

ENTERPRISE RISK MANAGEMENT

EMBEDDING ERM FOR VALUE FROM RISK

The economic crisis highlights the need to integrate enterprise risk management into performance management to enhance company value.

By Linda Chase-Jenkins

With the global financial crisis intensifying the competitive, regulatory and stakeholder pressures that contend for the attention of insurers, there is even greater focus on risk and value. Plummeting equity markets, high levels of volatility and credit spreads reaching levels not seen since the 1930s have left many insurers with significant losses.

The suggestion that companies should de-risk to avoid a repeat of the current situation may be the appropriate remedy in some cases, but in general, it is not a solution. Reduced risk may reduce exposure, but it also lowers potential reward; shareholders buy stock to reap rewards, and exposure to risk is part of the equation.

Managers need to embed an enterprise risk management (ERM) framework in the performance management process to prioritize key risk factors and develop operating, organizational and financial strategies to mitigate or exploit their exposures. If implemented properly, ERM can help companies weather these uncertain times, and improve profitability and shareholder value.

Many insurers continue to struggle to integrate ERM into their business decision making. In addition to robust traditional risk management, this process requires attention in five key areas:

- *Risk strategy and risk appetite* — to establish risk-based objectives
- *Capital management* — to improve capital efficiency
- *Risk-based pricing* — to appropriately reflect return on capital in pricing

■ *Risk optimization* — to design more efficient risk transfer structures

■ *Risk-based performance management* — to align risk-taking incentives with risk limits.

Embedding ERM means using the results of ERM analysis in strategic and day-to-day decision making. It means making risk management an essential part of the culture and structure of the organization.

HOLISTIC APPROACH TO RISK

An insurer needs a balanced approach to managing business risks and opportunities, informed by a realistic market perspective and supported by a sound risk management framework. Rating agencies and regulators demand robust financial risk management programs linked to sophisticated risk analysis and economic capital (EC) models. At the same time, investors expect these aspects of the business to be managed in a controlled, transparent and auditable manner.

If these demands are to be met, insurers need to take a holistic approach to risk management and be able to aggregate market, insurance, credit and operational risks across the enterprise as well as be able to aggregate risks by products, lines of business and major organizational units. This will provide them with the risk information they need to make better-informed risk/reward decisions on key issues such as pricing and capital allocation. Of course, the risk taking must also be aligned with a company's strategy and overall appetite for risk.

AN ENTERPRISE-WIDE VIEW

The credit crunch serves as a reminder of the severe damage that can occur when well-intentioned initiatives have unintended consequences. Financial institutions are now adding ERM controls and analytics to rein in not only rogue traders but also to identify systemic exposures. Institutions that once seemed unassailable have been brought down, not by a failure to manage established securities or insurance risks, but because they assumed new risks for which exposure was not fully appreciated (e.g., credit default swaps) or underestimated existing risks (e.g., liquidity risk).

Traditional risk management methods are an important foundation for ERM, but a broader, enterprise-wide view is now required. Effective ERM programs need to consider not only the range of usual potential losses, but also the potential for extreme “tail” events and stressed, as well as normal, market conditions.

As a result of the financial crisis and growing regulatory pressures, more companies are beginning to view ERM from an “offensive” mindset. Progressive insurers want to better allocate their capital from a strategic risk/reward perspective and gain a competitive advantage by leveraging ERM and EC modeling in their strategic thinking. This proactive mindset is well under way in Europe and Bermuda, and is spreading throughout the U.S., especially among companies with a global exposure.

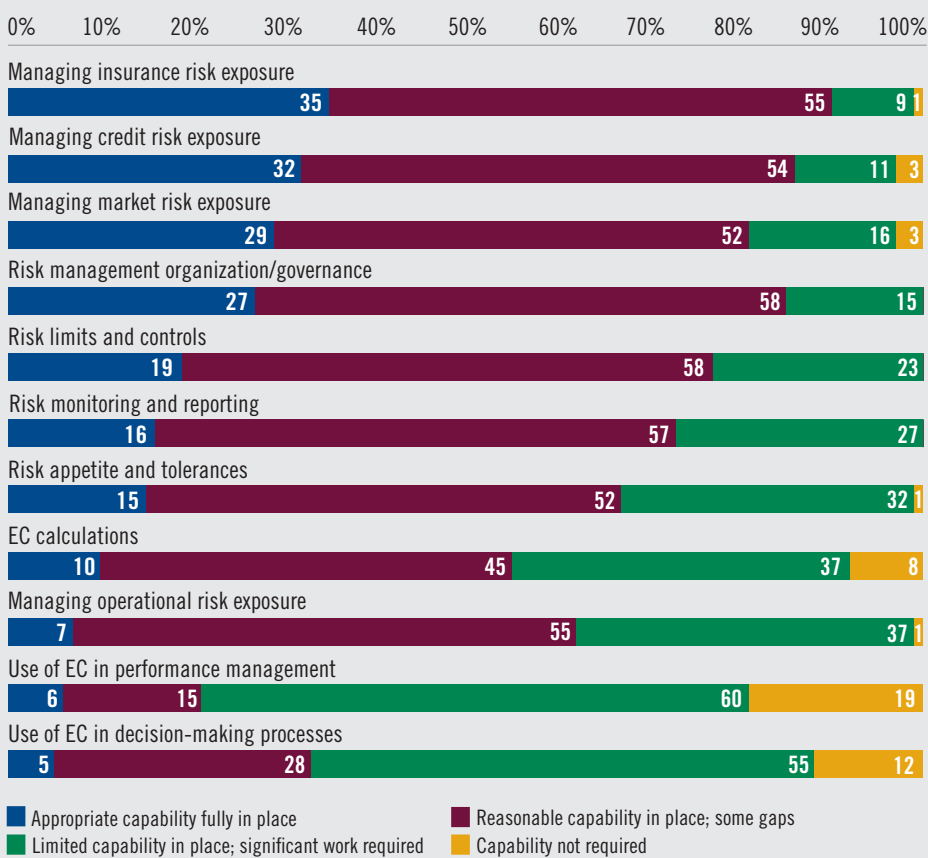


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EXHIBIT 1

Progress in embedding ERM

Significant work remains to be done in relation to EC calculations and even more on using EC in the business



THE VALUE OF ERM

Strategic and capital decision making should be rooted in bedrock corporate finance principles, such as the cost of capital and risk-adjusted return on capital. ERM can help by providing a framework to make that process risk-sensitive and more consistent and transparent across an enterprise. The objective of ERM, after all, is to enhance shareholder value as well as to protect policyholder interests.

Although companies have made progress with ERM, the results of a recent survey by Towers Perrin* suggest that insurers worldwide continue to struggle with the challenge of fully embedding ERM (see *Exhibit 1*). Less than one-fifth of respondents believe they have an appropriate capability in place for risk control, monitoring and reporting. The majority of insurers also believe that significant work

is required to use EC in decision making and performance management. Factors integral to the decision making, such as timeliness and granularity of results, are not yet a priority.

Under the proposed Solvency II framework in Europe, approval of an internal model, which is a tool central to enhanced decision making, requires the company to have a model that is used actively in the management of the business. Rating agencies have similar requirements for recognizing internal model results as a basis for determining capital requirements. However, according to the same survey by Towers Perrin, embedding the model within a company's business was considered by almost two-thirds of participants to be the greatest challenge to achieving internal model approval.

MAKING ERM PART OF THE BUSINESS

Effective integration of ERM in business decisions begins with strategy and policy formation. A strategy guided by sensitivity to risk requires a clear statement of risk appetite with well-defined risk tolerances. These relate to the key elements of the corporate strategy and form the basis for operating policies, organizational structure, and roles and responsibilities (see *Exhibit 2* on page 4).

Risk processes (e.g., risk identification, measurement, aggregation analysis) provide important insights into the potential for loss and reward from risk assumption, mitigation and transfer. Risk solutions are

*Embedding ERM — A Tough Nut to Crack, a Towers Perrin global survey of the insurance industry on the topic of ERM, 2008

the options for these responses. Performance is the outcome of these efforts, measured from a risk/reward perspective, based on effective monitoring and reporting.

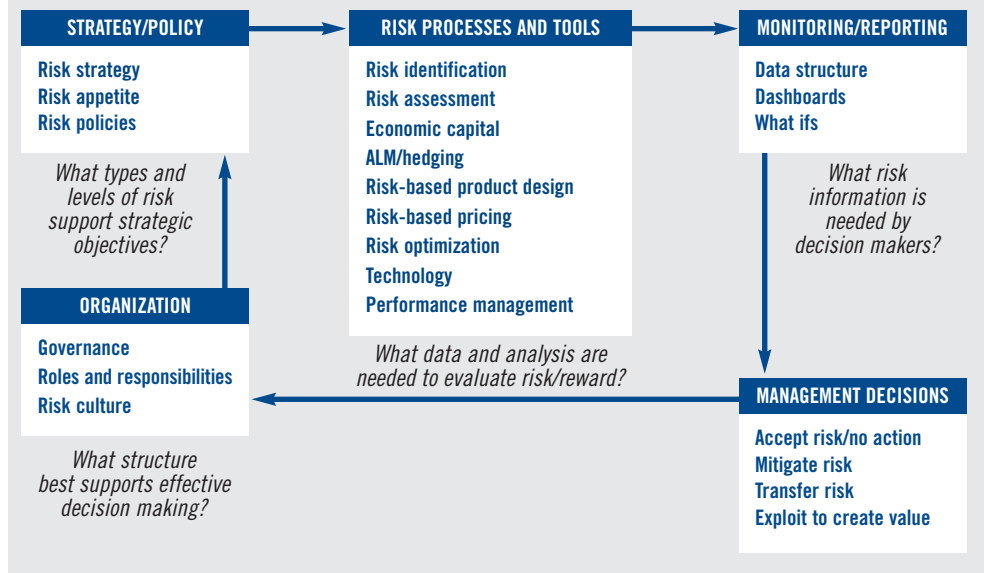
REWARDING RISK

When risk management becomes part of the day-to-day operations of the company and its decision-making processes, it ceases to be a separate initiative or special project. This does not mean the role of the risk management function or CRO becomes redundant; it simply means that ERM plays an equally integral part in running the business as, say, the finance department does, and that risk becomes factored into the strategy, governance, business processes and all ways of thinking.

Transforming theory into practice is one of the greatest challenges. Building an effective risk culture is critical for risk to be embedded within the operations and factored into day-to-day decision making. Leadership, commitment and engagement across the organization are all equally important. A risk management culture works best when these elements are present:

- strong leadership
- common understanding of the risk strategy
- a well-defined risk appetite to guide decision making
- strong communication between businesses, senior management and the board.

EXHIBIT 2 Embedding ERM for risk-based decision making



In order to ingrain risk into the culture, many organizations will need to rethink communication, education, training and incentive programs. Significant change management is often needed depending on the starting point.

These programs are necessary because ERM is not simply the sum of many individual risk management practices. A company should not depend on having a sophisticated model or robust risk limits in isolation. A model, regardless of its sophistication, is only as good as the timeliness and accuracy of the data it receives and the process for getting the results to the right people making business decisions. Because crises usually spring from multiple events rather than isolated incidents, an inability to view the aggregate impact of events means risk limits or business decisions should not be viewed independently, but instead made within the overall risk appetite boundaries.

INCREASED RETURNS

A real benefit of embedding ERM is the positive effect on the process for making risk-based decisions, such as those for reinsurance retention, pricing and capital allocation. Business managers are able to evaluate more accurately the range and likelihood of potential outcomes from key

decisions. The drivers of the variation in potential outcomes are then identified to enable better-informed decisions that recognize the interaction between risk and capital requirements or risk and value.

ERM achieves these results by establishing an ongoing system to identify key risk factors within the business and to model risk profiles for individual risk types, products and business units, as well as the whole enterprise, when evaluating capital projects and business or strategic plans. In this way, ERM provides a link between the strategy of the corporation, its financial planning and its risk management objectives.

Some insurers continue to view ERM as a compliance or cost initiative, or as a tool to avoid risk, when the primary goal of ERM is to maximize the reward for risk.

CORE COMPONENTS FOR EMBEDDING ERM

In order to embed ERM, a company must incorporate a risk perspective in the key decision-making processes. This entails concentrating on five risk elements that reflect the day-to-day operations of running a business while bringing together traditionally separated risk management processes.

Embedding ERM means using the results of ERM analysis in strategic and day-to-day decision making.

These core components include:

■ **Risk strategy and appetite.** Risk appetite continues to be an underdeveloped aspect of insurance companies' ERM programs. Hunger for returns without a defined appetite for risk can lead to disaster. Many apparent risk management failures have been caused by chasing profits when the risks being assumed were poorly understood. Defined well, risk appetite translates risk metrics and methods into business decisions, reporting and day-to-day business discussions. It sets the boundaries that form a dynamic link between strategy, target setting and risk management, and as a result is central to adopting ERM (see *Emphasis* 2009/1, "What's Your Risk Appetite?").

■ **Capital management.** The promise of better ERM is driving a wave of innovation in capital management through more sophisticated EC tools. "Breaking down the silos" is no longer a frontal attack on corporate culture, but is instead a subtle process of engagement, buy-in and understanding as we build from the ground up to create an aggregated view of a firm's capital requirements. Capital management success lies in producing timely and actionable results for decision making. Through a well-developed understanding of diversification, stress testing and capital fungibility, EC can offer a clear path toward optimum resource allocation and the pursuit of profits (see *Emphasis* 2009/1, "Preparing Economic Capital for Decision Making").

■ **Risk-based pricing.** Using predictive modeling in property & casualty insurance helps to refine the relationship between individual policyholder risk and cost-based

pricing. Adding competitive market analysis addresses market risks of cost-based pricing that is out of phase with market levels, being either too high or too low. The combination allows pricing that fits the company's risk tolerances and performance objectives (see *Emphasis* 2008/4, "Price Optimization for Profit and Growth"). Increasingly complex life product features (e.g., lifetime guarantees in variable annuities) require sophisticated risk-based analysis for pricing, supported by appropriate risk-hedging strategies.

■ **Risk optimization.** With the ERM focus on the broad range of enterprise risks, decisions on retention or risk transfer (e.g., reinsurance) can be optimized by applying risk capital analysis. In a fully integrated corporate modeling framework, it becomes directly apparent how much reinsurance costs and what the net benefits are in terms of reducing economic and regulatory capital requirements and the consequent reduction in the cost of capital (see "Reinsurance Optimization in the New Regulatory Environment" on page 22 of this issue).

■ **Risk-based performance management.** Insurers face a number of issues in setting mutually consistent measures of risk and return across different parts of the business and different product types. Management of these issues with their differing business characteristics has traditionally been approached through the application of very different techniques. More recently, companies have expressed the desire to be able to measure and manage their portfolio of risk in a more harmonized and consistent manner. This differentiates the risk characteristics of different aspects of the

business (e.g., investment versus insurance), but provides a common measurement approach to allow an overall, enterprise-wide view of reward to risk (see "Performance Management — Not Without Risk!" on page 10 of this issue).

ERM: AN EVOLUTIONARY PROCESS

Embedding risk management is easier said than done. It cannot be bolted on overnight like a new process. Merely putting ERM components or building blocks into place is also not enough to create value in the enterprise or to avoid corporate failure, as evidenced by many recent bank failures and losses. In order to be successful, these building blocks must be accepted, understood, communicated and, above all else, used in an integrated process of risk-based decision making.

ERM program development is an evolutionary and ongoing process and will continue to evolve as long as organizations change. Insurance companies have been shifting their approach in recent years from a segregated silo approach to a coordinated approach to managing risks. This consistent approach minimizes risks falling through the cracks and improves an organization's overall understanding of its risks. More important, it permits companies to strengthen performance by making better decisions that bring rewards instead of regrets.

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