SOCIETY OF ACTUARIES

Article from:

The Actuary Magazine

December 2012/January 2013 – Volume 9 Issue 6

A Look Into ERM

WHAT SHOULD YOU DO AT A YELLOW LIGHT?

BY DAVID INGRAM

AN AUDI ADVERTISEMENT STATES:

> "The yellow light was invented in 1920. Almost 100 years later, 85% of drivers have no idea what to do when they see one."

The level of risk in the real world is changing all of the time. Everyone anywhere near a hurricane zone knows the annual season for those storms. They make sure that they are prepared during that season and don't worry so much in the off season. Most risks do not have clear regular seasons, like hurricanes. (And, in fact, hurricanes are not really completely bound by those rules either.)

A good risk management program needs to have a system that looks for the conditions that mean that it is hurricane season for each of the major risks. And it needs to have plans for what needs to be done in each part of the firm when they "proceed with caution." The managers of each of the affected areas need to know those plans and their own roles. There needs to be a big yellow light that flashes somewhere. And then the managers need to act; they need to execute the plans to proceed with caution. Too many companies try to create a risk mitigation program that will work in all seasons. It is thought to be a sign of good discipline to practice full mitigation all of the time. That makes as much sense as walking down the street everyday with your umbrella open over your head. If you really understand your risks, then you can develop a good system for turning on the yellow light when things are trending riskier and thereby triggering enhanced risk mitigation actions.

The same thinking applies when a yellow light is triggered by company actions. Most firms have risk limits. Some of those risk limits are soft limits. That means that the limit itself is a yellow light. Hitting the limit in these firms means that you must proceed with caution.

More commonly, the limits are hard—either red lights, cement barriers or brick walls. A red light risk limit means that when you get to the limit, you must stop and wait for someone to tell you that you can proceed. A cement barrier risk limit means that you are prohibited from proceeding when you hit that limit. A brick wall risk limit means that if you hit the limit, you are likely to be fired.

In most cases, companies do not use these terms, nor do they necessarily understand that they have choices other than the one that they have made. But, if you talk to enough insurers, you will hear of examples of each. The companies that have red lights will often hold a meeting to discuss what to do about the breach that has already happened. They will choose whether to insist upon actions that negate the breach immediately or over time. They are very serious about the limits, but realistic that business involves many decisions and that operating at maximum efficiency means operating close to the limits, making breaches a regrettable possibility.

The firms with the cement barrier risk limits do not want to talk about breaches. They want to set up systems to prevent the breaches without intervention. The limits will be programmed into their systems and written into their agreements with their

intermediaries. Usually the firms with cement barrier limits are not seeking to maximize the utilization of their resources, they expect to operate a comfortable distance from the limits. They are protecting against an occasional mistake or rogue operator.

The brick wall firms, on the other hand, are aggressive and have a very performance-oriented culture. But, they are also very serious about avoiding excess losses and expect their limit systems to be their main protection against that eventuality. In these performance cultures, rewards for success are high. Subtle signals are commonly ignored. Credibility for the limits and for risk management in general demands an occasional sacrificial ram.

In these three sorts of control systems, there are often informal yellow lights and occasionally formal caution signals. All firms that use hard limits should create a formal yellow light system with a process that identifies an official caution point along with suggestions or rules or plans of how to proceed when the yellow light goes on.

On the roads, yellow lights cause problems because there are really three different understandings. One group believes that it means, "Speed up to avoid the red light," while another group thinks it means, "Stop now and avoid having to make an emergency stop when the red light comes on."

David Ingram

The third group knows that what the yellow light really means is "**watch out for the other two groups.**" A

David Ingram, FSA, CERA, MAAA, is executive vice president with Willis Re Inc. He can be contacted at *dave.ingram@willis.com.*