

# Managing risk

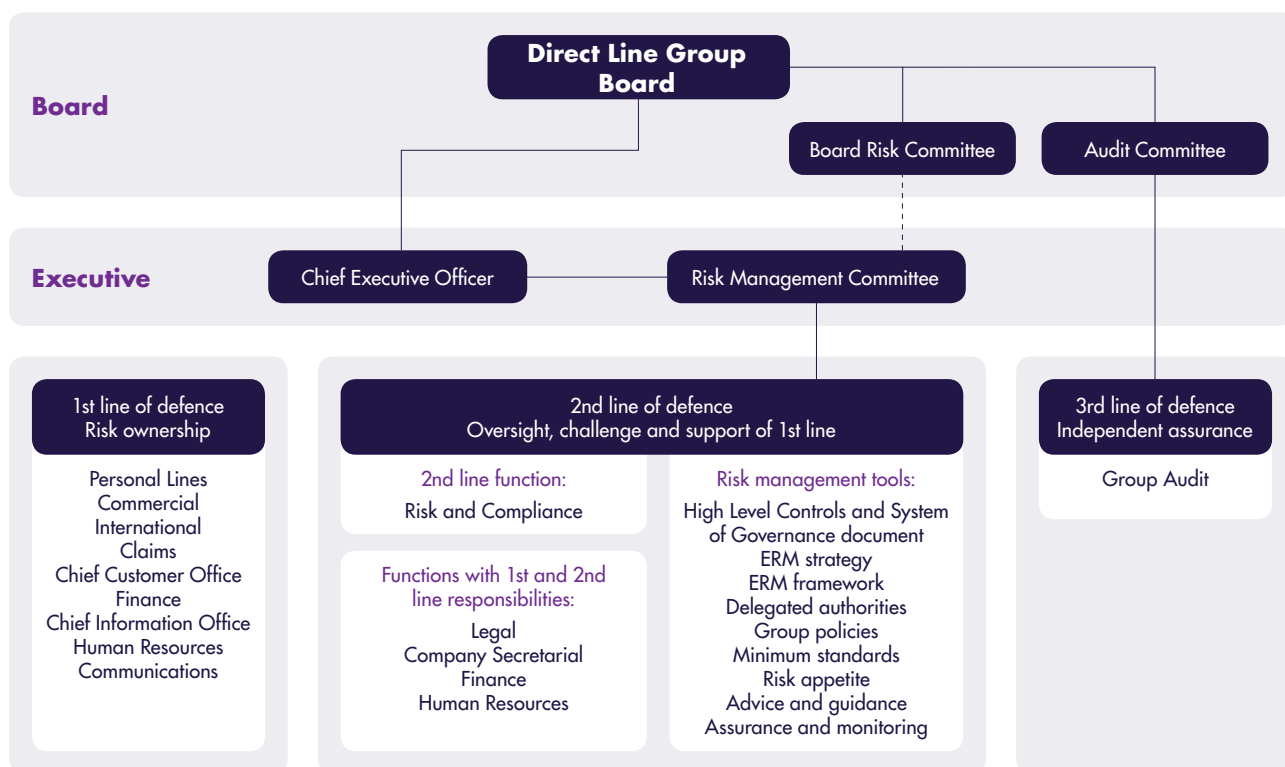
We have a robust and integrated risk management framework. This framework sets out and enables the monitoring of the responsibilities and accountabilities for risk management and internal control for the whole business.

**“Our risk and compliance strategy is designed to support our goal to become Britain’s best retail general insurer.”**

José Vazquez, Chief Risk Officer

The Board has responsibility for setting and monitoring adherence to the risk strategy, risk appetite and risk framework. The Board has established a risk management model that separates the business’s risk management responsibilities into ‘three lines of defence’ as set out in the diagram below.

## Our risk governance structure



Notes:

1. The 1st line of defence is provided by line managers who are responsible for ownership and management of the risks to the achievement of business objectives on a day-to-day basis.
2. The 2nd line of defence is provided by specialist control functions, including Risk and Compliance, which are responsible for the provision of proportionate oversight of the business and related or emerging risks.
3. Group Audit delivers the 3rd line of defence through the provision of an independent view for the Board on the effectiveness of risk management.

The Chief Risk Officer is a member of the Executive and reports to the Chief Executive Officer, with a right of access to the Board Risk Committee and the Audit Committee, assuring independence of the function. The Chief Risk Officer chairs the Risk Management Committee, which reviews material policies for the effective management of risk across the Group.

## Managing risk in line with Group strategy

Group strategy development is the responsibility of management and ultimately the Board.

Our strategic planning process aims to ensure that we have developed a clear set of objectives and targets and have identified the action plans necessary to deliver them. These must be consistent with our overall objective of a 15% RoTE and be delivered in line with our risk appetite. For information on our strategy see page 18.

Delivering a strategic plan will, by its very nature, result in taking risk. Management of this risk is therefore a key aspect of the strategic planning process and it is important that the link between strategy and its impact on capital is clear. We place Enterprise-wide Risk Management ("ERM") at the very heart of our approach.

We recognise that our long-term sustainability depends on having sufficient funds to meet our liabilities as they fall due. This protects our reputation and the integrity of our relationship with customers and other stakeholders. For information on our allocation of capital by risk type see page 42.

## Risk strategy and appetite

The risk appetite statements are expressions of the level of risk we are prepared to accept to achieve our business objectives. In order to monitor whether we are within risk appetite, we have aligned the statements to key business metrics, such as volumes of business or levels of exposure. These metrics form key risk indicators, which are both qualitative and quantitative and forward and backward looking, and our risk profile is monitored regularly using these indicators to ensure we remain within appetite.

We have an appetite for general insurance risk, with a focus on personal lines and commercial SME insurance in the UK and direct motor insurance in selected overseas countries. To support our primary activity of insurance, we have an appetite for appropriate non-insurance risks.

Risk appetite should not be static and we are committed to performing, as a minimum, an annual review of the risk appetite to ensure it remains suitable to support the Group. Such a review was undertaken in the second quarter of 2013 and resulted in Board approval of the risk appetite statements outlined in the table. We would also review risk appetite if the Group's strategy changed, ensuring risk management remains aligned to the Group strategy.

The risk appetite statements are aligned with the Board's strategic risk objectives.

Over the last 12 months, to help achieve these strategic risk objectives, we have:

- Strengthened financial risk oversight by developing the risk management function through tailored recruitment
- Enhanced the ERM framework to reflect our operation as a stand-alone Group
- Realigned risk management and oversight responsibilities as part of the 'three lines of defence' model
- Increased our focus on customer conduct risks in line with our Group objectives as well as with the objectives of the FCA.

## Our ERM framework

Strategic risk objective	Risk appetite statement
Maintain capital adequacy	Maintain sufficient economic capital consistent with the aim of achieving a stand-alone credit rating in the 'A' range.
Stable and efficient access to funding and liquidity	Meet all cash outflow requirements, including those that arise following a 1 in 200 year insurance, market or credit risk event.
Maintain stakeholder confidence	No appetite for material risks leading to reputational damage, regulatory or legal censure, fines or prosecutions and other types of operational risk losses associated with the firm's conduct and activities.

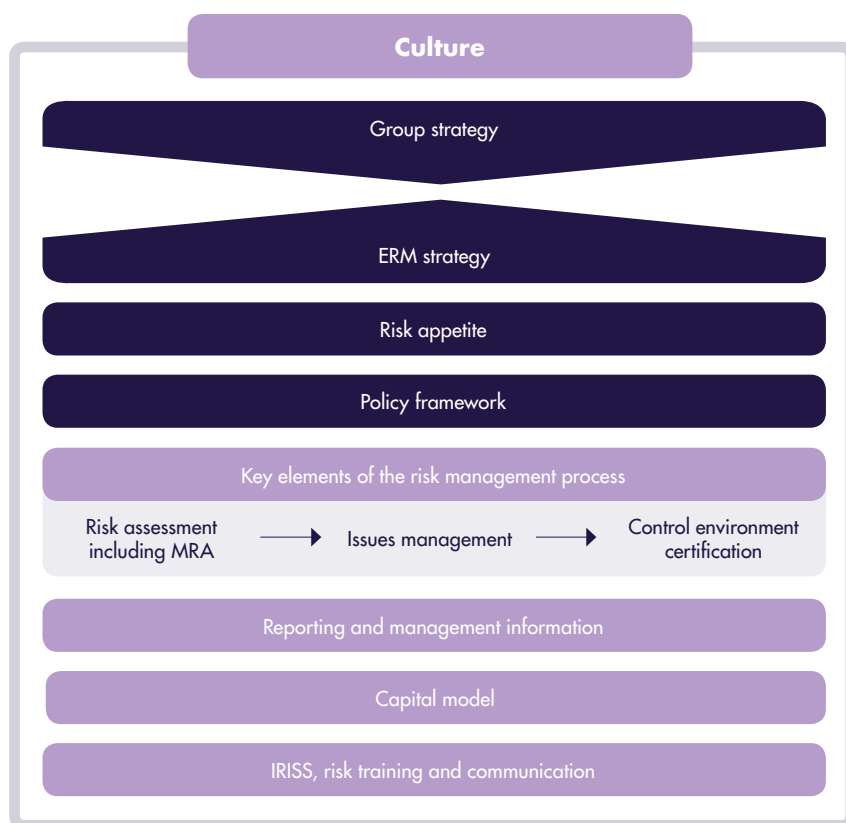
ERM is the process of organising and controlling the activities of the whole Group so as to ensure the Group remains within risk appetite. To enable ERM we have developed a framework comprising a number of components which are fundamental to good risk management. These are set out in the graphic overleaf.

A central component of the ERM framework is our policy framework, consisting of policies and minimum standards. These inform the business how it needs to conduct its activities so as to remain within risk appetite.

The policies cover the key risks to which we are exposed. Policies are supported by minimum standards which set out the minimum level of risk management and other corporate and personal behaviours that must be complied with. Where appropriate, these minimum standards are in turn supported by detailed guidance documents.

We also employ a number of risk tools to manage and monitor our risks, the output of which is tested and reported upon both internally and externally.

## Risk management continued



Notes:

MRA – Material risk assessment

IRISS – Internal Risk Intelligence Software System facilitates a robust and consistent approach to the way we capture risk information.

Our culture and ERM framework are mutually supportive. Our culture encompasses all risk management activity and helps embed risk management within our business.

Our ERM strategy supports our Group strategy.

Group strategy, ERM strategy, risk appetite and policy framework are approved by the Board.

The ERM strategy is enabled using risk management tools such as risk appetite and the capital model.

Underpinning these tools are IRISS, our specialist risk management software, comprehensive risk management training and communication.

Our ERM framework has been made stronger during 2013 as a result of:

- The linking of risk strategy and governance to our risk appetite and policy frameworks, documented in our High Level Controls and System of Governance document
- Improvements to our internal control environment self-certification process
- The development of our Own Risk and Solvency Assessment ("ORSA") which supports the achievement of our strategic objectives
- The introduction of a risk culture which helps our understanding and measurement of how well risk is embedded within the Group

### The ERM framework: enhanced by an effective risk and control culture

Risk culture is about how the principles, processes and tools of the risk framework are applied in day-to-day behaviour. A good risk culture is one where risk management is a significant part of the way we work. Our Group values align to the risk culture and seek to promote proactive risk management.

Our risk culture focuses on the key areas of strategy, employees, promoting good governance, communication, systems and reporting. We believe that the ERM framework is made stronger by the promotion of a good risk culture across the Group.

### Solvency II

Making use of Pillar I models, the PRA has developed the Individual Capital Adequacy Standards Plus ("ICAS+") process to enable UK insurers to make use of capital models developed under Solvency II programmes.

The ICAS+ process will also enable firms to obtain feedback on their progress towards Solvency II. U K Insurance Limited has engaged with this ICAS+ process and has used the new internal model for this purpose. This ICAS+ submission included Pillar II elements which are currently in development. The Group's internal model produces Solvency II, Individual Capital Adequacy and economic capital requirements for the UK general insurance business.

The Group's risk management system, including the automated risk management tool, is being embedded and the Solvency II data warehouse implementation is continuing to progress. The Group expects Solvency II to be in force on 1 January 2016 with the Internal Model Approval Process taking place in 2015. As a result, the risk management team is developing a revised timeline for progress towards internal model approval and engaging with the PRA about the Group's self-assessment of its progress towards Solvency II.

In addition, the requirement under Pillar III will result in additional reporting requirements both to the PRA and to external stakeholders. The Group continues to make progress to ensure all requirements will be met in line with developing best practice.

## Principal risks and uncertainties

Risks are always present in our business. The key role of the Risk function is to ensure that these risks have been identified and measured and are monitored and reported throughout the business on an ongoing basis. The Risk function also monitors changes in these risks over time. We believe that these risks are broadly unchanged over the last 12 months.

Principal risks	Management and mitigation examples
<p><b>Strategic risk</b> The external environment could put at risk our ability to meet our strategic objectives through the five key strategic priorities of distribution, pricing, claims, costs and Commercial and International.</p>	<ul style="list-style-type: none"> <li>• We have agreed strategic targets which are monitored and managed</li> <li>• Risk assessment of projects designed to enhance pricing and claims capability</li> <li>• Our multi-channel approach provides diversification, which mitigates this risk</li> <li>• Monitoring of cost savings to ensure they remain on track</li> <li>• The Chief Executive Officer owns and manages this risk</li> </ul>
<p><b>Insurance risk: underwriting and pricing</b> We are subject to the risk that inappropriate business could be written (or not specifically excluded) and inappropriate prices charged.</p> <p>Underwriting risk includes catastrophe risk arising from losses due to unpredictable natural and man-made events affecting multiple covered risks, particularly given the concentration of our Home business in the UK.</p>	<ul style="list-style-type: none"> <li>• We have set underwriting guidelines for all business transacted, restricting the types and classes of business that may be accepted</li> <li>• Pricing is refined through analysis of comprehensive data</li> <li>• Catastrophe reinsurance is purchased, limiting our exposure to large losses. We also purchase excess of loss cover on our Motor portfolio, as well as other selected reinsurance covers</li> <li>• We invest in enhanced external data to mitigate exposures, for example flood and individual underwriting risk through Geospatial</li> <li>• The Managing Directors of each division own and manage this risk</li> </ul>
<p><b>Insurance risk: reserving</b> Due to the uncertain nature and timing of the risks to which we are exposed, we cannot precisely determine the amounts that we will ultimately pay to meet the liabilities covered by the insurance policies written.</p> <p>Reserving risk is our biggest risk, generated by our large Motor portfolio. Reserving risk is heightened in the case of periodic payment orders ("PPOs") because of their long-term nature and is discussed further in the finance review on page 39 and in notes 2.1 and 3 to the consolidated financial statements on pages 120 and 123 respectively.</p> <p>Reserving generates both upside and downside risk, with the potential for outcomes to be in our favour, generating reserve releases.</p>	<ul style="list-style-type: none"> <li>• We estimate the technical reserves using a range of actuarial and statistical techniques. Projections of ultimate claims cost involve assumptions across a range of variables, including estimates of trends in claims frequency and average claim amounts. These are based on facts and circumstances at a given point in time</li> <li>• We ensure that management's best estimate of reserves is not less than the actuarial best estimate</li> <li>• The Chief Financial Officer owns and manages this risk</li> </ul>
<p><b>Counterparty risk</b> We partner with many suppliers and the failure of any of these to perform their financial obligations in a timely manner could result in a financial loss.</p> <p>Our principal area of counterparty risk is our use of reinsurance against underwriting risk, sometimes called reinsurance risk or reinsurer default risk.</p>	<ul style="list-style-type: none"> <li>• We set credit limits for each counterparty</li> <li>• Our reinsurance is purchased only from reinsurers that hold a minimum credit rating of 'A-' at the time cover is purchased</li> <li>• The business actively monitors broker credit exposures</li> <li>• The Chief Financial Officer owns and manages this risk</li> </ul>
<p><b>Market risk</b> We are subject to the risk that, as a result of market movements, we may be exposed to fluctuations in the value of our assets or the income from our assets.</p> <p>For the Group this includes: interest rate risk, spread risk, currency risk and property risk.</p>	<ul style="list-style-type: none"> <li>• We manage and control our investment portfolio through: <ul style="list-style-type: none"> <li>– Investment strategy and guidelines proposed to the Board by the Investment Committee and monitored by the Asset and Liability Committee</li> <li>– Diversity in the types of assets held, including by geography, sector and credit rating</li> </ul> </li> <li>• We use risk reduction techniques such as hedging foreign currency exposures with forwards and hedging foreign interest rates with swaps</li> <li>• The Chief Financial Officer owns and manages this risk</li> </ul>

## Risk management continued

Principal risks	Management and mitigation examples
<p><b>Operational risk</b> We potentially face the risks of direct or indirect losses resulting from inadequate or failed internal processes or fraudulent claims; from systems and people; or from external events.</p> <p>In particular we have IT systems risk, including that we are highly dependent on the use of RBS Group's information technology, software, data and service providers.</p> <p>Migrating IT systems away from RBS Group introduces different operational risks; there is increased likelihood of system failure at the point that functions are moved onto new infrastructure. Further, if the migration fails to stay on schedule, we will incur charges for remaining on RBS Group IT infrastructure.</p> <p>IT migration also introduces people risk, as management may be distracted away from day-to-day activities.</p> <p>Operational risk includes cyber risk, the risks relating to the use of computers, other IT and the storage of data.</p> <p>Within this category, we also consider the risk of the Group not recruiting and retaining suitable talent. This risk is particularly important during the Group's current period of change.</p>	<ul style="list-style-type: none"> <li>• We have strong operational processes and systems, including fraudulent claims detection systems. Our risk, business and capital strategies are integrated</li> <li>• We maintain a robust internal control environment</li> <li>• We have developed a bespoke risk capture, management and reporting system (IRISS)</li> <li>• Ongoing migration of IT away from RBS Group on to a new enhanced platform is continually monitored and managed by experienced personnel</li> <li>• We have strong recruitment processes to help our aim of ensuring that the right people are recruited and placed into the right roles</li> <li>• In addition to mandatory training, employees are encouraged to use the large number of training tools available to enhance their abilities</li> <li>• Specific members of the Executive own and manage the different aspects of operational risks</li> </ul>
<p><b>Regulatory risk</b> Regulatory risk arises if changes in law and regulations are not identified or understood, or are inappropriately and incorrectly interpreted or adopted.</p> <p>In particular, Solvency II regulations are currently being introduced. Solvency II requirements are still uncertain and subject to the outcome of discussion between UK and European regulators. The outcome and impact of the ICAS+ process is also uncertain. These uncertainties increase our level of risk.</p> <p>Regulatory risk also includes the risk that business practices are not efficiently modified following a regulatory change. Further, there is a risk that current legal or regulatory requirements are not complied with.</p>	<ul style="list-style-type: none"> <li>• We have a constructive and open relationship with our regulators</li> <li>• In addition, we use specific risk management tools and resources, such as our upstream risk team, to help manage our exposure to regulatory risk</li> <li>• We exercise risk-based monitoring to ensure our resources are used to greatest impact</li> <li>• The Chief Risk Officer owns and manages this risk</li> </ul>
<p><b>Conduct risk</b> We are subject to the risk of failing to deliver the appropriate treatment for our customers throughout all stages of the customer journey and the risk that our people fail to behave with integrity.</p> <p>This includes the risk that our organisational culture is not appropriate, with a failure to communicate the correct tone from the top.</p>	<ul style="list-style-type: none"> <li>• Our organisational culture prioritises a consistent approach towards customers and the interests of customers are at the heart of how we operate</li> <li>• We have developed a robust customer conduct risk management framework, to minimise our exposure to conduct risk</li> <li>• The Chief Executive Officer owns and manages this risk</li> </ul>
<p><b>Brand and reputational risk</b> We are dependent on the strength of our brands, our reputation with customers and distributors in the sale of products and services. We have entered into various strategic partnerships that are important to the marketing, sale and distribution of our products.</p>	<ul style="list-style-type: none"> <li>• Our brand and reputational risk is regularly reviewed through our governance framework</li> <li>• We undertake substantial marketing activities to protect and build our brands, and regularly measure their effectiveness</li> <li>• Specific members of the Executive own and manage this risk</li> </ul>

## Evolving risks

Risks can emerge and evolve over time, often as a result of changes in the environment in which we operate. As part of our risk management framework, we aim to identify these risks as they first emerge, working efficiently to mitigate their potential impact on the business. Set out below are examples of current significant evolving risks and the way in which we monitor and mitigate these risks.

Evolving risk details	Our actions
<p><b>Insurance risk: claims costs</b> Bodily injury claims costs are a key source of uncertainty with several regulatory, legal and market pressures facing the Group, including:</p> <ul style="list-style-type: none"> <li>• Underlying trends in bodily injury claims frequency and average cost per claim inflation</li> <li>• The results of the MaJ consultation into the discount rate used to value certain types of bodily injury claim awards</li> <li>• The propensity for large injury claims to settle as PPOs, and the inflation and longevity assumptions used to value PPOs</li> <li>• The impact on claims costs of the MaJ consultation and Transport Committee investigation into whiplash injuries.</li> </ul>	<ul style="list-style-type: none"> <li>• Monitoring claims costs to identify trends in the settlement of bodily injury claims</li> <li>• Investigating proposed changes in regulation and legislation and using risk fora to discuss these changes and develop a business response</li> <li>• Investigating asset-liability matching opportunities that would mitigate this risk</li> </ul>
<p><b>Regulatory risk: regulatory environment</b> The UK insurance market is subject to several regulatory reviews and potential areas of focus which are sources of uncertainty, including:</p> <ul style="list-style-type: none"> <li>• The CC investigation into aspects of the private motor insurance market</li> <li>• The FCA's market study of general insurance add-on products</li> <li>• The FCA's thematic review of complaints and claims handling</li> <li>• The impacts of Flood Re and the proposed levy on home insurance premiums</li> </ul> <p>There is also uncertainty around the way in which the FCA may apply the principles underpinning behavioural economics to the insurance industry and the impact that this has on our business.</p> <p>The EU is currently developing new EU Data Protection Regulations which will replace the UK Data Protection Act. This may impact our ability to use and benefit from our stored data. Specifically, restrictions or bans on profiling may impact our ability to identify the most appropriate products or solutions for our customers.</p> <p>The Italian regulatory landscape is changing which could lead to greater regulatory intervention.</p>	<ul style="list-style-type: none"> <li>• Investigating proposed changes in regulation and legislation and using risk fora to discuss these changes and develop a business response</li> <li>• Regular contact with the regulator to ensure the business is kept abreast of changes in expectations</li> <li>• Where appropriate, participation in lobbying</li> </ul>
<p><b>Strategic risk: business transformation and project delivery</b> The Group is carrying out initiatives to improve its operational efficiency as part of the implementation of its business transformation plan.</p> <p>There is a strategic risk of the potential failure to execute the plan, or that the expected benefits of the plan may not be achieved on time or to the extent targeted.</p> <p>There is also a large potential for upside risk should initiatives provide benefits that are greater than those planned, or if the expected benefits are felt by the business sooner than planned.</p> <p>Uncertainties include the potential changes in the market around use of PCWs, changes in customer behaviour and the increasing use of telematics.</p>	<ul style="list-style-type: none"> <li>• Having a detailed transformation plan</li> <li>• Monitoring of the project milestones ensures we remain on track and enables us to make adjustments where appropriate</li> <li>• Ensuring that the projects are managed by the right people with the ideal skills</li> <li>• Using 'lessons learnt' exercises to ensure later projects are improved by our experiences</li> </ul>

Risks can emerge over the very long term as a result of significant changes in the environment including technology, weather patterns and socio-economic behaviours. Examples of these risks would include driverless cars, new types of competitor entering the market and climate change.

A specific example of an emerging risk we have considered during 2013 is the failure of a competitor. A competitor failing may lead to an industry levy which we would be subject to. This risk could also impact our relationships with both investors and regulators, depending on the cause of the competitor's failure. There is also potential upside should the failure of a competitor enable us to increase the number of policies we issue.