SOCIETY OF ACTUARIES

ERM Symposium
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2B: The Keys to Successful Risk Identification

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The Keys to Successful Risk Identification

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ERM Symposium
Session 2B: The Keys to Successful Risk Identification
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Risk identification components

- Risk categorization and definition
- Qualitative risk assessment
- Emerging risk identification

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Common practice is not best practice

- Risk identification most common ERM stage completed, since it's the first
- Yet, suboptimal practices are pervasive, resulting in:
  - Incorrect prioritization from qualitative risk assessment
    - Focusing on some minor risks
    - Missing some key risks altogether
  - Inaccuracies in downstream ERM stages
    - Incomplete and misleading risk quantification
    - Poor risk decision-making
    - Improper risk disclosures

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5 Keys to successful risk identification

1) Define risks by source

2) Categorize risks evenly

3) Identify risks prospectively

4) Gather data appropriately

5) Define metrics clearly

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1) DEFINE RISKS BY SOURCE

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Risks are commonly defined inconsistently, by both source and outcome

	By Source	By Outcome
New competitor		
Supplier failure		
Technology failure		
Reputation damage		
Ratings downgrade		
New costly regulations		
Terrorist attack		

Which risks are defined by source and which by outcome?

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Risks are commonly defined inconsistently, by both source and outcome

	By Source	By Outcome
New competitor	X	
Supplier failure	X	
Technology failure	X	
Reputation damage		X
Ratings downgrade		X
New costly regulations	X	
Terrorist attack	X	

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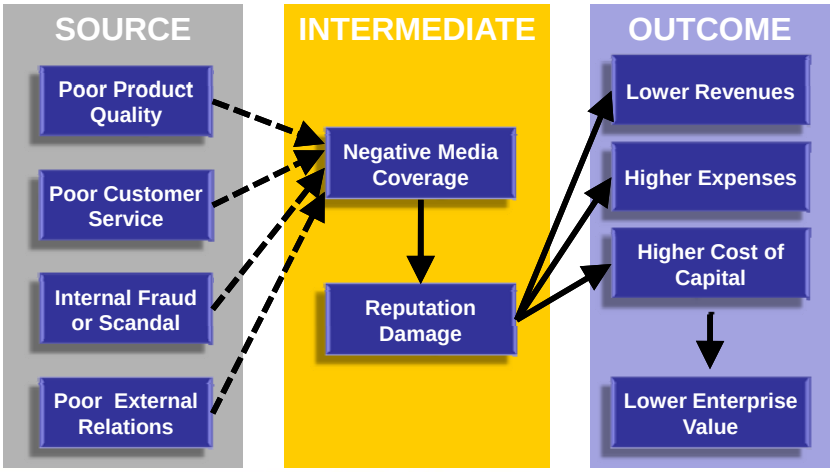
Many different sources of risk can cause reputation damage



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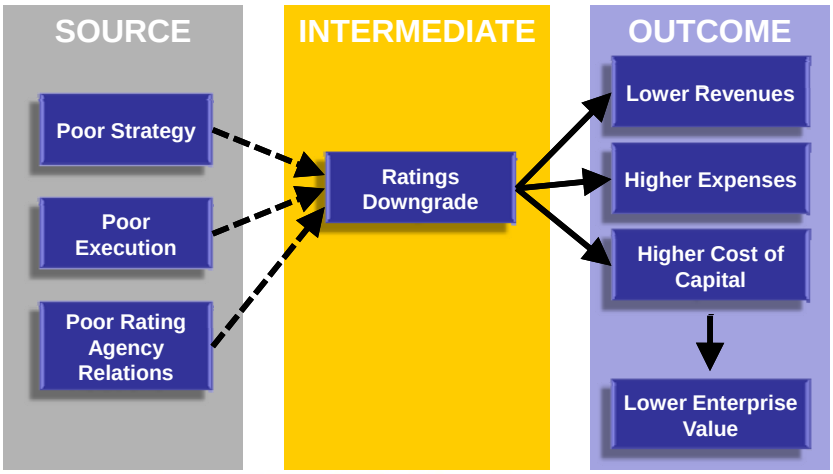
Ratings downgrades can be triggered by several different risk sources



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Issues caused by inconsistent risk definitions are resolved when defining risks by source

	Common Practice Inconsistent Definition	Best Practice Consistent Def. by Source
Qualitative Risk Assessment	Survey participants not all considering same risk source when scoring	Consistent understanding of each risk source by survey participants
Risk Quantification	Risk scenarios hampered by ambiguous definition	Risk scenarios flow logically from originating source
Risk Decision-making	Mitigation difficult to identify (since mitigation is done at source of risk)	Mitigation readily identified/evaluated: ▪ For both pre- and post-event ▪ Source and downstream impacts apparent

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2) CATEGORIZE RISKS EVENLY

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Categorize risks evenly to avoid difficulties

Level of Abstraction	Too High	Too Low	Appropriate
Example	Talent management	Low retention of mid-level staff in business segment X	▪Ability to recruit/retain ▪Succession planning ▪Labor relations ▪Etc.
Difficulties	Poor qualitative risk assessment, since it obscures individual risks within category	Causes some risks to be missed, since it may omit the overarching category and its other risks	

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3) IDENTIFY RISKS PROSPECTIVELY

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Identify risks prospectively to avoid the "fighting the last battle" syndrome

Diagnosis	"Fighting the Last Battle" Syndrome
Cause	Over-emphasis in risk identification process of past events
Symptom	Some risks on key risk list merely because of a recent past event burned into management's memory
Prognosis	▪Qualitative risk assessment scoring will be skewed, over-emphasizing risks with recent occurrences ▪Some risks that should be on the radar may be crowded out

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4) GATHER DATA APPROPRIATELY

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The right data, at the right time, in the right way

	Common Practice	Best Practice
What data?	▪Frequency score ▪Severity score ▪Additional data • Historical experience data • Mitigation in place/planned • Etc.	▪Frequency score ▪Severity score (only purpose: identify key risks)
When?	Additional data: during risk identification phase (too early), and for all risks	Selected additional data: during risk quantification (when needed), and <u>only for key risks</u>
How ?	Templates ▪Often filled in too quickly ▪No live guidance ▪No confidentiality	Interviews ▪Consistent time spent on each ▪Interactive guidance/discussion ▪Confidential, anonymous input

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5) DEFINE METRICS CLEARLY

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Typical Frequency-Severity Scoring Guide for Qualitative Risk Assessment

Frequency		Severity	
5	Very high	5	> $100M
4	High	4	$50M - $100M
3	Moderate	3	$25M - $50M
2	Low	2	$10M - $25M
1	Very low	1	< $10M

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Clearly defining frequency and severity avoids sub-par results due to inconsistent scoring

	Common Practice	Best Practice
Frequency	▪No guidance on risk scenario • Armageddon? • Most likely scenario? ▪Participants are all scoring different risk scenarios	▪Focus on credible worst case scenario ▪Participants are all scoring a similar risk scenario
Severity	No clear definition of metric • Earnings hit? • One time or cumulative? • Hit to market capitalization? • Other?	Single, consistent metric that captures all impacts: Δvalue • Provide brief tutorial to give feel of enterprise value metric

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