SOCIETY OF ACTUARIES

Article from:

Risk Management

March 2012 – Issue 24

How is Your Risk Appetite These Days?

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DEFINING OUR APPETITE FOR RISK IS A FUNDAMENTAL ELEMENT of risk management (ERM). Risk appetite defines the risks we are prepared to assume (or alternatively those we deliberatively choose not to assume) as well as the overall magnitude or size of those risks that we are prepared to manage. I am sure that events of the last few years have caused many a risk manager or insurer to question their previous ERM risk appetite statements.

Closely associated with risk appetite is the accompanying need for risk tolerances or limits to be applied for the risks assumed. One analogy that helps to make clear the difference between risk appetite and risk tolerance is highway driving speed. For example, a driver may make a conscious decision to travel at speeds that exceed the speed limit (i.e., their risk appetite) however, to avoid undue risk to others on the road or speeding tickets, the driver limits their excess over the speed limit to 10 or 20 kilometers (for those metric users!) per hour (i.e., their risk tolerance).

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As fundamental elements of ERM, the determination of risk appetite and risk tolerances properly require board level approval. Consequently, we might hope that once put in place, the appetite and tolerances would stand the test of time and require infrequent adjustment. However, the last few years have provided us with several examples of game changing circumstances requiring senior risk officers, CEO's and even boards to pay closer attention to their risk appetites and consider significant changes to their company's business models as a result. These companies found themselves in increasingly difficult positions as they accumulated risk positions unexpected by their existing (but now out of date) risk appetites and tolerances.

Examples of risks which have caused property and casualty insurers to reconsider their business models and their risk appetites include terrorism, climate change and asbestos. Consider the risk of water damage to homes and businesses (whether by rain, storm, flooding, wind or sewer back-up, etc.) for a moment. Our planet and the communities we serve are increasingly more densely populated with structures being built on increasingly challenging terrain (hillsides, flood prone land, etc.). When combined with increasingly volatile and changing weather patterns yet continuing high customer expectations for loss coverage, there is a need for property and casualty insurers to regularly review their risk appetites.

For life insurers, the examples may be different but the importance of properly defining risk appetite remains the same. The inexorable shift in customer base brought about by demographic trends (e.g., baby boom, Generation X, etc.) has shaped the products sold by insurers over the decades. Recent decades have witnessed the increasing sale of wealth management products including increasingly complex versions of variable annuity products (at least in North America). These very popular products have also exposed writers of these products to non-diversifiable market risk, sometimes in considerable amounts. These products mark a change from "traditional" life insurance products commonly considered to constitute diversifiable risks (at least with respect to mortality). However, as we experience continued market turbulence, increasing asset default risk on many fronts and a long continuing period of very low interest rates, the blocks of in-force traditional insurance face significant economic challenges. Several life insurers and their boards have had to react quickly in recent years to these significant changes in their risk exposures. These challenges will likely result in significant alterations by life insurers in their strategy, definition of their risk appetite (/ risk tolerance) and in their business models going forward.

It is important to remember that risk mitigation via such mechanisms as reinsurance or hedging (just two examples) is an important tool in risk management but it is not a substitute for proper definition of the risk appetite. Risk mitigation tends to transform risk exposure from one type to another, not eliminate risk completely. For example, reinsurance tends to transform types of insurance risk into counterparty risk with the reinsurer.

In summary, while we might think that risk appetite should be fixed, it requires careful periodic review, due to changing insurer but also broader industry, economic, climatic, demographic, etc. trends.

How is your risk appetite these days? Do you have an ERM blind spot?