



## ACTEX Virtual eFlashcards for Exam CP1

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5-1

Unit 05 - Risk Identification and Classification

**What is risk identification in the context of a business plan?**

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5-1

Unit 05 - Risk Identification and Classification



- It is the recognition of risks that can threaten an organization's business plan.
- Helps determine appropriate risk control processes.
- Aims to reduce the likelihood or impact of the risk event.

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5-2 Unit 05 - Risk Identification and Classification

**Why is risk identification essential for a business?**

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5-2

Unit 05 - Risk Identification and Classification



- To reduce potential threats through proactive control measures.
- To identify and exploit opportunities for competitive advantage.
- Because taking on risk can be profitable if priced correctly.

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5-3

Unit 05 - Risk Identification and Classification

**What are the main challenges in identifying all risks within an organization?**

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5-3

Unit 05 - Risk Identification and Classification



- Requires in-depth knowledge of:
  - The organization's circumstances
  - The business environment
  - The general regulatory landscape
- Some risks are not immediately obvious.

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5-4 Unit 05 - Risk Identification and Classification

**Why is senior management alone not enough for effective risk identification?**

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5-4 Unit 05 - Risk Identification and Classification



- Senior leaders may overlook weaknesses in specific processes.
- Junior staff may be more familiar with operational risks.
- Full input across all business levels is essential for completeness.

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5-5

Unit 05 - Risk Identification and Classification

**What techniques can be used to ensure all relevant risks have been identified?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-5

Unit 05 - Risk Identification and Classification



- 1. Risk classification:** Helps ensure a wide range of risks are considered.
- 2. Project management tools:** Useful for identifying risks in specific projects.
- 3. Regulatory frameworks:** Lists of risks used in regulations (e.g., Solvency II in Europe) can be adapted.
- 4. Expert experience:** Learnings from similar organizations and consultant insights.

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5-6 Unit 05 - Risk Identification and Classification

**What is the purpose of using a classification system like Solvency II in risk identification?**

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5-6 Unit 05 - Risk Identification and Classification



- Provides standardized lists of relevant risks.
- Helps ensure that no major category of risk is overlooked.
- Although not exhaustive, it ensures common industry risks are covered.

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5-7

Unit 05 - Risk Identification and Classification



Why might standard formulas for capital requirements (e.g., Solvency II) fall short in some cases?

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5-7

Unit 05 - Risk Identification and Classification



- They may exclude certain risk types like equity volatility.
- Might not be suitable for all business models, such as those offering guaranteed vs. non-guaranteed benefits.

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5-8 Unit 05 - Risk Identification and Classification

**How can experience from others support effective risk identification?**

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5-8

Unit 05 - Risk Identification and Classification



- By leveraging similar case studies and industry insights.
- Consultants with broad client exposure often recognize hidden or emerging risks.

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Unit 05 - Risk Identification and Classification

**What three areas of knowledge are essential for identifying organizational risks?**

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5-9

Unit 05 - Risk Identification and Classification



1. Organization's specific circumstances
2. Operating business environment
3. Broader business and regulatory environment

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5-10

Unit 05 - Risk Identification and Classification

**Why is risk identification considered a difficult task?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-10

Unit 05 - Risk Identification and Classification



- Not all risks are obvious.
- Requires holistic understanding of multiple business layers.
- Demands collaboration across hierarchy and functions.

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5-11

Unit 05 - Risk Identification and Classification



Why regulatory risk frameworks (like Solvency II) may not be sufficient for complete risk identification. What would you say?

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5-11

Unit 05 - Risk Identification and Classification



- Regulatory frameworks may **not be exhaustive** - they focus on common risks
- They may **miss industry-specific or organization-specific risks**
- Example: Solvency II standard formula does not include equity volatility risk, which could be highly relevant for businesses offering equity-backed products with guarantees
- **Remember:** "Regulatory compliance ≠ Complete risk identification"

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5-12 Unit 05 - Risk Identification and Classification

**What is the first essential step in analyzing project risks?**

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5-12

Unit 05 - Risk Identification and Classification



- Conduct a **high-level preliminary risk analysis**.
- Purpose: To determine whether the project has a low enough risk profile to justify further analysis.
- If risk is too high and not justifiable, the project **should not proceed**.

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Unit 05 - Risk Identification and Classification

**What is the main goal of a preliminary risk analysis in project management?**

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Unit 05 - Risk Identification and Classification



- To filter out unviable projects early.
- Prevent waste of resources on projects that are high-risk and not worth pursuing further.

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Unit 05 - Risk Identification and Classification

**Why is a brainstorming session important in project risk identification?**

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5-14

Unit 05 - Risk Identification and Classification



- Involves **project experts** and **senior internal/external stakeholders**.
- Helps identify a wide range of risks by leveraging diverse perspectives.
- Encourages **strategic long-term thinking**.

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Unit 05 - Risk Identification and Classification

**What are the key aims of a brainstorming session for project risk analysis?**

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5-15

Unit 05 - Risk Identification and Classification



- Identify both **likely and unlikely** project risks, along with upsides and downsides.
- Discuss **interdependencies** among risks.
- Provide a **broad initial evaluation**: frequency and impact of risks.
- Generate and briefly discuss **initial mitigation options**.

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Unit 05 - Risk Identification and Classification

**What follows a brainstorming session in project risk management?**

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5-16

Unit 05 - Risk Identification and Classification



- A **desktop analysis** is conducted to supplement findings.
- Identify additional risks and mitigation options by studying:
  - **Similar past projects**
  - **Sponsor experiences**
  - **International examples (if relevant)**

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Unit 05 - Risk Identification and Classification

**What role do expert opinions play after risk identification steps?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-17

Unit 05 - Risk Identification and Classification



- Experts familiar with the project provide **considered opinions** on risks.
- They help shape the **outline plans for financing and next steps**.

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5-18

Unit 05 - Risk Identification and Classification

**What is a risk register or risk matrix, and why is it important in project management?**

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Unit 05 - Risk Identification and Classification



- A document that carefully sets out all identified risks
- Includes **cross-references** to other risks where interdependencies exist
- Serves as a **central repository** of project risk information
- Provides a **foundation for risk monitoring** throughout the project
- **Visualization:** Think of it as a "risk map" showing all the danger zones and their connections

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5-19

Unit 05 - Risk Identification and Classification

**What should be included in a risk register post-brainstorming and desktop review?**

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5-19

Unit 05 - Risk Identification and Classification



- All identified risks
- Their initial evaluation
- Mitigation options
- Cross-references to interconnected risks

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5-20 Unit 05 - Risk Identification and Classification

**How does the process of identifying project risks ensure completeness?**

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5-20 Unit 05 - Risk Identification and Classification



- Combines **brainstorming, desktop analysis, and expert consultation.**
- Ensures a **comprehensive and practical understanding of risks.**
- Results are documented in a **centralized register or matrix.**

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5-21

Unit 05 - Risk Identification and Classification

**What is the primary objective of risk mitigation in project management?**

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5-21

Unit 05 - Risk Identification and Classification



- To identify **main options** for reducing or eliminating risks.
- Ensures the project is **less vulnerable** to negative events and more likely to succeed.

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5-22 Unit 05 - Risk Identification and Classification

**What are the typical steps in risk mitigation after identification in project management?**

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5-22

Unit 05 - Risk Identification and Classification



1. List the risks.
2. Evaluate their frequency and severity.
3. Identify mitigation options (technical, financial, managerial).
4. Implement and monitor these mitigation strategies.

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5-23 Unit 05 - Risk Identification and Classification

**Why must mitigation options be tailored to individual risks in a project?**

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5-23

Unit 05 - Risk Identification and Classification



- Each risk has a **different cause, probability, and impact.**
- One-size-fits-all mitigation does not work; strategies must be **specific and proportionate.**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-24

Unit 05 - Risk Identification and Classification

**When considering risk mitigation, why is it important to use expert opinions?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-24

Unit 05 - Risk Identification and Classification



- Experts help assess **practicality and effectiveness** of mitigation measures.
- They bring insights from **similar past projects or industry knowledge**.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-25

Unit 05 - Risk Identification and Classification

**What role does documentation (e.g. risk matrix/register) play in mitigation?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-25

Unit 05 - Risk Identification and Classification



- Provides a **centralized view** of risks and their mitigation status.
- Helps track **interdependencies** and supports **decision-making**.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-26

Unit 05 - Risk Identification and Classification

**What are the key steps in effective identification and analysis of project risks?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-26

Unit 05 - Risk Identification and Classification



- 1. Make a high-level preliminary risk analysis to determine if the project should proceed
- 2. Hold a brainstorming session with project experts and strategic thinkers to:
  - Identify risks (likely and unlikely) with upsides and downsides
  - Discuss interdependencies
  - Place broad initial evaluations on each risk
  - Generate initial mitigation options
- 3. Conduct desktop analysis to supplement brainstorming results
- 4. Document identified risks in a risk register or risk matrix
- **Remember as a cycle:** "Assess → Brainstorm → Research → Document"

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Unit 05 - Risk Identification and Classification

**How does desktop analysis complement a brainstorming session in project risk management?**

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5-27

Unit 05 - Risk Identification and Classification



- It **supplements brainstorming results** with additional research
- Helps **identify further risks and mitigation options**
- Involves **researching similar past projects** (including overseas experiences)
- Gathers **expert opinions** familiar with project details and financing plans
- **Think of it as:** "Filling the gaps" that brainstorming might have missed

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5-28

Unit 05 - Risk Identification and Classification



What fundamental uncertainty exists with financial products that have a delay between promise and provision?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-28

Unit 05 - Risk Identification and Classification



- There is always **uncertainty about future outcomes**
- This uncertainty may relate to:
  - The **level of benefits** (how much)
  - The **incidence of benefits** (when)
  - The **level or incidence of contributions/premiums** required
- There is a risk that the **beneficiary's circumstances will change**, making benefits less valuable or not received at the required time
- **Time concept:** "The longer the delay, the greater the uncertainty"

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5-29

Unit 05 - Risk Identification and Classification

**What is the main risk when benefits are pre-defined (known in advance)?**

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5-29

Unit 05 - Risk Identification and Classification



- Insufficient funds to pay the promised benefit.
- This may result from:
  - Underfunding
  - Sponsor/provider insolvency
  - Asset-liability mismatch
  - A combination of the above

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5-30 Unit 05 - Risk Identification and Classification

**What is liquidity risk in relation to pre-defined benefits?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-30 Unit 05 - Risk Identification and Classification



- Even if funds exist, they may not be liquid when required.
- Common if no separate assets were designated.

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5-31

Unit 05 - Risk Identification and Classification

**What happens if a benefit promise is changeable within contract terms?**

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5-31

Unit 05 - Risk Identification and Classification



- There is a risk of worsened benefit value unless the beneficiary agrees.
- Critical illness contracts may define “insured events” that change over time.

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5-32 Unit 05 - Risk Identification and Classification

**What are risks for members of defined contribution schemes at retirement?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-32

Unit 05 - Risk Identification and Classification



- Risk that annuity terms at retirement provide lower pensions.
- Investment performance before retirement may not match assumptions.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-33 Unit 05 - Risk Identification and Classification

**How can inflation affect benefits even when they are defined?**

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5-33

Unit 05 - Risk Identification and Classification



- Inflation reduces real purchasing power of the benefits.
- Planning based on inaccurate benefit recognition may lower standard of living.

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5-34

Unit 05 - Risk Identification and Classification

**How can inflation or valuation mismatches affect insurance payouts?**

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5-34

Unit 05 - Risk Identification and Classification



- Payout may be less than inflation-adjusted costs (e.g., property repair).
- Court awards may be lower than actual economic loss.

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5-35

Unit 05 - Risk Identification and Classification

**What additional uncertainties affect contribution timing and sufficiency?**

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5-35

Unit 05 - Risk Identification and Classification



- Legislative/self-imposed constraints on when contributions are made.
- Mismatch between expected and actual fund values.
- Additional funds might be needed urgently.

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5-36

Unit 05 - Risk Identification and Classification

**How can sponsor solvency itself become a risk?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-36

Unit 05 - Risk Identification and Classification



- Excessive contribution needs may damage sponsor's own finances.
- Particularly if employer is also the sponsor.

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5-37

Unit 05 - Risk Identification and Classification

**What happens if a sponsor is taken over?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-37

Unit 05 - Risk Identification and Classification



- New owner may refuse to honor past promises.
- Could result in discontinuation of benefits.

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5-38

Unit 05 - Risk Identification and Classification

**What are generic risks that cause uncertainty in contributions or benefits?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-38

Unit 05 - Risk Identification and Classification



- Fund misappropriation or fraud
- Incorrect benefit payment
- Inappropriate advice
- Administrative or legislative compliance costs
- Policy changes by tax authorities

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## ACTEX Virtual eFlashcards for Exam CP1

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5-39 Unit 05 - Risk Identification and Classification

**How can guarantees increase uncertainty for sponsors?**

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5-39

Unit 05 - Risk Identification and Classification



- They increase the **cost** and **liability** for the sponsor.
- Creates a **feedback loop** into actuarial pricing and funding strategies.

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5-40 Unit 05 - Risk Identification and Classification

**How can poor communication or advice contribute to risk?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-40

Unit 05 - Risk Identification and Classification



- Misunderstandings of guarantees or promises
- Inadequate updates to beneficiaries
- Mis-selling or unsuitable product recommendations

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5-42

Unit 05 - Risk Identification and Classification



What is meant by the '*strength of the sponsor/provider promise*'?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-42

Unit 05 - Risk Identification and Classification



- It reflects the reliability of the provider to meet benefit promises under adverse conditions.
- Beneficiaries must be clearly informed of any risks affecting promise fulfilment.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-42

Unit 05 - Risk Identification and Classification



Compare the risks for benefits that are "*known in advance*" versus "*unknown in advance*."

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## ACTEX Virtual eFlashcards for Exam CP1

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5-42

Unit 05 - Risk Identification and Classification



- Known in advance (pre-defined benefits):
  - Greatest risk: **insufficient funds** to provide promised benefit
  - Risk of **illiquidity** - funds not available when needed
  - Risk of **benefit promise changing** within contract terms
  - Risk that benefits **no longer meet needs** due to inflation or changed circumstances
- Unknown in advance (linked to funds/investment):
  - Risk of **lower benefits** if investment returns are lower than anticipated
  - Risk of **higher expense charges** than expected
  - Risk of **worse terms of purchase** for investment vehicles
  - Risk of payments being **much higher than anticipated** (for non-life insurance)
- **Key difference:** Pre-defined benefits face funding/security risks; undefined benefits face performance/adequacy risks

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## ACTEX Virtual eFlashcards for Exam CP1

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5-43

Unit 05 - Risk Identification and Classification



How might inappropriate advice impact financial products? List the potential sources.

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5-43

Unit 05 - Risk Identification and Classification



- **Incompetence** or insufficient experience of the advisor
- **Lack of integrity** (perhaps due to sales-related payments)
- Use of an **unsuitable model or parameters**
- **Errors in beneficiary data**
- **State-encouraged but inappropriate actions**
- **Over-complicated products**
- **Example:** UK mis-selling of personal pension policies to individuals who had better employer-sponsored provisions

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5-44

Unit 05 - Risk Identification and Classification

**What factors can cause errors in determining contribution/premium requirements?**

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5-44

Unit 05 - Risk Identification and Classification



- Use of an **unsuitable model**
- Use of **unsuitable parameters**
- **Errors in data** used to determine model parameters
- **Errors in beneficiary data**
- **Visualize as:** A cascade effect - bad inputs → bad model → bad outputs → funding shortfall

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## ACTEX Virtual eFlashcards for Exam CP1

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5-45

Unit 05 - Risk Identification and Classification

**How do financial products function as risk transfer mechanisms?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-45

Unit 05 - Risk Identification and Classification



- They allow **one party to transfer risk to another party**
- The party taking on the risk typically **receives a cash payment**
- This payment must cover both the **cost of the risk being transferred** and **enable profit**
- **Examples:** Term life cover, motor vehicle insurance, property damage insurance
- **Insight:** Even investment products transfer risk - the risk of poor performance due to lack of expertise

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## ACTEX Virtual eFlashcards for Exam CP1

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5-46

Unit 05 - Risk Identification and Classification

**Why is investment in collective schemes not always seen as risk transfer?**

5. **Essential** – appears repeatedly on every exam
4. **Important** – appears on every exam
3. **Average** – regularly appears on exams
2. **Minimal** – appears occasionally on exams, or easy to derive as needed
1. **Obscure** – on syllabus, but unlikely to appear on exam

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5-46

Unit 05 - Risk Identification and Classification



- The investor is not transferring risk but **avoiding personal underperformance**.
- They rely on expert managers due to lack of market knowledge.
- The investor pays for **expertise**, not just for transferring specific risks.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-47

Unit 05 - Risk Identification and Classification

**How can annuity-based insurance companies reduce product costs?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-47

Unit 05 - Risk Identification and Classification



- By pooling longevity risk across many policyholders.
- May design contracts with **negligible or zero mortality cost**.
- E.g. Products for funeral costs or inheritance taxes often use this logic.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-48

Unit 05 - Risk Identification and Classification

**What should good product design techniques ensure?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-48

Unit 05 - Risk Identification and Classification



- List all possible risks in the product.
- Consider how each risk is:
  - Controlled
  - Transferred
  - Accepted
  - Costed

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5-49

Unit 05 - Risk Identification and Classification

**What risk arises from product design not aligned with recipient expectations?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-49

Unit 05 - Risk Identification and Classification



- Products are often designed by **someone other than the beneficiary**.
- Misalignment may result in **product rejection or non-usage** by the beneficiary.

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5-50 Unit 05 - Risk Identification and Classification

**How can misalignment between designers and beneficiaries be addressed?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-50

Unit 05 - Risk Identification and Classification



- Through **market research**, **small-scale trials**, and **focus groups**.
- This ensures product meets **actual needs** rather than assumed ones.

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5-51

Unit 05 - Risk Identification and Classification

**What is the relationship between product complexity and risk in financial product design?**

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5-51

Unit 05 - Risk Identification and Classification



- Each additional option or feature **introduces new risks**
- Each new risk **needs to be paid for**
- Complexity should be balanced against **target market needs**
- For mass-market products: **Simpler designs** may be more appropriate
- For high net worth markets: **Additional options** may be worth the cost
- **Balance concept:** "Feature richness vs. risk management"

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5-52 Unit 05 - Risk Identification and Classification

**Why is returning to the original risk analysis useful during product design?**

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5-52 Unit 05 - Risk Identification and Classification



- Helps determine which **additional risks** need coverage.
- Guides decisions on whether a **mass-market** or **bespoke** product is more suitable.

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5-53

Unit 05 - Risk Identification and Classification

**What is the purpose of risk categorization in financial services?**

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5-53

Unit 05 - Risk Identification and Classification



- To classify risks affecting financial product providers.
- Helps in structuring risk analysis across different organizations.
- Focuses on contingent event-based benefits.

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5-54

Unit 05 - Risk Identification and Classification

**What is credit risk, and what are some examples?**

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5-54

Unit 05 - Risk Identification and Classification



- Credit risk is the risk of a **third party failing to meet obligations**.
- Examples include:
  - Borrower default
  - Counterparty/settlement risk
  - Credit concentration risk
  - General debtor non-payment

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5-55 Unit 05 - Risk Identification and Classification

**How does security help reduce credit risk?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-55

Unit 05 - Risk Identification and Classification



- Makes lending more attractive by offering protection.
- Depends on:
  - Borrower's covenant
  - Nature of transaction
  - Market conditions
  - Available security
- Lender must be able to **realize security cost-effectively**.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-56

Unit 05 - Risk Identification and Classification

**What is a credit rating and why is it important?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-56

Unit 05 - Risk Identification and Classification



- A credit rating reflects the **likelihood of default**.
- Issued by rating agencies to indicate creditworthiness.
- Impacts **market perception** of the company and its securities.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-57

Unit 05 - Risk Identification and Classification

**What is liquidity risk and how does it differ between different financial institutions?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-57

Unit 05 - Risk Identification and Classification



- The risk that an entity, **although solvent, cannot meet obligations** as they fall due
- For **trading companies**: Most common reason for liquidation
- For **insurance companies/benefit schemes**: Generally low exposure due to liquid assets
- For **banks**: Significant exposure due to maturity transformation
- For **investment funds**: Can arise with illiquid assets (property, hedge funds)
- **Visual concept**: "Cash flow is like water - you need the right amount at the right time"

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5-58 Unit 05 - Risk Identification and Classification

**How do insurers manage liquidity risk?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-58

Unit 05 - Risk Identification and Classification



- Maintain liquid assets like **cash deposits and bonds**.
- Allows quick asset sales to meet benefit payouts.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-59 Unit 05 - Risk Identification and Classification

**What behavioural factors can impact liquidity risk in banks?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-59

Unit 05 - Risk Identification and Classification



- Early withdrawals from fixed deposits.
- Panic during stress leading to mass withdrawals.
- Unexpected movements in interest rates.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-60

Unit 05 - Risk Identification and Classification

**What challenges do investment funds face with liquidity?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-60 Unit 05 - Risk Identification and Classification



- Real estate funds cannot sell properties instantly.
- Use **lock-in periods** and **notice periods** to manage withdrawal pressures.

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5-61

Unit 05 - Risk Identification and Classification

**What is market risk and what are its three main components?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-61

Unit 05 - Risk Identification and Classification



- Risks related to **changes in investment market values** or correlated features
- Components:
  1. **Asset value changes** (equities, property, interest rates)
  2. **Liability value changes** (from market-linked promises or discount rates)
  3. **Asset/liability matching issues** (mismatches between assets and liabilities)

**Remember as:** "AVL" - Assets, Values of liabilities, Lack of matching

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## ACTEX Virtual eFlashcards for Exam CP1

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5-62 Unit 05 - Risk Identification and Classification

**What causes asset value changes?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-62

Unit 05 - Risk Identification and Classification



- Market fluctuations in **equities, properties, or bonds**.
- Changes in **interest and inflation rates** impact fixed-income and index-linked securities.

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5-63

Unit 05 - Risk Identification and Classification

**What causes liability value changes?**

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5-63

Unit 05 - Risk Identification and Classification



- Liabilities tied to **interest rates or market values**.
- Lower discount rates → higher liabilities.
- Policyholder options create **uncertain cashflows**.

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5-64

Unit 05 - Risk Identification and Classification

**What makes perfect asset/liability matching difficult in practice?**

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5-64

Unit 05 - Risk Identification and Classification



- Limited asset availability
- Timing mismatches
- Liabilities may contain **options or uncertainties**
- High cost of full matching

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5-65

Unit 05 - Risk Identification and Classification

**How does operational risk differ from business risk?**

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5-65

Unit 05 - Risk Identification and Classification



- **Operational risk:** Loss from inadequate/failed internal processes, people, systems, or external events
- **Business risk:** Risks specific to the business undertaken
- **Key difference:** Operational risks are non-financial events with financial consequences; business risks are direct financial risks of doing business
- **Example to distinguish:** Poor underwriting standards (business risk) vs. IT system failure (operational risk)

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Unit 05 - Risk Identification and Classification

**How is operational risk assessed effectively?**

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5-66

Unit 05 - Risk Identification and Classification



- Deep understanding of the **business model and structure**.
- Inputs from **owners, managers, and subject matter experts** are crucial.

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5-67

Unit 05 - Risk Identification and Classification

**What is external risk?**

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5-67

Unit 05 - Risk Identification and Classification



- Arises from **outside events**: storms, floods, terrorist attacks.
- Often systematic and **difficult to diversify**.
- Mitigation is usually an **operational risk function**.

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5-68

Unit 05 - Risk Identification and Classification

**What is business risk and how is it different from operational risk?**

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5-68

Unit 05 - Risk Identification and Classification



- Business risk stems from the **specific business activities**.
- Unlike operational risk, it includes **financial consequences** from:
  - Poor underwriting
  - Mispricing
  - Product failures
  - Competitive market pressures

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5-69

Unit 05 - Risk Identification and Classification

**What are business risks specific to financial product providers?**

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5-69

Unit 05 - Risk Identification and Classification



- **Mortality/longevity risk:** Incorrect life expectancy assumptions.
- **Morbidity risk:** Wrong predictions on illness frequency or severity.
- **Expense risk:** Unexpected rise in fixed/variable costs.
- **Lapse/persistency risk:** Unexpected policy terminations.
- **Volume/mix of business:** Imbalance can distort unit costs.
- **Claim frequency/amount:** Unexpected surge in claims.

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5-70

Unit 05 - Risk Identification and Classification



Compare and contrast the three types of climate risks that affect financial companies.

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## ACTEX Virtual eFlashcards for Exam CP1

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5-70

Unit 05 - Risk Identification and Classification

**• Physical Climate Risks:**

- First-order effects of environmental changes
- Can be chronic (global warming) or acute (extreme weather)
- Direct impact on assets and operations

**• Transition Climate Risks:**

- Economic/political/market changes from climate change mitigation
- Examples: Consumer preference shifts, policy changes reducing fossil fuels
- Affects business models and strategies

**• Liability Climate Risks:**

- Injured parties seeking compensation for climate change impacts
- May relate to physical or transition impacts
- Example: New link between pollution and health leading to insurance claims

**Framework:** Physical (what happens) → Transition (how we respond) → Liability (who pays for damage)

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## ACTEX Virtual eFlashcards for Exam CP1

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5-71

Unit 05 - Risk Identification and Classification



You are designing a financial product. What steps would you take to ensure you have properly accounted for all risks?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-71

Unit 05 - Risk Identification and Classification



1. Identify all risks involved in the product using classification frameworks
2. For each risk, determine whether to:
  - o Control it (reduce likelihood/impact)
  - o Transfer it (to another party)
  - o Accept and cost it (price it into the product)
3. Consider how the product interacts with **existing business** and risk exposures
4. Evaluate whether the risk-adjusted pricing remains **competitive and attractive**
5. Test with **potential customers** to ensure benefits are appreciated
6. Consider whether **complexity adds value** or just unnecessary risk
7. **Checklist approach:** "Identify → Decide strategy → Price → Test → Refine"

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## ACTEX Virtual eFlashcards for Exam CP1

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5-72

Unit 05 - Risk Identification and Classification



If you were evaluating asset/liability matching for a pension fund, what factors would make perfect matching impossible?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-72

Unit 05 - Risk Identification and Classification



- **Insufficient range** of available assets
- Lack of assets with **long enough duration**
- **Uncertainty** in liability amount and timing
- Presence of **options** in liabilities creating uncertain cash flows
- Inclusion of **discretionary benefits**
- **Prohibitive cost** of maintaining fully matched portfolio
- **Practical takeaway:** Even well-matched portfolios retain some risk elements
- **Measurement framework:** "Duration gap + Convexity gap + Option gap"

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5-73

Unit 05 - Risk Identification and Classification



How can a deeper understanding of project risk management techniques benefit the broader risk identification process?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-73

Unit 05 - Risk Identification and Classification



- Project risk techniques provide **structured approaches** to risk identification
- Methods like **brainstorming sessions** bring diverse perspectives together
- **Desktop analysis** ensures thorough research of similar past situations
- **Risk registers/matrices** create accountability and communication tools
- These methods can be **scaled and adapted** to ongoing business risks

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5-74

Unit 05 - Risk Identification and Classification

**How would you use risk classification to design a more resilient financial product?**

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## ACTEX Virtual eFlashcards for Exam CP1

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5-74

Unit 05 - Risk Identification and Classification



- Start with a **comprehensive risk taxonomy** (Credit, Liquidity, Market, Operational, Business)
- Identify **which risks the product is exposed to** in each category
- Determine which risks to **retain vs. transfer** based on core competencies
- Price retained risks** appropriately into the product
- Build in **risk mitigation features** for key exposures
- Consider **natural hedges** with existing product portfolio
- Test extreme scenarios** across risk categories

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## ACTEX Virtual eFlashcards for Exam CP1

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5-75

Unit 05 - Risk Identification and Classification



The financial consequences of operational risk can be as severe as market or credit risk. How would you apply this insight to risk management?

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## ACTEX Virtual eFlashcards for Exam CP1

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5-75

Unit 05 - Risk Identification and Classification



- Ensure operational risks receive **equal priority** in risk identification
- Develop specific **operational risk controls** at all levels
- Recognize that operational risks often have **complex interdependencies**
- Address common sources: **internal processes, people, systems, external events**
- Pay special attention to **conduct risk, dominance risk, outsourcing risk**
- **Mental model:** "Operational risks are the plumbing of the organization - invisible until they fail catastrophically"

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10-5

Unit 05 - Risk Identification and Classification



What is the typical level of state benefits in many countries, and what does this mean for individuals?

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## ACTEX Virtual eFlashcards for Exam CP1

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10-5

Unit 05 - Risk Identification and Classification



State benefits are typically:

- **Low level** – often just sufficient to keep individuals **out of poverty**
- **Insufficient** for most people's lifestyle needs

This means many individuals require:

- **Employer-provided benefits** (retirement schemes, health arrangements)
- **Personal insurance or savings** to supplement state provision

*The state provides a safety net, not a comfort blanket.*

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