meet the payment of anticipated benefits and expenses.

The Insurance company shall pay particular attention to any inconsistency between related assumptions (such as investment return and inflation), and inconsistent pricing of different products that share relatively similar features.

6.5.2. Risk Control and Mitigation

Insurance company shall collect adequate data to validate the reasonableness of the underlying assumptions used for pricing. The base rate shall represent the amount required to meet the value of anticipated benefits, expenses, and margins for risks and profit. Data should primarily relate to the insurance company own historical experience and that of the industry where relevant. These may be supplemented by other internal and external data, and could include trends observed in claims costs and expenses.

Pricing shall be done by modelling all identified risks, using appropriate methodologies depending on the complexity of the risks and available data. There should be adequate buffers in the premiums to cushion against the risk that actual experience may turn out to be worse than expected.

There shall be clear documentation that the base rate has been approved at the requisite level of authority. The premium rate that the entity eventually charges may be different from the approved base rate after taking into account market and competitive considerations, in which case, appropriate authorization shall be obtained and documented.

6.5.3. Risk Monitoring and Review

Insurance company shall analyze the profit and loss of their business. There shall be procedures to monitoring emerging trends and risk indicators to trigger a pricing review. For example, a trigger may be based on an experience analysis which shows that the key risk driver for a product has deviated significantly from its pricing assumptions. Insurance company shall involve actuaries approved by Beema Samiti for the evaluation and provision of advice on product pricing and development matters.

6.6. UNDERWRITING

Underwriting is the process by which an Insurance company makes an assessment of the risks to be accepted and determines the terms on which the risks would be acceptable. The underwriting process generally involves obtaining and managing essential underwriting information on the risks, assessing and accepting risks according to underwriting guidelines and authority levels, and monitoring and reviewing the risks accepted. The entity shall involve actuaries in the evaluation and provision of advice on underwriting matters.

6.6.1. Risk Identification and Measurement

Insurance company shall consider the implications associated with selecting, accepting and retaining risks which may deviate from what was envisaged during the pricing stage. Such risks may include:

- accepting risks without imposing adequate loading or conditions; accepting risks which should have been declined given the risk tolerance;
- accepting nonhomogeneous risks under the same risk category;
- inadequate reinsurance protection or inconsistencies between the terms offered under the direct policies and that under the reinsurance outward contracts.

6.6.2. Risk Control and Mitigation

Insurance company shall regularly review the proposal or application form to ensure that the proposal form (which is the main source of underwriting information) remain clear and pertinent.

Insurance company shall have an efficient insurance information system in place that links all key information on underwriting, claims and reinsurance. It shall ensure that the information captured, including the rationale for the underwriting decision, is up-to-date and accurate to facilitate monitoring of the progress of the underwriting process and validating the quality of the underwriting decision.

There shall be clearly documented underwriting guidelines approved by the Board for each of the key types of benefits or products it underwrites so as to provide sufficient guidance to the underwriters. Any significant deviation of the underwriting decision from the guidelines shall be duly approved and the rationale for approval properly documented. No risks shall be accepted before the necessary reinsurance protection is finalized and effected.

6.6.3. Risk Monitoring and Review

Insurance company shall conduct regular reviews to ensure that the underwriters continue to be competent in the area of their delegated authority and the quality of the underwriting decisions made remains satisfactory.

There shall be a systemic method to monitor its accumulation of risks across product types and geographical areas so that the overall risks underwritten are within its reinsurance protection limits and risk appetite.

Insurance company shall conduct audits or checks of underwriting files regularly and monitor risk indicators, such as claims experience or number of complaints relating to underwriting decisions made or the timeliness of the decisions.

6.7. CLAIMS HANDLING

Claims handling is the process by which an insurance company processes and pays claims in accordance to the terms and conditions specified in the insurance contracts. The process generally comprises registering new claims, selecting the surveyor, setting and revising reserves, obtaining essential information to assess, manage and settle the claim, making reinsurance and other recoveries, and reviewing and closing claim files.

6.7.1. Risk Identification and Measurement

An insurance company shall put in place measures to identify the risks associated with poor claims handling and case reserving, which may include:

- making claim settlement decisions which are not in accordance with the policy terms and conditions, thereby either incurring liability that is not considered in the pricing or failing to fulfill its contractual obligations to policyholders;
- inefficient handling of claims leading to slow responses or higher cost overheads, thereby impeding its market competitiveness; and
- setting inadequate reserves or delay in revising case reserves for reported claims resulting in under provision of claims liabilities and time lag in adjusting premiums for new policies.

6.7.2. Risk Control and Mitigation

An insurance company shall have a clear process in place for the notification of claims, which ensure that all claims are reported at the earliest opportunity and that relevant information is captured in its information system in a timely manner.

Insurance company shall review the claims form regularly to ensure that questions remain clear, unambiguous and pertinent to enable the claims staff to form an accurate assessment of the validity of the claim.

Insurance company shall have clearly documented claims handling guidelines for each of the key types of claims to provide sufficient guidance to the claims staff, covering the documents required for verifying the claim, references to warranties or restrictions imposed at acceptance, method for calculating the settlement amount, settlement options, and policies on large or ex-gratia claims. There shall also be clear guidelines on when claims should be referred to the reinsurer or other parties such as lawyers for claims support or decision. The claims handling guidelines shall be regularly reviewed.

Insurance company shall set case reserves accurately for each claim in a timely manner. The components of case reserves shall be captured in sufficient details to provide useful statistics for in-depth analysis.

6.7.3. Risk Monitoring and Review

Insurance company shall conduct regular reviews to ensure that the surveyors are competent in their area of delegated authority and quality of the claims decisions remains satisfactory. It shall monitor whether the authority for granting ex-gratia payment is exercised appropriately and review the appropriateness of the limits regularly.

Insurance company shall conduct reviews of claim files regularly. There shall be a systematic way to identify files for review and clear guidelines for follow-up actions and closure of files. Insurance company shall have in place regular claims reporting to senior management to raise awareness of key claim exposures and losses, especially where a single claim, loss event or series of losses could in aggregate have an impact on its balance sheet.

6.8. REINSURANCE

Reinsurance is an arrangement where a portion of the risks assumed by a direct insurance entity is ceded to other insurance entities. The mechanisms to transfer risks include traditional reinsurance and other alternative risk transfer approaches,

such as catastrophe bonds and securitization. The insurer must specifically demonstrate that material and catastrophic risks are appropriately covered by reinsurance treaties and facultative arrangements. This forms part of insurance risk.

6.8.1. Risk Identification and Measurement

An insurance company shall analyze their risk profile to decide what and how much risks are to be retained, taking into consideration their risk appetite and the availability and cost of reinsurance. They should also be mindful of possible gaps in the reinsurance program, resulting in more risks being retained than intended.

Another potential material risk is the risk that the reinsurance contract wording does not accurately reflect the intent for the reinsurance cover, or the contract is not legally enforceable. Insurance company may also face credit risk arising from potential defaults by its reinsurers. In addition, they are exposed to liquidity risk in the event of large losses whereby they may have to pay the claims prior to receiving all the reinsurance recoverable.

6.8.2. Risk Control and Mitigation

In designing the reinsurance program, Insurance company shall take into account relevant factors including business plans and strategies; underwriting philosophy and capabilities; size and profile of each line of business; frequency and size of loss by line of business; geographical distribution of the business; and financial strength.

Insurance company shall ensure that their reinsurance contracts cover all applicable lines of business and the limits of cover are adequate. They shall assess the impact of likely adverse events through stress testing and realistic disaster scenario analysis to ensure that their catastrophe reinsurance cover can be relied upon to reduce the impact of most conceivable calamities to a magnitude that will not threaten their viability. Insurance company shall put in place appropriate systems and processes to facilitate achieving contract certainty.

The reinsurance management policy and procedures shall spell out clear criteria for the selection of reinsurers and outline the information that is required to assess the financial soundness of a reinsurer.

6.8.3. Risk Monitoring and Review

Insurance company shall monitor that only reinsurers as per reinsurance directive issued by Beema Samiti are used and track aggregate exposures to individual reinsurers or groups of related reinsurers against established exposure limits. They shall monitor the outstanding balances from their reinsurance counterparties and the credit standing of the reinsurers on their panel on an ongoing basis. Insurance company shall review whether their reinsurance program has, over a period of time, supported their business objectives and strategies, and helped to mitigate their losses to within their risk tolerance level.

6.9. RESERVING

An insurance company should adequately make a provision for technical reserves. Technical reserves in non-life insurance company consists of unexpired risk reserve, outstanding claim reserve and reserve for incurred but not reported claims. In life insurance company, unexpired risk reserve is created for term insurance policies of which no benefits are paid on expiry of term. Further, a life fund is created as per valuation report for the policyholder's liability. Further, outstanding claim reserve is provided for the payables to policyholder.

6.9.1. Risk Identification and Measurement

The appropriate valuation of insurance liabilities is one of the most important issues facing an insurance company and its Board. Reserving is important for the financial soundness of the insurance company, and ultimately for the protection of policyholders. The insurance company shall be required to value insurance liabilities in a realistic and consistent manner. The insurance company shall be required to consider the following while reserving:

- the nature of risk and risk distribution (probability) of claims data;
- particular characteristics of the class of business;

- reliability and volume of available claims data (data quality framework);
- past experience of the insurance company and the industry;
- robustness of the valuation's models and its assumptions (using assumption setting control cycle); and
- Materiality of the risk post quantification.

In addition, the insurance company must adopt the directives, circulars, guidelines and other forms of secondary legislations issued by the relevant authority in regard to Valuation of Technical Liabilities.

6.9.2. Risk Control and mitigation

In general terms, reserves are calculated as the present value of expected future outflows for claims and related expenses, less the present value of expected future inflows from premiums in respect of the related period of insurance coverage. The primary objective when establishing reserves is to ensure that they adequately recognize the extent of the insurance company' obligations to policyholders. If not, and the technical provisions proved to be inadequate, the insurance company could eventually find itself with insufficient assets to meet its obligations and thus become insolvent. It is also desirable that the reserves are fairly realistic estimates of the potential obligations. This will facilitate analysis of the insurance company' balance sheet and trends in its profitability.

Insurance company must select appropriate methods for valuing the various types of obligations. They should establish assumptions for the parameters that will affect the value of the obligations. Economic, demographic, and business conditions change over time, and information becomes available about the experience of the business that has been underwritten. Therefore, the assumptions used in calculating reserves often differ from those used in the pricing process and may change over time. Insurance company must ensure that the policy and claims data used in the calculations is as complete and accurate as possible. They prepare models that incorporate the methods and assumptions they have selected and apply these models to the data to calculate the reserves.

Insurance company should also test the sensitivity of reserves to changes in the assumptions, to ensure that the provisions will be adequate even if future experience differs somewhat from the assumptions. The results of this testing may show a need to modify the methods or assumptions. Pooling the risk is another way. For instance, aviation insurance may be jointly done by more than one company. In addition, terrorism insurance and foreign employment term is done by pooling arrangement so as to share the loss in an equitable way among several insurance company.

6.9.3. Risk Monitoring and Review

An Insurance company must be guided by the solvency margin directive issued by Beema Samiti to ensure the availability of appropriate type and level of reserves. Reserves must be maintained as per normal contingent business situations and unexpected catastrophic events. Sensitivity, scenario and stress testing of reserves should be conducted periodically to incorporate the change in business environment due to various direct and indirect factors. The insurance company must document (with details about assumptions, models and implications) any material changes in any type of changes as a result of the testing process in the insurance company' Financial Condition Report (FCR).

7. THE MANAGEMENT OF CREDIT RISK

7.1. Credit risk is the risk that a borrower or counterparty will fail to meet their obligations according to the agreed terms, resulting in economic loss to the insurance company. In Insurance sector, credit Risk — the possibility that either one of the parties to a contract will not be able to satisfy its financial obligation under that contract. Many insurance arrangements, especially finite risk programs, also involve varying degrees of credit risk—on both sides of the transaction—depending on the financial stability of the parties. Since insurance and reinsurance company are leveraged (i.e., their capital supports many times its value in outstanding policy limits), an unforeseen number of severe losses could impair such capital. While it is generally assumed that credit risk is borne by the insured or ceding insurance company (under a reinsurance contract), insurance and reinsurance company also bear credit risk.

- 7.2.** Insurance company shall have a Credit Risk Management Function independent of the risk-taking units. This Risk Management Function shall have the power to challenge and, if necessary, escalate its concerns to senior management, in relation to development of the credit risk management framework
- 7.3.** Credit policies must address credit risk in all the insurance company's activities, at both individual and portfolio levels. Such policies should be clearly defined, consistent with the credit strategy, comply with regulatory requirements, international standards and insurance practices, and be adequate for the nature and complexity of the insurance company's activities.
- 7.4.** Monitoring of credit risk should be performed by the Risk Management Function without any influence of the risk-taking units. Insurance company should have in place a methodology to adequately classify their credit risk, at portfolio and reinsurance level. This includes timely collection and regular review of financial information, including audited annual financial statements.

8. THE MANAGEMENT OF LIQUIDITY RISK

- 8.1.** Liquidity risk is the risk that an insurance company loses its ability to fund its assets or to meet its obligations without incurring unacceptable cost or losses. The insurance company must ensure that it can draw on sufficient cash to meet its liabilities as and when they fall due, which are primarily payments of claims and benefits to policyholders. The company must have processes in place to convert investments and other assets into sufficient cash, as needed to meet its liabilities.
- 8.2.** The liquidity risk management and control functions shall be part of an organizational framework with clearly defined tasks and responsibilities, including those units or committees which are integrated in the monitoring and decision processes in charge of reviewing the risk profile and approving the risk strategy and appetite.
- 8.3.** Considering its risk profile, an insurance company shall establish a liquidity risk management strategy that is customized to its institutional structure, organization, activities, products, and customers. The strategy should outline the targeted mix of assets and liabilities with clear implications for liquidity risk. The

assessment of its own liquidity risk position and profile by the insurance company is the first step for defining the liquidity risk strategy and risk appetite and to build up a consistent liquidity management and liquidity risk management system. This assessment of the risk profile, risk strategy and risk appetite shall be formalized taking into account forward-looking aspects with regard to potential risks as well as changes in business strategies.

8.4. Policies and procedures shall clearly define and describe risk management tools that the insurance company plans to use for assessment, monitoring and control of its liquidity risk. To obtain a forward-looking view of liquidity risk exposures, an insurance company should use metrics that assess the structure of the balance sheet, as well as metrics that project cash flows and future liquidity positions, considering off-balance sheet risks such as contingent liabilities.

8.5. Timely and adequate reporting of risk-related information is especially important for effective liquidity risk management. The top-level management should be able to easily look at the flash reports related to liquidity risk from the insurance company's MIS itself.

9. THE MANAGEMENT OF MARKET RISK

9.1. Market risk is defined as the risk of losses resulting from movements in market prices that adversely affect the value of on- and off-balance-sheet positions of insurance company. They may be exposed to market risk in a variety of ways. Insurance company shall have robust governance arrangements, including a clear organizational structure with well-defined, transparent and consistent lines of responsibility and effective processes to identify, measure, manage, monitor and report the risk they are or might be exposed to.

9.2. The organization of the market risk management shall be aligned with the risk profile of the institution and the overall risk strategy set by the board, with clear lines of authority. The risk-taking units shall be aware of the organization's risk profile, products and limits assigned to them. The market risk management function shall be independent with clear reporting lines.

9.3. Based on its risk profile and the level of market risk it is willing and/or able to take, the insurance company should develop a strategy to manage its market risk.

The market risk strategy should be aligned with the institution's objectives, risk appetite and risk tolerance. Policies shall include clear definitions of roles and responsibilities of individuals and teams performing market risk management functions, including structural balance sheet management, pricing, marketing, management reporting, lines of authority and responsibility for market related decisions.

9.4. Insurance company shall ensure they have in place appropriate management information system (MIS) for accurate and timely identification, aggregation, monitoring, controlling, and reporting of market risk and aid it developing market risk reports to board and senior management.

9.5. Internal audit plays a vital role in the monitoring and control of market risk by reviewing and validating the market risk measurement process regularly; it also contributes to ensuring the accuracy of data entered in risk models, validity of risk models and risk measurement calculations, reasonableness of scenarios and assumptions. Insurance company shall have adequate internal controls to ensure proper risk management process.

10. THE MANAGEMENT OF OPERATIONAL RISK

10.1. Operational Risk is the risk of direct or indirect loss, or damaged reputation resulting from inadequate or failed internal processes, people and systems or external events. Operational risk has always been inherent to insurance company and exists in all of their activities. This refers to all the risks associated with the operating units of an insurance company, such as the underwriting, claims and investment departments. Each department has its own risks which must be managed.

10.2. Insurance company shall develop a clear operational risk governance structure with well defined, transparent and consistent lines of responsibility. The governance structure should be commensurate with the nature, size, and complexity of the activities undertaken by the insurance company. A sound operational risk management structure should rely on three lines of defense: the business line management, an independent Risk Management function, and internal audit.

10.3. Based on the insurance company's risk profile, the operational risk strategy shall clearly articulate the nature, types, and levels of risk that the institution is willing to take (risk appetite). While formulating the strategy, the board must understand not only the level and complexity of risks inherent in the insurance company's activities, products, services, and systems, but also the expected outcome of not undertaking certain activities or systems.

10.4. Insurance company shall identify and assess the operational risk inherent in all products, activities, processes, and systems. The business line should assess for itself the relevant operational risks in their operations considering both internal and external factors. Operational risk management and monitoring require an adequate internal reporting framework for making regular reports to the appropriate levels of the insurance company, to inform the senior management and the board on the implementation of the risk strategy and the extent to which the risk appetite is reflected in actual risks being taken by the insurance company. The reports should be comprehensive, accurate, consistent and actionable across business lines and products.

10.5. Data integrity and cyber risk

10.5.1. Data integrity is the preservation of confidentiality, integrity and availability of information and/or information systems.

10.5.2. The Cyber Resilience is the ability of an organization to continue to carry out its missions and activities by anticipating and adapting to cyber threats and by withstanding, containing and rapidly recovering from cyber incidents.

10.5.3. A proper cyber-security framework requires: identification (risk exposure and expected losses), protection (third party security capabilities), detection (assessment of vulnerabilities), response (pre-determined incident response capabilities) and recovery (preparedness and effectiveness of business continuity plans). To strengthen their resilience to cyber-risk, insurance company shall:

- incorporate data integrity risk into their governance and risk management framework;
- identify their critical information assets;

- develop an effective control and response framework for cyber-risk;
- promote cyber-security awareness among their staff; and,
- collaborate with other institutions in strengthening the financial sector cyber-security.

10.6. Strategic risk

10.6.1. Strategic risk is the emerging threats that could undermine assumptions at the core of a company's value proposition and foundational business model. The key strategic risks emerging in insurance:

- Technology and culture shifts
- Accelerating medical breakthroughs
- New (digital native) competitors/players in insurance distribution

10.6.2. To cope with game-changing technologies and new competition from non-traditional sources, the company shall adopt Strategic Risk Management (SRM) as a holistic framework to not only help manage the downside of disruptive risks, but achieve faster growth by capitalizing on the resulting opportunities. Carriers establishing SRM programs will hold an advantage of quickly spotting evidence of potentially disruptive developments and adapting products, services, and business models more effectively to changing competitive environments.

10.6.3. The steps for implementing SRM, includes the following component areas:

- Establishing an SRM capability: Map the implications of strategic risks with the company's risk appetite; and Leverage risk sensing tools to generate early warning signals for emerging strategic risks.
- Integrating SRM into risk-sensing: Build a risk sensing system to help the Chief officers and board of directors remain on top of the key strategic risks facing the company.

- Preparing a scenario-based action plan: Prepare an action plan formulated by a newly constituted strategic risk oversight committee, with input and approval from senior management and board of directors; and Conduct periodic mock drills to test preparedness
- Leveraging cognitive tools to enhance decisions: Power a continuous feedback loop to highlight the cognitive traps that can hinder strategic risk assessments; and implement remedial programs that enhance decision making and minimize influence of biases.

10.7. Legal risk

10.7.1. Legal risk arises from the uncertainty due to legal actions or uncertainty in the application, interpretation of contracts, laws or regulations. Legal risk is the risk arising from the failure to comply with statutory or legal requirements. A legal risk management framework for legal risk and compliance should meet objective of the organization.

10.7.2. Risk identification process shall include finding the sources of legal risk like contracts, regulations, litigation, and structural changes. Risk analysis is about understanding the risks and begin with an assessment of controls. Once the effectiveness of risk controls is gauged, the likelihood and consequences of each risk is analyzed.

10.7.3. To evaluate a legal risk is to prioritize the response to the risk. At the core of risk evaluation is the organization's risk tolerance. Legal risks that are above the line - intolerable - need risk treatment.

11. ENFORCEMENT

11.1. Remedial Measures

11.1.1. When the Authority determines non-compliance with the provisions of these guidelines, it may take any intervention or step prescribed in the Insurance Act.

11.2. When the Authority determines that the insurance company' noncompliance with the provisions of this regulation impact the company's ability to identify, assess, manage and mitigate its risks in a systemic manner, the Authority may

issue such orders which it considers necessary to protect policyholders in accordance with the Insurance Act.

11.3. Administrative Sanctions

11.3.1. Where the Authority determines that an insurance company has not met the requirements of this directive, the Authority may impose any or all of the administrative sanctions to correct the situation in accordance with the provisions of the Insurance Act, including but not limited to:

11.3.1.1. Suspension of the establishment of new branches and/or expansion into new financial activities;

11.3.1.2. Suspension or closure of the insurance company to new business.