Risk management

The future success of the Group is underpinned by our conservative risk profile and clear risk appetite.

RISK MANAGEMENT APPROACH

We take a broad view of the scope of risk management, which is taken to include the risk of underperformance as well as adverse events and the failure of processes.

This approach is reflected in our risk appetite statement and key risk indicators, which cover all aspects of our strategic objectives. The risk appetite statement is updated annually in line with the strategic review. It is supported by more granular portfolio strategy statements for each of our underwriting portfolios, setting out our preferred segments and products as well as those that are outside the core appetite.

The Board is closely involved in risk management via the Board Risk Committee which meets quarterly (see pages 73 to 74). The quarterly risk reports monitor the status of all risks and forms an integral part of our ORSA process.

More detail on how we manage different types of risk is set out in pages 137 to 150.

PRINCIPLES

Simple objectives

- Create value for all stakeholders
- Focus on general insurance in our selected markets
- Commitment to sustainable, profitable performance.

Clear risk appetite

- Underwriting and operating excellence
- Strong control environment
- Tight financial management
- Protecting and managing the Group's reputation.

Robust governance, control and reporting

- Comprehensive policies, procedures and controls
- Clear delegation of authorities
- Robust lines of defence
- Regular and relevant reporting and assurance processes.

OUR RISK MANAGEMENT IN PRACTICE

1. MAJOR EVENT ROOT CAUSE ANALYSIS

The Group Risk team use a cause – event risk map to identify the root causes of material risk events and learn the lessons from them.

This goes beyond identifying process failures and traces further back to identify the underlying internal management causes of significant events such as culture, leadership behaviour and reporting lines. The major event root cause analysis process helps to embed learnings across the organisation to ensure that similar events do not reoccur.

2. CULTURAL HEALTH INDEX

The Group Risk and HR teams worked together to create an index of positive and negative indicators to help senior leaders spot the early warning signs of cultural risk.

The index is based around the levers that determine culture, including leadership, communication, and decision making. The index is brought to life through a quarterly process which involves senior HR, Audit and Risk leaders working together to discuss their assessments on the health of the culture and agree mitigating actions. Importantly, the index and process gives people the language to name the behaviours that they may intuitively feel, a permission to flag concerns, and a framework for ensuring these conversations take place regularly.

RISK STRATEGY AND SUMMARY RISK APPETITE

RSA GROUP STRATEGY AND ACTION PLAN

1. Tighten strategic focus of the Group
2. Reset the quality and quantity of capital strength
3. Improve business performance and capability to sustain it

Serve Customers Well
Operate with Capital Strength
Focus on driving shareholder value

KEY RISK STRATEGIES

Capital Risk:
- Strong discipline in capital planning

Insurance Risk:
- Varied risk mix of insurance business; with volume and mix effectively managed
- Limited exposure to defined segments of special high risk business (e.g. Terrorism, Nuclear, Inwards Re)
- Strong insurance risk management disciplines
- Efficient reinsurance strategy
- Well reserved

Market Risk:
- Cautious asset allocation and investment management policies with limited exposure to higher volatility asset types (e.g. equities) or to balance sheet forex volatility
- Asset Liability duration matching with some limited flexibility for tactical asset management

Credit Risk:
- Cautious credit risk policies; with credit rating exposures laddered from AAA to A- and only limited exposure below

Liquidity Risk:
- Substantial proportion of assets are highly liquid

Operational Risk:
- Strong and efficient operational control environment

Pension Risk
- Cautious asset allocation and investment management policies within pension schemes

Reputational Risk:
- Proactive management of reputational risk with key focus on Serving customers well

RISK APPETITE SUMMARY

Capital Surplus:
- Economic, Regulatory and S&P Coverage Ratios above determined levels and buffers

Insurance Risk
- Risk mix strategy clearly defined at detailed portfolio level with rigorous risk selection
- Rigorous underwriting and claims control with appropriate pricing sophistication
- Special High Risk business to be specifically licensed by Group Underwriting Director and Group COO and within set limits
- Per event catastrophe reinsurance limits to be set at no less than 1 in 200 year return period (e.g. £1.6bn for UK/Europe), supported by strong exposure control
- Retentions in 2015: £50m per Property risk, £15m for Marine, £50m/C$50m per Catastrophe ex UK, £75m for UK Catastrophe, subject to group aggregate cover with a £180m excess.

Financial Risks
- Exposures remain within specified limits for allocation by asset class, single counterparties, balance sheet FX exposure, asset-liability matching and credit profile

Operational:
- No significant financial or reputational impacts from any operational loss event (including IT)
- Strong and efficient financial control
- Effective business recovery processes
- Ensuring delivery of change programme benefits
- High performing people, disciplined culture

Reputation:
- No significant damage to RSAs Reputation, including with Customers, Business Partners, Regulators, Investors or in the Media

OUR RISK MANAGEMENT IN PRACTICE: REVIEW OF INTERNAL CONTROL SYSTEM

In 2013, RSA found financial and claims irregularities in its Irish business. Following these an independent review by PWC was commissioned to satisfy the Board and shareholders that the problems in Ireland were not to be found elsewhere in the Group.

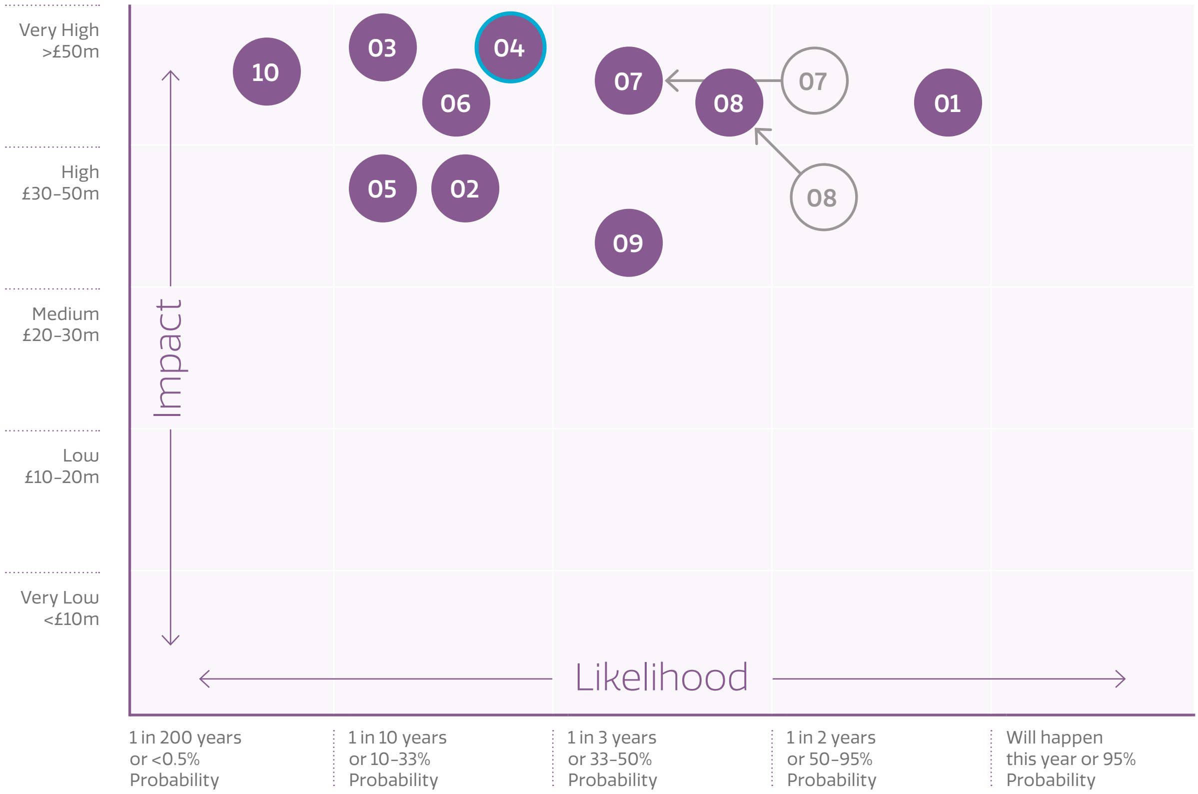
In January 2014, the results of the PWC review were published. This described the Group System of Governance, which includes the Control Framework, as appropriate in terms of structure and design for an international insurance group of RSA's size and complexity, and elements of its design compare favourably across the market. The effectiveness of the framework as it related to Ireland was weakened due to independent controls not operating effectively.

PWC confirmed that the framework is built on the good market practice of three lines of defence, is designed to have multiple reinforcing layers with a comprehensive network of policies, clear accountability including through self-certification, a framework of business controls and a range of additional assurance processes.

This notwithstanding, the Group Audit Committee and Board Risk Committee Chairmen set up a Global programme, led by the Group Risk function, to enhance the effectiveness of the Internal Control System.

This programme has enhanced control and assurance processes across eight key functions in our business. This involved improving the clarity of our risk policies, as well as advancing the organisation's understanding of the control framework and how the three lines of defence operate. We have made explicit the minimum requirements expected in each business with regard to controls and the first line control checking that must take place.
We have also strengthened our second line assurance processes that are independent of first line regional management. We have restructured our Group and Regional Risk teams to make sure there is focus on both enterprise risk management and oversight of the internal control framework.

GROUP STRATEGIC RISK PROFILE



GROUP STRATEGIC RISK PROFILE

Solid border denotes new risk

Arrow shows movement of risk since previous report

DISTRIBUTION OF QUANTIFIABLE RISKS

Our internal model provides a quantification of the total amount of risk borne by the Group, expressed as the amount of capital required to enable it to meet all liabilities to a confidence level consistent with the Group's target 'A' rating.

By analysing the cashflows in our model, we can assess the extent to which the overall level of risk is attributable to broad categories of risk.

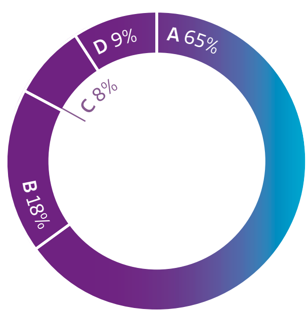
Consistent with our strategy and appetite, the majority of the Group's risks relate to insurance, comprising higher than anticipated underwriting losses, net catastrophe losses and reserve deterioration.

Our conservative investment strategy means that investment risk forms a relatively small proportion of our overall risk compared with the industry. This indicates exposure to financial market risks arising from unhedged inflation, and currency and other exposures in our insurance operations.

Within our defined-benefit pension schemes we have progressively reduced risk over a number of years through a succession of significant de-risking actions; however, due to the large size of the schemes relative to the business, they still present a material exposure, currently exacerbated by the economic environment producing a prolonged period of low real-yields.

ECONOMIC CAPITAL BY TYPE OF RISK

A Insurance Risk
B Investment Risk
C Operational Risk
D Pension Risk



Risk ID/Owner	Risk Description	Controls/key mitigants/actions	Likelihood change in year
01 (R Houghton)	Impact of negative long-term macro-economic trends, financial market volatility and/or persistent low yields, including impact on pension scheme position particularly of low real yields	· Geographic diversification · High quality, low-risk investment strategy and portfolio · Pension de-risking actions taken, and ongoing Trustee dialogue on future action · Tactical actions to mitigate reduction in yields · Defensive positioning to challenged Eurozone economies	↔
02 (D Coughlan)	Systemic failure in, or obsolescence of, pricing, underwriting and claims processes	· Granular MI on rating and claims trends · Underwriting strategy statements, licence and controls · Ongoing development of portfolio classification and pricing tools · Quarterly Business Reviews and BRC governance · Accumulation management and large loss review actions	↓
03 (R Houghton/ Regional CEOs)	Insufficient capital generation over medium term to support dividend and strategy or to cover any increase in capital requirement	· Delivery of UK strategy and other regions' operational plans · Capital and risk reduction actions taken in Q1 2014 and ongoing business review including disposals · M&A moratorium · Achieving Internal Model approval	↔
04 (R Houghton/ D Weymouth/ P Bergander)	RSA fails to secure Solvency II internal model approval, all or in part, by Q4 2015, resulting in a requirement to enter SII regime on a Standard formula basis for a material additional capital requirement	· Ongoing dialogue with regulators to resolve questions · Model governance and validation processes · Maintain core Solvency II programme · Continue to work with local teams to deliver Group and local Internal Model Approval work plan	N/A
05 (V Evans)	Failure of reward systems to align with corporate aspirations and external stakeholder expectations	· Remuneration committee governance · Review of remuneration system · Investor and media relations	↔
06 (R Houghton/ Regional CEOs)	Failure to align shareholder expectations with strategy, execution and financial performance	· Robust strategic and operational planning processes · Delivery of operational plans · Robust management of underperforming businesses · Management of corporate governance requirements · Investor and media relations	↔
07 (R Houghton)	Further restrictions on fungibility of capital following tighter regulatory measures	· Internal dividend policy · Simplification of entity structure (e.g. Scandinavia) · Regulatory dialogue (and clarity from PRA on UK targets)	↓
08 (D Price)	Failure to deliver on the IS transformation programme, including stability issues or business disruption during implementation	· Programme is made up of small, incremental investments · Commenced uplift of regional capability and recruitment of new IT Leaders · Implemented a transparent governance and assurance model · Specific focus and capability uplift on design, partner selection and contracting · Implementation costs and benefits reviewed and benchmarked by advisors · Better alignment and joint ownership of execution with the business across all regions	↓
09 (V Evans/ Regional CEOs)	Failure to create and sustain a culture and working environment that engages, attracts and retains diverse and talented staff with appropriate capabilities and experience to deliver the Group strategy	· Retention strategies targeted at key senior leaders and critical skill · Market mapping of key areas to develop talent and succession pipeline · Engaging our people in the Group strategic narrative · People expectations roll-out as part of Brand refresh	↑
10 (D Coughlan)	Failure of reinsurance programme to deliver planned benefits through, e.g. counterparty failure, operational error or failed recovery processes	· Board, Exco and BRC governance · Reinsurance recovery processes · Group-wide reinsurance placement management · Reinsurance Security controls and processes	↔

Our 2014 Strategic Report, from page 2 to page 47, has been reviewed and approved by the Board of directors on 25 February 2015

STEPHEN HESTER
Group Chief Executive