Managing risk

We have a robust and integrated risk management framework. This framework sets out the responsibilities and accountabilities for risk management for the whole business.

“The risk and compliance strategy is focused on fully supporting the Group’s goal to become Britain’s best retail general insurer, delivering sustainable returns.”
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.

Risk strategy and risk appetite
The Board has set clear strategic risk objectives:
- To maintain capital adequacy
- To stabilise earnings volatility
- To ensure stable and efficient access to funding and liquidity
- To maintain stakeholder confidence

These objectives have been developed to recognise that, for long-term sustainability, we need to have sufficient economic capital and we need to protect our reputation and integrity in our relationships with customers and stakeholders.

Within the Group, a well-articulated risk appetite lies at the heart of effective enterprise risk management ("ERM") to support:
- Our strategic risk objectives, as outlined above
- Risk management
- Setting of boundaries for risk taking
- Stakeholder value optimisation

Our risk management structure

Board of Directors

3rd Line defence Internal Audit function
- Independent assurance on adequacy and effectiveness of risk framework

Board Risk Committee

Audit Committee

Risk Management Committee

Financial risk
Regulatory, compliance and conduct risk
Enterprise and strategic risk
International

Business units and support functions

2nd Line defence Risk function
- Advise Board on risk strategy and risk appetite
- Advise Board on appropriate risk framework and risk tools
- Oversight, challenge and support of 1st line

1st Line defence business and support functions
- Adhere to risk strategy and risk appetite
- Own and manage risks
- Compliance with risk framework
- Assurance on adherence to policies

José Vazquez, Chief Risk Officer

“The risk and compliance strategy is focused on fully supporting the Group’s goal to become Britain’s best retail general insurer, delivering sustainable returns.”

26 Direct Line Group Annual Report & Accounts 2012
The risk appetite statements are expressions of the level of risk we are prepared to accept to achieve our business objectives. In order for these statements to be defined quantitatively as well as qualitatively, they are aligned to key metrics. These metrics are monitored regularly.

Risk appetite should not be static and the Group is committed to performing an annual review of the risk appetite framework to ensure its continued suitability to support a well-managed company.

The strategic risk objectives link to a set of risk appetite statements and key metrics.

The table below sets out these objectives and shows, at a high level, examples of corresponding appetite statements.

<table>
<thead>
<tr>
<th>Strategic risk objective</th>
<th>Risk appetite statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain capital adequacy</td>
<td>Maintain sufficient economic capital to a defined target</td>
</tr>
<tr>
<td>Deliver stable earnings</td>
<td>Profitability over a defined period</td>
</tr>
<tr>
<td>Stable and efficient access to funding and liquidity</td>
<td>Cash outflows met under stress</td>
</tr>
<tr>
<td>Maintain stakeholder confidence</td>
<td>No appetite for material reputational, legal or regulatory risks</td>
</tr>
</tbody>
</table>

The aim of the risk framework is to provide a robust, proportionate, proactive and forward-looking process for risk management across the Group. A central component of this framework is the Group’s policies and minimum standards, which inform the business as to how it is required to conduct its activities and risk management processes to remain within risk appetite. We employ a number of risk tools to manage and monitor risk. The output of our risk management activities is thoroughly tested and reported upon both internally and externally.

The policies and minimum standards cover all key risks to which the Group is exposed. Each policy is supported by minimum standards which set out the minimum level of risk management and other corporate and personal behaviours. The minimum standards are in turn supported by detailed guidance documents.

We incorporate the identification, assessment, management, control, reporting and mitigation of risk as part of our daily operations.

We believe the strengths of our risk framework are:

- Strong culture and risk leadership underpinned by training of our people
- Engagement with the business
- Embedded risk management processes, linking risk and capital
- Quantitative approach to risk analysis, for example, development of a robust economic capital model
- Leveraging off our market leading position in home and motor provides access to a significant volume of data
- Risk assessment and management information through integrated risk systems
- Influencing decision-making and shaping behaviours, via the provision of accurate, timely and relevant risk advice and challenge

Notes:

1. The Chief Risk Officer is a member of the Executive Committee 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 executive Risk Management Committee, which reviews material policies for the effective management of risk across the Group.

2. IRISS – Internal Risk Intelligence Software System is designed to facilitate a robust and consistent approach in the way we identify and capture risk information thereby significantly enhancing our ability to measure, report and manage our risks.
Principal risks and uncertainties

The Group writes products that are subject to a number of uncertainties and risks. It is a key role of the Risk function to ensure that these risks have been identified, measured and considered throughout the business.

<table>
<thead>
<tr>
<th>Principal risks</th>
<th>Impact</th>
<th>Management and mitigation</th>
</tr>
</thead>
</table>
| **Strategic risk** | The value of the Group decreases, resulting in a lack of shareholder confidence. | • Constant monitoring and management of agreed strategic targets  
• Monitoring of cost savings to ensure they remain on track  
• Investment in brand awareness, and improved pricing and claims models  
• Upgrading and enhancement of numerous operational processes and systems |
| **Underwriting and pricing risk** | Adverse loss experience impacting current year and future year business performance. | • Underwriting guidelines for all business transacted, restricting the types and classes of business that may be accepted  
• Exception reports and underwriting monitoring tools  
• Internal quality assurance programmes  
• Pricing policies by product line and by brand  
• Analysis of comprehensive data to refine pricing  
• Insurance governance forums whose remit include examination of data  
• Central control of policy wordings  
• Purchase of catastrophe reinsurance to limit the exposure  
• Quarterly analysis of all property portfolios to determine expected maximum losses  
• Investment in enhanced external data to mitigate exposures (for example, flood and individual underwriting risk through Geospatial) |
| **Reserving risk** | Adverse development in prior year reserves resulting in a financial loss. | • Technical reserves are estimated by:  
− A range of actuarial and statistical techniques, with projections of ultimate claims cost involving assumptions across a range of variables, including estimates of trends in claims frequency and average claim amounts based on facts and circumstances at a given point in time  
− Making assumptions on other variable factors including, the legal, social, economic and regulatory environments; Ogden discount rate and the process by which it is set; results of litigation; and the extent and terms on which periodical payment orders ("PPOs") are made by the Courts. Other factors considered include rehabilitation and mortality trends, business mix, consumer behaviour, market trends, underwriting assumptions, risk pricing models, inflation in medical care costs, future earnings inflation and other relevant forms of inflation, the performance and operation of reinsurance assets and future investment returns  
− Stress and scenario testing  
− Management’s best estimate of reserves being equal to or in excess of the actuarial best estimate |
| **Operational risk** | Adverse events with potential financial, reputational, legal and customer impacts. | • We have upgraded and enhanced many of our operational processes and systems, including the claims system and fraud detection system. This includes enhancing our ERM framework to integrate risk, business and capital strategies  
• We maintain a robust internal control environment  
• We have developed a bespoke risk capture, management and reporting system  
• Migration of IT onto a new enhanced platform |
## Principal risks Impact Management and mitigation

### Investment risk
- **Market risk** – the risk of adverse financial impact due to changes in fair values of future cash flows of instruments held in the investment portfolio as a result of changes in interest rates, credit spread, foreign exchange rates and property values.  
  - Adverse movements due to asset value reduction, mismatch in assets and liabilities, and default of third parties.  
  - Inability to meet cash flows under stress.  
  - Our investment portfolio is managed and controlled through:  
    - Investment strategy and guidelines proposed to the Board by the Investment Committee and monitored by the Asset and Liability Committee  
    - Diverse holding of types of assets including geographies, sectors and credit ratings  
    - Utilisation of risk reduction techniques, for example hedging  
    - Stress testing and scenario analysis

### Credit risk
- The risk of exposure if another party fails to perform its financial obligations, including failing to perform them in a timely manner.  
  - Loss due to default of banks, reinsurers, brokers or other third parties.  
  - Credit limits are set for counterparties, particularly banks  
  - Requirement for minimum credit ratings for reinsurers  
  - Broker credit exposures are monitored by the business

### Liquidity risk
- The risk of maintaining insufficient financial resources to meet business obligations as and when they fall due.  
  - Customer impact, financial loss and regulatory censure.  
  - Regulatory sanction, legal action or revenue loss.  
  - We have a constructive and open relationship with our regulators and other official bodies (for example the Ministry of Justice and the Office of Fair Trading), in addition to specific risk management tools and resources to minimise our exposure to regulatory risk

### Counterparty risk
- We partner with many suppliers and the failure of any of these to perform their financial obligations or perform them in a timely manner could result in a financial loss. The principal area of counterparty risk is our use of reinsurance against catastrophe risk.  
  - Customer impact, financial loss and regulatory censure.  
  - Regulatory sanction, legal action or revenue loss.  
  - We have a constructive and open relationship with our regulators and other official bodies (for example the Ministry of Justice and the Office of Fair Trading), in addition to specific risk management tools and resources to minimise our exposure to regulatory risk

### Regulatory risk
- Changes in law and regulations are not identified, understood, or are inappropriately and incorrectly interpreted, or adopted, or business practices are not efficiently modified. Further, there is a risk that current legal or regulatory requirements are not complied with. For example, in the beginning of 2012, the FSA imposed a £2.17 million fine on the Group in relation to complaint file alterations.  
  - Potential customer detriment, financial loss and regulatory censure and sanction.  
  - Our organisational culture prioritises a consistent approach towards customers and the interests of customers are at the heart of how we operate  
  - We have developed a robust customer conduct risk management framework, to minimise our exposure to conduct risk

### Conduct risk
- The risk of failing to deliver the appropriate treatment for our customers throughout all stages of the customer journey and that our people fail to behave with integrity.  
  - Loss of brand value negatively impacts our ability to retain and write new business.  
  - Our brand and reputation risk is regularly reviewed by various governance committees  
  - A key focus for us is to build our brands business through marketing, whilst regularly monitoring performance using a range of brand metrics  
  - We seek to offer a superior service to customers and to treat customers fairly in line with FSA principles

### Brand and reputational risk
- 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.  
  - Loss of brand value negatively impacts our ability to retain and write new business.  
  - Our brand and reputation risk is regularly reviewed by various governance committees  
  - A key focus for us is to build our brands business through marketing, whilst regularly monitoring performance using a range of brand metrics  
  - We seek to offer a superior service to customers and to treat customers fairly in line with FSA principles

As long as RBS Group remains a significant shareholder, there are certain risks that apply to the RBS Group and, should they arise, may have an adverse impact on our business. For example, RBS Group will continue to exert substantial influence over us while it has a substantial shareholding; RBS Group could face the risk of full nationalisation or other resolution procedures; our contractual arrangements may be impacted by events that occur within RBS Group; and RBS Group is subject to a variety of risks as a result of implementing the state aid restructuring plan which could adversely affect us. RBS Group has a legal obligation to divest its controlling interest in the Group by the end of 2013 and completely divest by the end of 2014. The manner and exact timing of any divestment is uncertain.