Enterprise Risk Management for Insurers

A Comprehensive Package

'THE NUMBER AND TYPES OF RISKS FACED BY INSURERS GO FAR BEYOND THE ONES THAT ARE TYPICALLY ENCOUNTERED BY ENTERPRISES IN OTHER SECTORS' SAYS **ALAM SINGH**.

Introduction

Enterprise risk management (ERM) is the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings. It is based on the premise that a holistic approach to risk management is the most effective one. On a theoretical level, this makes sense for a number of reasons:

- Not all risks can be effectively measured and quantified in the manner of claims risk, and many "soft" risks can pose significant threats to a company's financial health.
- A company should try to understand risks in relationship to one another. Risks tend to be interrelated. The risk posed to a company by a specific natural disaster, for instance, also has implications for the region or the economy as a whole.
- Spreading the awareness of risks and the responsibility for managing them throughout a company increases the likelihood that they will be dealt with effectively.
- Risk is always there, and it is ever-changing. Managing it effectively requires a strategic, long-term approach reliant on consistent tracking and reporting.

Insurers are intimately familiar with the concept of risk - it is the heart of insurance. Insurers qualify, quantify, and analyze risk through underwriting; they also manage financial risk through the practice of maintaining reserves. The number and types of risks faced by insurers go far beyond the ones that are typically encountered by enterprises in other sectors. The main differentiator for insurers, while planning risk management, is the long-term nature of the insurance business and the effects of unplanned risk on insurers' ability to fulfill long-term commitments, which can frequently extend into decades. An integrated, strategic, and consistent approach to managing risk is required by insurers. This will result in better decision-making, particularly in terms of the reserves and capital needed to support any given initiative, but also in choosing which risks to mitigate and how.

ERM requires effort and attention over the long term to realize its benefits. As regulators and markets around the world judge companies on their risk management effectiveness, ERM is rapidly becoming industry-standard practice.

The scope of enterprise risk management

Risk is an extremely broad concept. It can include any potentially negative future event whose occurrence is not certain. To begin, ERM takes a vast field of possibility and breaks it down into a number of more manageable categories. Apart from the core actuarial and pricing

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risks inherent to the insurance business, enterprise risk for an insurer can be classified into the following areas:

Strategic risk
Strategic risk occurs based on corporate decisions that have an impact over time. Growth strategy, executive decision-making, mergers and acquisitions, and approaches to capital management are all areas of strategic risk. The very act of strategic planning represents an attempt to manage strategic risk, but such efforts can be greatly enhanced by an ERM approach.

A simple example of strategic risk is the entrance by an insurer into a new product line with inadequate operational expertise in underwriting, claims processing, or policy servicing. The failure to anticipate the strategic moves of competitors is itself a strategic risk. Hence, multiple competitors simultaneously targeting the same product market will give rise to intense competition and product failure, if not anticipated in advance and not planned for.

For instance, if the top management takes a decision to shift its focus from traditional business to the unit-linked insurance plan (ULIP) product going by the market demands; agents may not be willing to push the product due to low commissions and the regular renewal requirements of a ULIP.

Strategic risk management is effective if it is applied throughout the organization. Strategic risk management may include risk-adjusted pricing, capital budgeting, hedging, investments, and risk-adjusted performance measurement through the creation and use of financial reporting systems.

An emerging concept is economic capital. Insurers should make strategic decisions based on a realistic assessment of the capital required or available. Economic capital takes a more rational view of risk specific to the insurer's conditions than the conventional methods, which focus on the difference between the value of assets and liabilities on the statutory balance sheet. Different companies may use different approaches for economic capital measurement using internal models.

Financial risk
Insurance is fundamentally a finance business; financial risk is an area that the industry plans for fairly well. Nonetheless, ERM asks that insurers take an even wider view of financial risk. Interest rate hedging and reserving are fairly well-known examples of this risk type. The risk of losing financial data to theft or damage falls under this category, as does "model risk," the possibility that financial models could fail to predict real conditions within an acceptable range of error. On the level of individual assets, default, changes in liquidity, and poor reinvestment returns are all areas of financial risk.

In the past, insurance companies have generally approached the business of insurance with a focus on premium growth and non-claim-related cost containment. While never optimal, this approach was able to leverage rising capital market returns on a fairly large scale. However, the focus of insurance executives is beginning to shift to pricing management rather than premium growth, and to overall risk control rather than cost containment.

Operational risk
Under the heading of "operations" come all those things that keep an insurance company running from day to day, including human capital, billing, claims processing, contracts, IT systems, and so on. And under the heading of operational risk are all the things that can bring a company's operations to a halt: natural disasters, labor problems, fraud perpetrated from within the company, and data problems.

Operational risks can be divided into cluster risk and commingled risk. Cluster risk involves the extent of exposure to any single event based on the accounts and/or type of coverage a company underwrites.

Cluster risk is best exemplified by geographic exposure. If the accounts are clustered in one area, for example, then that entire book of business could potentially be affected by a single event. Such a situation is inconsistent with the principle of diversification, which, in many ways, is a cornerstone of the insurance business. In fact, aggregate exposure can put a company's solvency at risk from a single event. Commingled risk involves the correlation of risk between insurance coverage/exposure and the risks related to the investment portfolio.

Operational risk can also be associated with core processes such as the problem of accurately processing claims. It also arises in recordkeeping, processing system failures, and compliance with various regulations. As such, individual operating problems are small probability events for well-run organizations but they expose a firm to outcomes that may be quite costly. Managing operational risk is made somewhat easier by the fact that operational elements tend to be more controllable than other business functions. In India, the recent interest in business continuity plans represents an increasing awareness of the need to manage operational risk - but even continuity plans must be considered within the total risk profile for maximum effectiveness.

Reputation risk
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- especially in this age of instantaneous information transfer. A negative news story, analyst's report, or agency rating can wreak havoc on an insurer's bottom line. Reputation is intimately related to the other areas of risk. Unexpectedly poor financial results, fraud, disgruntled employees, a bad model - almost anything could result in the propagation of negative stories in the media, among customers or even among competitors. Sometimes the reputation risk is not just to one company but to the entire industry, in which case it might be harder to control. In such cases the industry regulator may take steps. In a recent press release, "Misleading Sales Literature on Unit Linked Product," issued on March 2, 2007, IRDA clarified that: "Returns under unit-linked products are dependent on the performance of the chosen fund, which is in turn affected by the performance of the stock markets." Such cases of mis-selling by insurance agents are a serious threat to the industry's reputation.

Most companies have a corrective or reactive approach to reputation risk. It is essential to recognize reputation risk as a separate risk class and take necessary steps to identify, quantify, and manage potential threats to the company's reputation and public image.

Elements of an ERM strategy

Planning

Whether or not the company hires a risk management team and/or chief risk officer (CRO), outsources ERM development, or simply works with a team of current employees; ERM begins with an audit of an organization's potential liabilities, with special attention paid to their likelihood and severity. Given the difficulty of quantifying diverse kinds of risk in a common framework, this evaluation typically begins in qualitative fashion.

While this effort typically involves senior management, it is important to gather information from a wide variety of sources, as individuals at a high level may not be in a position to see every significant risk that could affect the company. At minimum, the risk plan should be reviewed annually and adjusted in light of changing conditions and ongoing risk management efforts. Where possible, the risks to the business should be quantified, but this may not be possible or practical in every case. What is crucial is to gain an understanding of the total universe of risks and their relative importance.

Another element of planning is to define a company's risk tolerance and propagate it to decision-makers throughout the enterprise. Reducing risk should produce some value for the company. If a risk is highly unlikely and not particularly severe, yet mitigating it could be quite expensive; it may be best to just leave it alone. The most difficult cases are when a risk is somewhat or very severe but not very likely, in which case a company's risk tolerance comes into play in a big way.

Risk tracking and reporting

A key component of ERM is to track risks over time to see how well they are being managed—and to deal with trends early. It may turn out that many of the risk elements inside a company are already being tracked in one form or another, in which case it is just a matter of gathering those metrics together in one place. Comparing them to each other is not as important as establishing a baseline that can be tracked across reporting periods. Insurers need to continually remind themselves that just because a risk cannot be effectively quantified or compared to others does not mean it should be discounted or excluded from an ERM plan. Even if the financial impact of a risk is difficult to measure, its occurrence can still be recorded and tracked.

Risk mitigation

Once the relative severity and likelihood of various risks is assessed, a mitigation plan is developed to reduce both. As in all things, ERM decision-makers should assess the impact of a decision on various areas of risk. In other cases, a mitigation strategy for one risk could actually increase the likelihood or severity of another risk, in which case the trade-off must be examined carefully. Also, some risks can actually represent competitive advantages. This might happen when a competitor is more susceptible to the risk, or if your company can manage it more effectively than others.

Risk financing

No matter how carefully a company understands and plans for risk, many risks will eventually become adverse events. Guarding the business from failure under such conditions is a familiar practice to most insurers because of reserve requirements. Most businesses also have typical business insurance coverage like Directors and Officers, Errors and Omissions, and so on. What is different under ERM is how financing and coverage requirements are calculated.

While ERM might increase a company's reserve or liability coverage requirements, its goal is to provide the optimum preparation for adverse events. In some cases, an ERM framework will reduce certain costs by reducing the double-counting of risks by previously siloed risk management efforts. In any case, under ERM a broader variety of risks is likely to be considered. Modeling techniques are changing to accommodate this fact, including the use of stochastic techniques to calculate "tail risk"—long-term risks associated with events that are unlikely but severe.

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Implementation

There are certain ERM fundamentals - objectives, scope, organization, and tools - that companies can use to establish an ERM framework and implementation plan. For an ERM strategy to succeed, it is important to prioritize the objective according to company needs. The objectives, ranging from the reactive to the proactive, are as follows.

- **Compliance** - Reacting to externally imposed corporate governance guidelines that concern risk identification, disclosure, management, and monitoring.
- **Defense** - Anticipating problems before they threaten the company's strategic objectives; this is largely a matter of avoiding the "land mines."
- **Coordination/integration** - breaking down internal silos by coordinating various pockets of risk management activity for efficiency's sake.
- **Exploiting opportunities and creating value** - appreciating how risks interact across the enterprise and exploiting natural hedges among them.

However prioritized, the company's ERM objectives should be measurable and should articulate the expected payoff from achieving them. ERM encompasses two dimensions: both the types of risks that ERM will cover and the management processes that ERM is intended to influence. The management processes that company executives desire ERM to influence could be strategic planning, internal audit, capital management, asset allocation, risk financing, hedging, reinsurance, mergers and acquisitions, performance measurement, etc.

In addition to a CRO (Chief Risk Officer), many organizations have established an ERM policy committee or an ERM working group. The combination of CRO and ERM committee is regarded as a "best practice," coupling the individual capabilities of a professional CRO with the integrating mechanism of a committee.

Tools

Some of the specific tools that are important for implementing ERM are :

- Risk audit guides - These guides can be used for risk mapping of individual risks, risk assessment workshops, and risk assessment interviews - the latter a "best practice" because interviews are very effective at uncovering how the business actually works.
- Stochastic risk models - A mathematically rigorous approach used to simulate the dynamics of a specific system by developing cause-effect relationships between all the variables of that system.
- Risk monitoring reports - These can include regular reports to managers, boards, and relevant external stakeholders such as regulators and investors. Our experience suggests these reports today are primarily "ad hoc." Where reporting is more formal, the reports are most likely to go to the executive committee and the board of directors. Reports are least likely to go to operational managers through "dashboards" that will enable them to adjust their actions to the reality of their risk environment.

The risks should drive the choice of tools. The choice of tools should not drive the choice of risks covered in an ERM program.

Conclusion

The most important step in any ERM effort is to gain buy-in and participation at all levels of the company. ERM is an ongoing, organized, systematic process of managing risks throughout the organization. Risk management must become part of the consciousness of every decision-maker, and even of low-level employees. Nearly any decision can be improved by the consideration of its impacts on key areas of risk. What kinds of risks are exacerbated by the decision? Which are mitigated? How likely are various outcomes?

At the core of the existence of insurance companies is the solvency maintenance and growth. All risk management activities would revolve around the same, although they may not be directly related. Additionally, quality risk management systems would positively provide a competitive edge to management's pursuing the same in true spirit.

Across the industry, related movements—like economic capital, risk-based capital, and principles-based reserving—are refining our understanding of how to plan for and mitigate risks that affect the health of insurance enterprises. As rating bodies, analysts, and legislators continue to catch on, ERM will become a requirement rather than an option. Insurers who begin the process now—or have already begun to do so with the right data quality, relevance, modeling, and measuring capabilities and implementation—are likely to have a competitive advantage in the future.

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