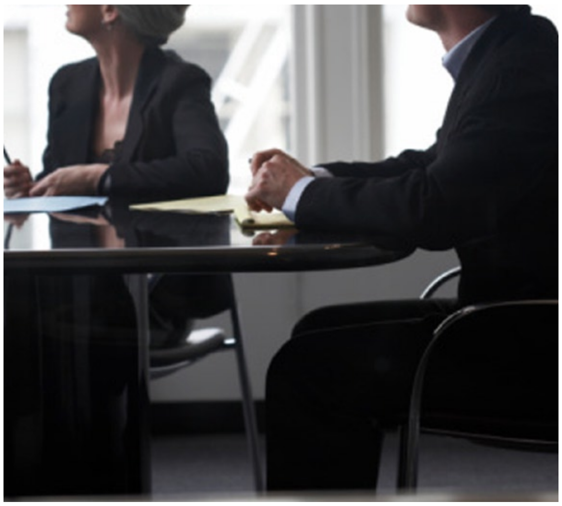
Article from:

Risk Management

March 2009 – Issue 15

The Financial Crisis—the CRO Forum's Views on the Consequences for Enterprise Risk Management and Regulation in the Insurance Industry

By CRO Forum



Editor's Note: This article was originally published by the CRO Forum in October 2008. It is reprinted here with permission.

INTRODUCTION

THE RECENT DEVELOPMENTS in the financial markets have raised serious questions about the effectiveness and efficiency of risk management in financial services. The CRO Forum addresses this topic from an insurance industry perspective and will focus on the implications of the crisis on Enterprise Risk Management and regulation in the industry as a whole.

While we acknowledge that it may be premature to undertake a comprehensive post mortem on the current financial crisis, we nevertheless wanted to express our view now, in particular in the light of the ongoing efforts in terms of insurance regulation (Solvency II).

ENTERPRISE RISK MANAGEMENT (ERM) —LITMUS TEST PASSED SUCCESSFULLY?

The insurance industry is not immune towards the effects of the current crisis. Insurance companies have significant asset bases that are affected by the currently depressed market values of assets, both from lower equity values as well as a significant widening of credit and liquidity spreads. Also, certain insurance undertakings are part of larger financial groups, and may hence suffer from contagion effects.

Nonetheless, the insurance industry as a whole has managed to navigate through the crisis, although there are exceptions. Is this because ERM is strongly embedded into the genes of the organisations? Or just because exposures to "toxic products" have been lower as compared to the banking industry?

Indeed, insurers in average have been more cautious in terms of taking on structured credit risk. This has certainly also been driven by lessons learnt in the past, in particular the 2000/2003 crisis, which triggered large scale improvements in ERM, for instance a strong focus on Asset Liability Management. In this regard, the CRO Forum is confident that ERM has helped the insurance industry coping with the crisis.

The CRO Forum also believes that this crisis, which is characterized by a complete dryout of credit and a subsequent collapse of liquidity, naturally hits the insurance industry to a lesser extent. Insurers are primarily funded by policyholders, which is a naturally more resilient source of funding. In P&C insurance, an insurance event needs to occur before policyholders can demand funds, while surrender penalties and tax considerations provide a hurdle for policyholders to lapse their traditional life insurance policy.

Nevertheless, just like the rest of the financial industry we do rely on risk models and hence there is a need to carefully analyse the reasons for risk management failures in financial institutions, and draw the conclusions for our models and ERM approaches.

"QUO VADIS, RISK MANAGEMENT?"—WHAT HAS BEEN LEARNT IN THE LIGHT OF THE CRISIS

A good deal of the pre-crisis discussion went around the details of risk modelling. If there is one thing the crisis reinforces, it is: Risk management is much more than models. The CRO Forum believes that risk models are indispensible for managing the business. However the risk models must be—and in many cases are already—complemented with Internal Controls, such as risk concentration limits on a notional gross and net basis, Probable Maximum Loss (PML) limits, or stress and scenario testing. Finally, there is no substitute for a deep understanding of the risks involved in the business—and for common sense.

CONTINUED ON PAGE 10

The Financial Crisis … | from Page 9

Every crisis of this dimension is associated with fundamental changes of business models and hence implies changes of basic parameters. Parameter values, e.g. default probabilities and equity market stresses, which have been estimated from pre-crisis times may no longer be adequate during and maybe even after the crisis. Risk management is just as much about preparing for what has not happened as it is for understanding and preparing for what has been experienced in the past. Stress tests and scenario planning can address the problems related to system change. Consequently these tools will become increasingly important and commonly used.

In terms of valuation, we believe that the market consistent valuation approaches that are the basis for our risk models have proven to be a suitable approach in times of crisis. The essence is the word "consistent" in the term market consistent: Insurance liabilities are usually not traded in liquid financial markets, but are often fulfilled over the lifetime of a policy. Market consistent valuation therefore means that components of the insurance liabilities that can be replicated in liquid financial markets shall be valued at market values, and the components that can't shall be marked to model. The liquidity of a market can change over time, in which case the valuation is adjusted accordingly. It is our view that very much the same approach can be applied to value assets for which trading has ceased to exist. Furthermore, due to the fact the insurance liabilities are not traded in liquid markets, the valuation of those liabilities should reflect actual illiquidity spreads. We have expressed this view in detail in our paper "Market Value of Liabilities for Insurance Firms", published July 2008.

Given the huge market value losses in certain financial institutions, the CRO Forum believes that Risk Management must be viewed as an investment into the company's future rather than simply as a cost factor. We expect to see management and regulators seeking to further strengthen ERM functions, resulting in growing powers and responsibilities of CROs and their teams. Given the role of risk management as second line of defence after line management, it is important that risk teams have the freedom and the capability to take an independent view from business management. A word of caution here: independence does by no means imply ignorance. We are firmly convinced that both operating units and risk management functions need a deep understanding of the business. Independence has to be supplemented by mutual understanding and respect. Hence risk management will increasingly become an integral part of the business.

THE IMPACT ON REGULATION—SOLVENCY II ON THE RIGHT TRACK

The financial market crisis has demonstrated that a principles based, economic and risk based regulatory framework is essential for the stability of the financial industry. For example, the absence of appropriate risk-sensitive capital charges for sub-prime related lending and for CDOs has contributed to the current crisis. Traditional regulatory approaches did not identify and mitigate these critical risk concentrations. Differences between regulatory regimes create arbitrage opportunities and hinder efforts for greater industry transparency which in turn contributes to an increased risk of instability and crises. Consequently we favour an approach to regulation that is consistent across legislations.

The CRO Forum therefore believes that the current crisis strongly reinforces the case for Solvency II, in particular its principle based, economic and risk-sensitive approach. In many respects, Solvency II is a reflection of the advances the insurance industry made in terms of ERM in the aftermath of the 2000/2003 crisis. While the impact of the current crisis on these efforts needs to be evaluated, we are very confident that the basic principles of ERM and Solvency II remain equally valid. We therefore believe that the EU legislators should adopt the Solvency II directive as soon as possible, and not postpone the legislative process. Insights resulting from the crisis shall be addressed through the implementing measures (level 2 of the legislative process).

The necessity for the group supervision and the group support regime has also been reinforced. It has become clear that there is a need to also supervise holding companies in a similar fashion to other group entities. Group supervision would stimulate communication between group companies, its subsidiaries and regional regulators. The CRO Forum views lack of communication and silo mentality as one of the main drivers in the current crisis.

Attention shall be paid to the potentially pro-cyclical nature of the Solvency II regulation. In particular, forced sales of assets in market downturns should be discouraged. A decrease in available capital due to distressed market prices for assets shall not require immediate regulatory intervention. We strongly believe that this should be dealt with in Pillar 2 as part of the regulators' ladder of intervention, rather than reflected in the capital requirements.

In responding to the crisis the regulators need to recognise the structural difference between the banking and the insurance industry. Imposing actions on insurance companies solely based on observations in the banking industry would not be appropriate.

As with risk management and the operating business, the CRO Forum strongly advocates the equality of talent between regulator and industry. Only then can regulators take appropriate decisions. ✦