SOCIETY OF ACTUARIES

Article from:

Small Talk

October 2012 – Issue 38

Enterprise Risk Management Can Work for Smaller Insurance Companies

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This article is a summary of two presentations sponsored by the Smaller Insurance Company Section. The first was a webcast on March 13, 2012, and the second was at the ERM Symposium on April 20, 2012.

The subject of enterprise risk management has been growing in importance over the last several years. For the actuary in a smaller insurance company, the concepts discussed may be either intimidating or sound completely unnecessary. The Smaller Insurance Company Section sponsored a webcast in March and a presentation at the ERM Symposium in Washington in April designed to specifically address the issues from a small company perspective.

The theme of both presentations centered on the idea that all companies can benefit from a sound risk management framework, and that it should be proportional to the risks in the company's business. The webcast featured five speakers:

- Jeremy Rosenbaum, CFA, analyst, Financial Services Ratings, Standard & Poor's
- Connie Dewar, FSA, FCIA, managing director, Life Insurance Group, Supervision Sector, Office of the Superintendent of Financial Institutions (OSFI)
- Todd Henderson, FSA, CERA, MAAA, vice president and chief risk officer, The Western and Southern Financial Group
- Lance Smith, CA, MBA, vice president, chief risk officer and chief internal auditor, Foresters
- Mark Milton, FSA, CERA, MAAA, senior vice president and actuary, Kansas City Life Insurance Co.

The ERM Symposium session featured myself, Mark Milton and added Amit Ayer, FSA, MAAA, adviser, Ernst & Young LLP.

The following represents a summary of the key concepts presented during these presentations.

Expectations of Risk Management

In both the webcast and the live presentation, the first speakers set up the reason companies should be incorporating enterprise risk management. Rating agencies have distinctly stepped up their expectations, and their methodologies now include an assessment of a company's risk framework. S&P reviews five components:

- Risk management culture
- Risk controls
- Emerging risk management
- Risk models
- Strategic risk management

Under each of these, a financial institution will be assessed against a range of indicators from least effective to strongest. These indicators will be included, among other factors, in the establishment of the rating for the institution.

Regulators, too, have recently taken a more formal approach to assessing risk management in institutions as part of their supervisory duties. Own Risk Solvency Assessment is being discussed in the United States as is Solvency II in Europe; these form the foundation of a risk-based solvency regime (as differentiated from the current factor-based approaches). In Canada, the risk-based approach to supervision is well established in OSFI. There is a clear emphasis in the review of institutions on risk and capital management using stress-testing techniques.

The Evolution of Risk Management in an Organization

It is well recognized that risk management is an evolving field and that each company will need to find the appropriate approach for its business. It also seems clear that what is acceptable today may be insufficient in the future. There is a need to continue to improve and expand risk thinking. This evolution was summarized as follows.

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Siloed risk management
- Functional risk management
- Informal communication among risk managers
- Inconsistent risk management and measurement techniques
- Independent reporting to executives and directors

Organized risk management
- Centralized risk management administration
- Formal communication among risk managers
- Consistent risk management and measurement techniques
- Risk aggregation model mechanism (model)
- Overriding risk policy
- Coordinated reporting to executives and directors

Integrated risk management
- Organized risk management, plus
- Statement of risk appetite
- Articulated risk thresholds
- Risk-monitoring mechanism (dashboards)

Enterprise risk management
- Integrated risk management, plus
- Strategic deployment of capital
- Risk-adjusted performance measurement
- Emerging risk analysis
- Strategic risk analysis

One can easily assess a company's practices in these categories to decide where they are along the spectrum of increasing sophistication. Clearly, too, this is an area where the appropriate proportionality can be assessed for a company's individual circumstances.

Framework of Reporting and Governance

Another way of looking at this is to see the actual framework of risk management in an organization, where each of the elements above can be reviewed to see if there is a fit. One such framework is shown below.

Risk Appetite

One aspect of risk management that can be difficult is clear articulation of what and how much risk the company is willing to take to achieve its objectives. This is the risk appetite statement. While it is likely that most individuals in an organization would have an idea about their risk appetite, it is extremely unlikely that each person would say the same thing, unless it has been formally discussed, agreed to and documented. This statement can then be used to ensure alignment of decision-making to organizational objectives.

Generally, the statement would include both quantitative and qualitative measures. Quantitative measures may include statements about capital, earnings and a value measure, as well as statements regarding lines of business. Qualitative statements would address reputation, market position, ratings and regulatory standing.

Risk Management Framework

REPORTING

Risk policy
- Risk appetite/tolerance

Risk report
- Risk profile (heat map)
- Discussion of high risks
- Assess against appetite
- Emerging risk identification

Risk analysis
- Asset-liability management
- Sensitivity/stress test
- Pricing reports
- Business cases

Risk register
- Identify all risks
- Likelihood/consequence
- Measurements/triggers
- Mitigation plans

GOVERNANCE

Board of directors
- Risk committee

Executive risk committee
- Chaired by CEO
- Includes chief risk officer

Corporate risk department
- Chief risk officer
- Actuarial and modeling

Operations risk committee
- Risk network
- Project teams

Tone at the Top

Risk Culture

Tips and Challenges

Through the presentations, speakers were happy to share keys to success and pitfalls to avoid. Some of these are summarized here.

1. Risk discussions can and should lead to some tension. There will be different perspectives offered by the leader of sales, the operational leader and the chief actuary. These are to be expected, and need be worked through to achieve a common understanding of the goals.
2. Small companies tend to have risk as an add-on to someone's responsibilities. While a challenge to time management, risk thinking must be shared among all decisionmakers—which is the goal in the end, anyway.
3. The degree to which modeling is essential varies from company to company depending upon the specific risks inherent in the business. A company with only traditional participating whole life business has a different need from a company with variable annuities with living benefit guarantees.
4. Ensure there is a forward-looking aspect to risk management. It is easy to point out the failure of risk management after a flaw has manifested itself. The real goal is to find the leading indicators, so that such circumstances can be avoided.
5. Risk management is most effective when conducted simultaneously bottom-up and top-down. Line staff are highly likely to be the first to be able to identify a trend in the business; success is more likely if they know what to look for. At the same time, if the board has no interest, and incentives for senior management do not have a risk management orientation, then any program can fail from inattention.
6. Reporting dashboards or "heat maps" should be constructed in a way that integrates information and allows quick assessment of current conditions. Of course, it is critical to have robust, reliable and assessable data sources.

Conclusion

Enterprise risk management is an important and evolving discipline in the insurance business. Even in companies with relatively low technical risk, there are still many landmines that can derail a company's strategy. Additionally, the current low interest rate environment has highlighted that even companies with a conservative stance can find themselves more at risk than they had expected. And, who knows what the next risk to emerge that we will all need to manage will be?

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