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A Look Into ERM

# FINDING A SAFE PLACE

BY DAVE INGRAM

**EVERYONE WANTS** to operate in a safe place and to have a plan to stay safe.

All else being equal, almost everyone would want their safety to be more secure. Absolute safety and security is unobtainable, and even near absolute safety and security is extremely expensive. Risk managers help organizations to find their safe place from which they can operate with an acceptable and affordable degree of safety. The risk manager leads a dialogue about the trade-offs between safety and the objectives of the organization.

However, if your organization's objectives involve taking on other people's risks so that they can find their safe place, safety and security is not your only risk goal. In fact, to make a business of risk-taking work, you need some pretty complicated goals for your risk taking:

- **Diversification**—Business theories that firms should concentrate only on what they do best can be ruinous for an insurer. Diversification is the first and most important idea for a risk-related business.

- **Risk selection**—Diversification needs to be limited to those risks where the firm has enough expertise to make money over time. Underwriting of risks needs to be practiced at both the micro- and the macrolevel for risk-taking work.

- **Control cycle**—Even if the risks are selected carefully, it is quite possible to accept too much aggregate risk. The control cycle is a process to keep the aggregate risk within bounds.

- **Consideration**—The amount that the risk-taking firm is paid for taking the risks is something that needs to be carefully examined and is often part of the risk selection and control process. Usually the firm ends up with some risks that they are not being paid for that must be managed on a cost benefit basis.

- **Provisioning**—More often than not, the risks accepted extend over time into the

## ERM Sessions Offered at SOA 2013 Annual Meeting & Exhibit

**JOINT RISK MANAGEMENT SECTION LUNCHEON**
Monday, Oct. 21,11:30 a.m. – 1:30 p.m., Session 31

Learn about the rating agency view on risk management and ORSA, the approach of an external party to get comfortable with companies' ERM programs, and the impact on rating of a robust ERM program.This luncheon is open to all meeting attendees. There is a nonrefundable fee of $10 for Joint Risk Management Section members and CERAs and $30 for all others. Please include the additional fee with your registration.

**ERM—WHERE IS THE VALUE?**
Tuesday, Oct. 22, 3:45 – 5 p.m., Session 124 Panel Discussion

Take a critical look at current enterprise risk management (ERM) practices and results in light of recent history. Examine why ERM succeeded in some instances or may not have always added the value expected in others.

Get the full list of ERM sessions at ***SOAAnnualMeeting.org***.

## Be sure to take part in this seminar after the SOA 2013 Annual Meeting & Exhibit:

**GENETICALLY INFORMED RISK ASSESSMENT I**
Wednesday, Oct. 23, and Thursday, Oct. 24

Join world class geneticists, scientists, and biostatisticians to learn how genetic information and the coming revolution in personalized medicine can be applied to risk assessment and life underwriting. Visit ***SOAAnnualMeeting.org*** to learn more.

Presented by the SOA and Genecast Predictive Systems.

future. Provisions for expected losses in terms of reserves and for possible extreme losses in terms of risk capital should be determined and should also be an important consideration in the selection, control and pricing for risks.

These five goals are called *risk management* if they are given any label at all. Sometimes they are called *traditional risk management*. To the modern risk manager, these are sometimes seen as "Old School." But modern "Enterprise Risk Management" completely relies on the strong base that comes entirely from this "Old School" risk management. In fact, the first task for a new corporate risk officer (CRO) in a risk-taking organization like an insurer or pension plan should be to make sure that these five goals are being met for each of the top insurance and investment risks of the firm. Shortfalls found in that kind of review may be why CROs often have an odd traditional department or two reporting to them.

The "New School" ERM adds two largely new goals to risk management:

- **Portfolio**—Some risk-taking firms are extremely entrepreneurial and can make plans to adjust their portfolio of risks to take the best advantage of the opportunities in terms of the combined risk-adjusted returns. Other firms are more institutional but could still benefit from planning their risk and reward portfolio.

- **Future Risks**—Preparing for the Unknown Unknowns, Black Swans, and Emerging Risks is the final goal for risk taking. A risk taker needs to be clear when they are being paid to take these extreme and extremely uncertain risks and make sure that they are not caught completely unawares if these actually emerge as losses.

These two new ERM goals represent almost polar opposites in terms of thinking about risk. The Portfolio principle suggests that the risk manager can know so much about risk, the potential rewards for risk taking, and especially the interactions among a wide variety of risks that they can help their firm to "optimize" their portfolio of risks. The Future Risks are defined by some who work with Solvency II as those risks that are not well known enough to be included in the risk model that supports the Portfolio process.

The risk manager will find that they need to concentrate their efforts. They will need to create the safe place for their firm with a strong emphasis on only three or four of these seven risk principles. Those will be the topics that take up the risk manager's time and will be on the agenda for top management and the board. Which three or four are chosen will differ from firm to firm.


Dave Ingram

To many, ERM is concerned almost solely with the Portfolio principle of optimizing risk and reward. Firms that are doing an excellent job with the other six items are deemed to be deficient at ERM if they do not optimize their portfolio. That should not be the primary concern in defining the priorities for an ERM program, because the rest of this list cannot be taken for granted.

The firms that concentrate primarily upon their risk portfolio optimization will eventually find that they have two existential problems. The first is that the models upon which the portfolio optimization depends will be unreliable. Many users of complex models forget that one of the basic assumptions behind the use of statistics is homogeneity. When a company does not carefully attend to underwriting, pricing and reserving, then the data from the past will likely at some point not be a good predictor for the future or, especially, a good basis for developing a model of the future variability of potential experience.

The risk manager should periodically look at a list such as that provided above and make sure that they are aware of the level of quality of the application of all these principles at their firm. If one of the principles that was not a priority falters, the walls of the firm's safe place may at some point simply cave in. A

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