ERM in Five Words

Part 2: Alignment, Adaptability and Resilience

By Dave Ingram

Editor's note: "ERM in Five Words" is a series of two articles. Part 1: Resilience, Transparency and Discipline was previously published in the December issue of Risk Management.

In Part 1, we talked about how Transparency and Discipline make ERM strong. But a strong ERM program is not always best for an organization. We hear stories of such ERM programs clashing with business managers and sometimes winning those fights. You only want that to happen if said strong ERM program is aligned with corporate goals and strategies. Otherwise the "wins" for ERM could be "losses" for the company.

In addition, a strong ERM program can also be brittle, meaning that it fails under unanticipated stress. To avoid brittleness, ERM must be adaptable as well. In Part 2, we address two more of the five words for ERM—Alignment and Adaptability—and how all four lead to Resilience.

ALIGNMENT

Risk has traditionally played a minor role in the strategic discussions that firms face.

Often, planners get risk out of the way at the very start with a discussion of strengths, weaknesses, opportunities, and threats (SWOT). Then, as quickly as possible, the planners shift into concentrating on a discussion of opportunities. That is what they are there for anyway—opportunities.

Risk management has been a part of business practices for thousands of years. ERM is a new approach to risk management that, when taken to extremes, may noticeably increase the cost of doing business and can take the attention of executives away from running their firms. But, through the alignment of ERM with your business plans, ERM can more than cover those costs with its benefits.

The alignment of enterprise risk management and business strategy takes place at two levels: first as part of the aforementioned strategy and planning discussion, and second, in the more operational discussions that result from the strategy and plan.

Risk Appetite and Strategy

The idea that aligning risk management and strategy is highly important may be a stretch for some businesses; but for insurers, risk is the raw material of the business. So it seems very natural that a discussion of risk management should fit well within the strategic discussion of the insurance business.

The main building block of the strategic discussion of risk and risk management is the risk appetite statement. Risk appetite is defined in the *U.S. National Association Insurance Commissioners (NAIC) Own Risk and Solvency Assessment (ORSA) Guidance Manual* as:

> Documents the overall principles that a company follows with respect to risk taking, given its business strategy, financial soundness objectives and capital resources. Often stated in qualitative terms, a risk appetite defines how an organization weighs strategic decisions and communicates its strategy to key stakeholders with respect to risk taking. It is designed to enhance management's ability to make informed and effective business decisions while keeping risk exposures within acceptable boundaries.

ERM Tools

Besides risk appetite there are several ERM tools that can aid in the strategic risk discussion.

Risk Profile

A part of the statement of the impact that the plan will have on the company should be a before-and-after risk profile. This will show how the plan either grows or diversifies the firm's larger risks. Risk cannot be fully described by any single number; therefore, there is no one single pie chart that is *the* risk profile of the firm.

The risk profile should be presented so that it articulates the key aspects of risk that are the consequences of the plan—intended or otherwise. This may mean showing:

- the geographic risk profile,
- the product-by-product risk profile,
- the risk profile by distribution system,
- or, the risk profile by risk type.

By looking at these different risk profiles, the planners will naturally be drawn to the strengths and weaknesses of the risk aspects of the plan. They will see the facets of risk that are growing rapidly and consequently require extra attention from a control perspective.

And even if there are none of those reactions, the exposure to the risk information will eventually lead to a better understanding of risk and a drift toward more risk aware planning.

Risk Management View of Gains and Losses

Planning usually starts with a review of recent experience. The risk managers prepare a review of the prior year describing the experiences for each risk in terms of the exceedance probability from the risk models. This can lead to a discussion of model calibration, and possibly to either better credibility for the risk model, or a different calibration that can be more credible.

Risk Controls Review

Each risk is operated within a control system. The review of recent experience should discuss whether the control systems worked as expected or not.

Risk-Adjusted Pricing

The review of gains and losses can also be done as a review of the risk margins compared to the risks for each major business or product or risk type. Comparison to a neutral index could be considered as well. With this review, the question of whether the returns of the firm were a result of taking more risk or from better selection, and management of the risks taken, should be addressed.

Management groups may be much more interested in one or more of these tools. The risk manager must search for the approach to discussing risk that fits management's interests in order for risk to become a part of planning and strategy. Without that match, any discussions of risk that take place to satisfy regulatory or rating agency pressures will be largely perfunctory.

Recent studies[1] have found that insurers who link ERM to strategy are much happier with their ERM program. Over half of insurers who responded to a recent poll on risk appetite said that a linkage between ERM and strategy was an explicit objective included in their risk appetite statement.

Risk Tolerance and Company Plans

Risk tolerance is the term of art for the aggregate risk plan. A company can skip having an aggregate risk plan, but if they have one, that plan is the risk tolerance. So, it is probable that more companies actually have a risk tolerance and simply do not realize it.

A majority of companies who recognize that they have a risk tolerance[2] have set it to reflect the consideration of rating agency and regulatory requirements, and sometimes also include a statement about the amount of surplus that is at risk under pre-determined circumstances. So, if the insurers who do not use the term "risk tolerance" indeed have a target for their RBC ratio or for their AM Best BCAR score, they are thereby setting an aggregate risk plan, which means that they do actually have a risk tolerance.

Strategy and Plans Impact on Risk Management

ERM should stand out of the way of the aggregation of risks the insurer plans to exploit.

An enterprise risk management program will also work to align the management of individual risks to strategy and plans. At the highest level, there are four possible strategies for controlling individual risks:

- Exploit
- Manage
- Minimize
- Avoid

The company strategy identifies the risks that are going to be exploited and managed. The ERM program should be active to assure that risk management is not serving as the business prevention function for those risks.

ERM should stand aside of the aggregation of the risks that the insurer plans to exploit, and it should make sure that due care is taken with the risks that require managing. But, that care should be of the "not too hot" and "not too cold" variety that allows for the business's success.

The ERM program should also provide assistance with the processes and procedures needed to minimize and avoid the risks that are not a direct part of the insurer's success formula. Ultimately, this means plans for risk acceptance, limits and mitigation need to be carefully reviewed by ERM for each and every of the firm's important risks.

Without a Link to Strategy

If risk management is well developed into a strong, effective, disciplined, function there are two possible outcomes: it can either help achieve the business strategic objectives, or, it can be a strong force that will, at times, prevent the achievement of strategic objectives that are perceived to be too risky (see Figure 1).

An ERM program with transparency and discipline is a powerful tool for management to use. Such a program, if set on the path of alignment, can be counted on to stay on that path and to continually support the overarching strategy while providing evidence of that alignment for all to see.

Figure 1
Effectiveness of Risk Management Impacts Alignment with Strategy

Effectiveness of Risk Management	Alignment between Risk Management and Strategy: Less	Alignment between Risk Management and Strategy: More
More	Risk management works to prevent actions taken to support strategic objectives; **causing major management clashes.**	**Risk Management seen as strategic partner;** can successfully discourage actions that nave potential to stymie strategic objectives.
Less	Risk management will ineffectively oppose actions taken to support strategic objectives; **as a result, it is ultimately ignored.**	Risk management will discourage actions that it thinks may hinder strategic objectives; **sidelined from strategic discussions.**

ADAPTABILITY

Deliberately cultivating adaptability is how enterprise risk management works to reduce exposure to and losses from surprises. Here are four ways that ERM programs work to encourage adaptability.

Revisiting Risk Identification

All ERM programs start with risk identification. A company will identify its top risks—those that are a potential threat to the existence of the firm—in the initial risk identification process.

But that risk identification and prioritization process becomes less and less accurate as time passes. Depending on the areas where a company does business, it may need to revisit its risk identification and prioritization process every other year; some companies even find it easier to just repeat the process annually.

But there is a danger with repeating the process too often. If there are no noticeable changes in the risks identified or priorities from year to year, then the process that merely reaffirms the prior choices will appear to be a needless piece of excess bureaucracy.

One way to enliven the update process is to consider what others in the industry are thinking. (See 2017's Most Dangerous Risks[3]) The result you should expect is a shifting in the prioritization of risks from year to year. But it needs to be a shift of priorities that have enough credibility to actually shift the amount of thought, resources and attention towards the risks that have increased in priority. That means a shift that top management really believes in.

Emerging Risks

Standard risk management deals with "presenting" risks—the risks that we are generally aware of mostly because we have some experience or have seen others experience losses from those risks. But, we have also been warned of black swans and unknown unknowns that might come out of nowhere and knock us for a major loss. In ERM, we call those unexpected risks emerging risks. ERM includes processes for identifying and preparing for the next emerging risks.

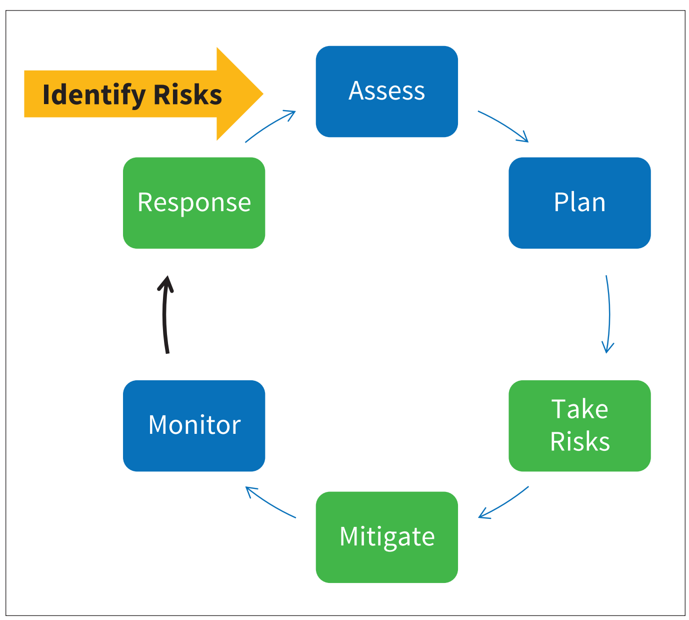
As the risk register is updated, risk managers and company executives should consider whether it is time to elevate an emerging risk into the list of important presenting risks. In the "2017 Most Dangerous Risks" survey, for example, cyber-crime made the top of the list. Several years ago, cyber-crime would have been considered an emerging risk.

Risk Control Cycle

Much of ERM takes place within a risk control cycle (see Figure 2). The risk control cycle has seven steps:

- Identify
- Assess
- Plan
- Take Risks
- Mitigate
- Monitor
- Response

Figure 2
Risk Control Cycle



Of the seven steps, the last step, Response, is the opportunity to adapt if the deviation from the plan is great enough. In a highly developed risk control cycle, the Response step will also be planned in advance.

When the situation actually occurs where the Response is needed, the actual choice might or might not be the planned Response. But companies have found that if they have discussed and planned a potential Response in advance, they can be faster in developing an actual effective Response when the need arises.

Another key feature of a risk control cycle is that it is repeated and at each repetition the Assessment step is redone. When the Assessment step is repeated, the company has the opportunity to improve the risk management process. This is especially important for a new ERM system that is best developed by a step-by-step trial-and-error process.

Risk-Learning Process

In addition to the continuous improvement that comes with the risk control cycle, companies should include a deliberate risk-learning process as a part of their ERM program. One firm made risk-learning a regular part of their risk committee meetings. The first fifteen minutes of each meeting is taken up by a risk management lesson brought to the group by a member on a rotating basis.

ERM will not be successful for the long run as a fixed, static system because risk in the real world is constantly changing, and usually in such ways that will gradually render old ERM processes ineffective. That is not a failure of those who build ERM systems; it is simply part of the nature of risk.

Continuous Improvement of Risk Management

After the initial development project ends, ERM needs to be on a course of continuous improvement. Just as the risk prioritizations of an organization are constantly adapting, the effectiveness of risk selection and mitigation processes are also evolving all of the time. Revisiting risk identification and the emerging risks process work to adapt the subject of ERM—the risks—to the present and near-term future.

The risk control cycle is designed as a feedback loop that will bring the effectiveness of last year's risk management into next year's planning. Risk learning is the part of ERM that works to incorporate lessons from both the company's own experience and the experiences of others into the knowledge bank of the firm. Adaptability is encouraged and institutionalized via ERM.

The ERM process that draws its power from Transparency and Discipline and its direction from Alignment, but only with Adaptability can ERM maintain its effectiveness over the long term.

RESILIENCE

Which brings us back to Resilience. And here we are not just talking about Resilience in the context of business continuity and disaster recovery, we are using the term Resilience in the broadest possible sense. This Resilience is the capability for an organization to survive any possible adversity and to continue operating.

With this sort of Resilience, an insurer will be able change, renew and reorganize to survive in a world and market that is constantly changing, renewing and reorganizing as well. This is where the two-sided definition of Risk becomes one again—the up side and the downside management are one and the same. In the event of an extremely adverse scenario, a vision of a new opportunity can be the ultimate form of risk management of the situation. This is adaptability.

And when an insurer has a clear vision of a new opportunity, if risk management is not aligned with the efforts to achieve success and avoid failure while pursuing that opportunity, it will be brushed aside, relegated to the periphery. However, when risk management is aligned with the new strategy of the insurer, then the discipline and transparency that make risk management strong will be eagerly accepted.

Risk management that does not adapt will not be aligned and will fight against changes in company strategies that are vital to long-term survival. Meanwhile, Transparency and Discipline are what makes ERM strong and reliable so that the organization will be able to maintain its desired strategy in many stressful situations.

Enterprise risk management is **Transparency**, it is **Discipline**, it is **Alignment** and it is **Adaptability**. Which together, all leads to **Resilience**. These five words are ERM.

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ENDNOTES

1 *https://www.towerswatson.com/en/Press/2015/04/global-insurers-embrace-risk-management-as-a-strategic-business-partner*

2 *http://blog.willis.com/2015/04/risk-appetite-and-tolerance/*

3 *https://blog.willis.com/2017/01/2017-most-dangerous-risks-for-insurers/*