



SOCIETY OF ACTUARIES

Article from:

# Risk Management

August 2013 – Issue 27

# Chairperson's Corner

By Barry Franklin

**AS RISK MANAGEMENT PRACTITIONERS** we live in interesting times, and as I survey the horizon it seems they are bound to become even more interesting in the future. Between evolving regulatory requirements, continual improvements in (and increasing expectations of) risk modeling, unrelenting global financial headwinds and the incredible pace of technological advances, it is sometimes difficult for today's risk manager to know where to focus attention. The Joint Risk Management Section (JRMS) seeks to further the science of risk management by promoting practical and technically sound research to help risk management professionals meet emerging challenges, through which efforts the profile of the actuarial profession is enhanced. Let's take a brief look at three current and proposed areas of research.

## HOW TO READ AN ORSA

*"Perhaps when a man has special knowledge and special powers like my own, it rather encourages him to seek a complex explanation when a simpler one is at hand."*  
Sherlock Holmes

ORSA reporting requirements in Europe, the United States and Canada present actuaries with an opportunity to communicate risk concepts to a broader audience—for better or worse. While some would argue the opportunity lies in providing actuaries with a vehicle for demonstrating our quantitative prowess through economic capital modeling and prospective solvency assessment, I would suggest the more significant opportunity relates to our ability to clearly communicate risk information to key stakeholders. Rightly or wrongly, actuaries are more often chided for our communication skills than our calculation skills. While we absolutely need to ensure the quality of the technical work underlying various ORSA reports, we cannot stop there.

The JRMS plans to launch a call for essays on how to read an ORSA; it is hoped that publishing a collection of such essays will provide a useful road map for insurance executives to effectively navigate an ORSA report and find the information they require. Along the way, such a resource might also help practicing actuaries produce more user-friendly reports for their audiences.

## MODEL VALIDATION

*"Mathematicians finally developed a financial model to accurately compare apples and oranges. Any two kinds of fruit can be compared, although guavas still cause minor rounding errors."*  
Graham Parke

A model can be a powerful tool, an interesting distraction, or potentially a weapon of mass destruction. One of the lessons learned from the global financial crisis was the need for financial models, including critical assumptions and key parameters, to be challenged and validated. The JRMS is encouraging research to provide practical guidance to actuaries in the validation of economic capital and similar models. As with the Hippocratic Oath in medicine, the first objective of actuaries using sophisticated models should be to "do no harm."

This effort dovetails quite nicely with the ORSA topic as well. A critical aspect of ORSA addresses prospective solvency assessment which by its very nature relies on models—stochastic or otherwise. Even the most effective communication cannot overcome the reputational damage associated with actuaries relying on results derived from inappropriate models and assumptions. Thus, while we need to communicate effectively, we first need to calculate correctly. Model validation is a must.

## INCENTIVE COMPENSATION

*"The fact that people are full of greed, fear, or folly is predictable. The sequence is not predictable."*  
Warren Buffett

Stock-based incentive compensation programs were initially introduced to remove the incentive to mask current financial problems in order to maximize reported revenue and earnings and boost annual cash bonus payments. Now there is concern that such programs may increase risk even further by incentivizing executives



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to mask long-term growth and profitability problems. The issue extends well beyond stock options and the executive suite, however. While actions of executives garner more headlines and arguably have the potential to do the most visible damage, misaligned incentives at any level of the organization can have a profound effect on risk culture.

Analyzing the interaction of incentive compensation with risk behaviors can benefit companies of all types and sizes. Research of this nature opens the door for

actuaries to provide relevant risk management advice outside of our traditional areas of influence.

I hope you enjoy this edition of *Risk Management* and encourage you to look for developments with respect to these and other research efforts in the coming months. If you have ideas for practical research or other suggestions for the JRMS to provide support to risk management practitioners, please send your comments to: [dschraub@soa.org](mailto:dschraub@soa.org). ■

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# YOUR VOTE COUNTS



## CALLING ALL ELIGIBLE VOTERS

Elections open **August 19** and will close **September 6 at 5 p.m. CDT**. Complete election information can be found at [www.soa.org/elections](http://www.soa.org/elections). Any questions can be sent to [elections@soa.org](mailto:elections@soa.org).

# SOA '13 ELECTIONS

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