GETTING UP TO

ERM IN THE LIFE INSURANCE INDUSTRY

BY ROBERT WOLF

THIS ROUNDTABLE DISCUSSION focuses on the life insurance industry and how far it has come in instituting ERM practices.

In this edition of the Evolution of Enterprise Risk Management series, our focus will be on the life insurance industry.

In the ongoing evolution of the ERM discipline, in what phase is the life insurance industry? What are some unique aspects, considerations, and risks that differ in this sector than in other sectors of the economy? How is the corporate risk culture evolving? These and several questions will be addressed in this roundtable discussion with three prominent advisors and experienced practitioners in the sector. They are Dale Hall, vice president and chief actuary at COUNTRY Financial; Max Rudolph, founder, Rudolph Financial Consulting; and Larry Moews, formerly chief risk officer at Allstate Financial Group. Their bios appear at the end of this article. Robert (Bob) Wolf, staff fellow, Risk Management, SOA, moderated the discussion.

Bob: Gentlemen, thank you for participating in this discussion. Maybe we can start with this question. In part two of this article series, I categorized the evolution of ERM in three stages: Phase 1—Deterministic Risk Adjusted Discounting, Phase 2—Risk Analysis and Phase 3—Corporate Risk. Where do you see the life insurance industry today?

Dale: I would say on average, 2.5. Many companies at the very least are doing a lot of risk analysis. ERM control cycles seem to be finally getting in place at most companies where risks are analyzed on a consistent basis. Monitoring happens on a more consistent basis. Reporting and triggering happens on a more consistent basis. It's hard to establish a full risk tolerance until you have consistent risk analysis and a consistent feedback loop. That holds true whether it's your company, yourself or your family. So I think that we're getting to the point where a lot of the analysis is being done; as time goes on, and it probably will happen pretty quickly, the evolution of a more defined risk tolerance at corporations will happen.

Larry: It seems the P&C companies tend to have a better handle on enterprise risk appetite. A lot of their risk tends to be catastrophe-related or coverage extension, whether it's asbestos or D&O coverage, and so they're most used to thinking in terms of appetite. We don't want to risk more than 30 percent of the capital in a one-in-250-year event for example. Life companies, in my experience, tend to struggle with it a bit. They tend to evolve into more of a rating agency, or RBC conversation as opposed to a pure economic conversation. So I guess from an appetite perspective, I would put the life companies behind the P&C companies, but I certainly think they're moving toward catching up to them.

Max: I would say that the life companies are closer to Phase 2 than Phase 3, but it does continue to evolve. The life companies, in general, tend to be reactive to yesterday's problems as opposed to looking at emerging risks and trying to really get a handle on what could happen in the future. I see evolution today on the operational risk side in terms of providing metrics and trying some things to see whether they work or not. That's going to evolve over quite a few years as we try to figure out what works and what doesn't, and where we can utilize what people are doing in the banking industry as well as in casualty and the other types of financial services. I agree with the previous risk appetite comments that we're moving in that direction and boards have become engaged in risk management issues as the markets have struggled. Perhaps they don't want to be on the front page of *The Wall Street Journal* with: "Hey, why didn't you consider any of this stuff?" There's a lot of work yet to be done, and unfortunately it takes these financial shocks to actually move us off the dime.

Dale: I would add that companies are fortunately taking the opportunity to incorporate ERM more into their operations. How should we run marketing campaigns? How should we correspond with policyholders? What type of feedback methods should we use? How do we ensure privacy of information? ERM processes have really helped shine a lot of light on big questions. Issues that previously may not have been quantified and were pretty nebulous in the past are getting better handled in optimizing solutions for those types of questions.

Max: By improving our ERM Practices, at the same time silo risks, such as pricing and credit, are also seeing benefits. We're finally starting to look at how different risks interact on a quantitative basis. At the same time, the companies that have done it well have used a combination of resources, looking at it both from a quantitative standpoint as well as the contrarians and skeptics looking at it from a common sense and qualitative standpoint.

Bob: What are some unique aspects and considerations of ERM in the life insurance industry that may differ from other insurance sectors, the broader financial sectors and perhaps the nonfinancial sectors of the economy?

Dale: Life insurance companies play a large community and marketplace role as institutions. We hold a large amount of assets. We invest those assets and in turn, that helps support the operations of municipalities, governments and other corporations. We really are an effective pass-through of dollars from the general public to the world all around us. That puts us in a little bit of a unique situation and differentiates us from maybe some of the other nonfinancial sectors where balance sheets don't grow as dramatically. We have products that have recurring revenue over many years and therefore build up a more exponential growth in our balance sheets rather than maintaining more of a static size. So the role that we play in our local, global and international economies adds another unique aspect or consideration to how we manage the risk of a life insurance company's operations and balance sheet.

Larry: As a general rule, P&C companies, in contrast, basically did not get very exotic in the investment arena. Good examples of that are Travelers and Chubb. They've had a heavy municipal bond portfolio, and very highly rated securities. They didn't go into sec lending or a lot of subprime loans and so forth. They don't have a mega commercial mortgage portfolio, I mean. P&C companies think differently. I've always criticized them for thinking this way, but in this case it worked for them. They always think combined ratio and cash flow, and what you take in as premium. How much is paid in benefits? And how much in expenses? We don't take risk on the investment side. We only do it on the underwriting side. So, they tend to stay in extremely safe territory. In this particular scenario, it worked out well for them.

Max: I'm seeing the same thing from health insurance companies during some current project work. I agree that it's a risk because they really haven't optimized. They've just reduced their downside risk.

Larry: It's interesting you say that because I used to say that about P&C companies, "You're not optimizing the profile." Of course I was saying this four or five years ago.

I believe most life insurance companies in general would agree that the major risk that companies assume is capital markets risk. I've had many spirited debates with the investment folks who tend to like to use most recent experience in terms of credit spreads, in terms of volatility and so forth. They tend to ignore what happened in the early '80s or what happened back during the Depression and say, "Hey, we're in a different world now. We have different types of regulation. There are more controls and this and that." Obviously these comments and discussions went on before what's happened in the last year and a half or so. A lot of them, at least based on my experience, don't like using a lot of history. So the tactical decisions they're making today are based mostly on what's happening now in the marketplace. A lot of life companies got fooled and totally underestimated their capital markets risk a year-and-a-half to two years ago.

Max: Another group that is susceptible to that type of investment risk is the smaller life insurance companies, where they don't have a lot of people in their investment department. They outsource that risk and have people outside their organization managing it. But then they don't really have anybody inside who knows enough to challenge the assumptions that are being used. So you end up getting a little bit of double speak sometimes from the outsourced investment guys. They want to do one thing and they really don't want to see those benchmarks tied to the actual liabilities of the insurance company.

Larry: Life companies, particularly the international firms, seem to do a lot of risk-neutral analysis and so forth. One of the things I really struggle with is when you're discounting your liabilities at a risk-free rate or spot rate, you're doing an economic balance sheet under Solvency II, and credit spreads all of sudden widen dramatically. A lot of times when you're doing your balance sheet under this risk-neutral approach, your assets can collapse but yet your liabilities don't move at all. I think we've really got to come to grips with that whole issue.

Max: We've certainly seen some real experience in those types of metrics lately. As an example, some liability features use proxies for various assumptions. A credited rate might use Treasury plus the spread. All of a sudden Treasuries drop and spreads widen by about the same amount. The nominal rate stays about the same, and so the credited rate stays about the same. But you're discounting using the Treasury rate, which just went down 200 basis points. So it's very material and it's something that people really need to think about in advance. It's a reason why pricing actuaries need to think about more than just the liability side of the balance sheet.

Bob: We're hearing a lot of talk on what a prudent planning time horizon is for ERM implementation. What do you feel a sufficient time horizon should be in considering the risk profile of a company in the life insurance industry?

Dale: What's the prudent ERM time horizon? It's probably hard to discern for the industry as a whole. I think it's pretty much a function of what your company's reaction

time to risk is. Just as a quick example: Your distribution may be independent and therefore there are a lot of other opportunities to sell through other partners. Your senior management may be very reactive. It only takes them a day or two or a week to respond to situations, so maybe a shorter time frame is appropriate in those instances when contemplating ERM because you know things are going to be reacted to and the risks are going to be attended to. On the other hand, your board or your senior management may desire a broader examination of the issues. They may discuss them, but the decisions come a little more down the road or they're more apt to say, "Well, we'll research this more thoroughly and come to a conclusion when the board meets next quarter." So if that's the case, then the reaction by your agents and the policyholder behavior may not be occurring until well over six months, 12 months, 18 months or 24 months from now. Therefore, in this case, I think you need to have a broader, longer horizon on your ERM measurements to really see what decisions you're making and how they impact the monitoring that you do.

Max: I personally think you should look at several different time horizons, not just one. Any time you're saying you have a distribution out to the seventh decimal place from a one-year model, it just tells me there's no credibility in that model. There are so many assumptions in the model that if we're getting past one or two significant digits, we're doing really well.

Larry: I agree with all that. I like multiple measures too. I'll tell you my experience. P&C companies in general will use a one-year horizon because they're so event-specific—catastrophes and so forth. What we did when I was at Allstate was we used a three-year horizon. The reason we used three was because the P&C business has cycles. You overprice and you get results and then you underprice to get market share and then you get a higher combined ratio. So if you try to even that out over a three-year period, it gives you maybe a better reflection of risk when you're doing all these various scenarios and so forth. On the life side, in addition to more of the traditional stuff, I also like to do runoff methods and look over long periods of time because you have long duration liabilities and you have a lot of stuff that can happen over that period of time.

Bob: It looks like a key consideration here may be in categorizing how event-based versus momentum-based the risks at a life insurance company truly are.

Max: A lot of bad things can happen to a life company. If interest rates start going low but they only stay low for a month or two, it's really not that big a deal. It's when they stay low for a year or two and then, as you were saying Larry, considering low rates for three years or something in that range will help you pull in that risk.

Larry: Although I mentioned that casualty risks appear more event-based than momentum-based, there are some event-based risks that are really critical in the life industry. The obvious one is a pandemic. I know many companies have done a lot of work in this area. We have not life-tested that because we haven't had a 1918 event again. We may have one this fall; we don't know. Let's hope not. But that would be a big one, particularly for the life reinsurers and for the life companies—especially the ones that aren't necessarily in the upper income or senior citizen market—which may have antibodies—but more so that are in the middle market and lower age distribution. I think there are some real key issues there.

Dale: That kind of touches on one of your previous articles, Bob, on what determines ERM successes and failures. One can argue that the H1N1 scare was a potential success dues to it showing the value of some risk management planning. We also tend to look at these risk situation in terms of game preparation.

I view our CRO and our risk management team as a coach and his players preparing for a big game. Over the last 12 months, we did a lot of game planning; we did a lot of drawing on the chalkboard and ran a lot of practices along the way. But, we hadn't had very much game time against the true competition. With the equity markets fluctuating, H1N1 getting a little bit more attention, and then the widening and now tightening of corporate spreads, we've been able to compete in a lot of games over the last 12 months. We had a lot of film to review to help improve our future planning and see if our game plans made sense. It helps us answer whether our assessment of risk and assumptions come true under game time pressure. So while H1N1 hasn't yet evolved into a big issue, and it still could, I think it's been helpful to at least review some of that game tape and know what steps and other dynamics should be revised or put into play if something dramatic were to occur down the road.

Max: One of the assumptions that has to come into play a lot more than it has in the past is the whole erroneous assumption of the independence between different risks. I think a lot of models have assumed, even in their scenario plans, that only one thing would go wrong at a time. Even though you may be in the middle of a pandemic, that's not going to stop an earthquake from happening.

In the last year, you've seen an oil shock; you've seen a systemic risk to the whole financial system; and you've seen kind of a mini pandemic, which may grow to be

more. It provides, as Dale said, some real on-the-ground training to say, "OK, do we just freeze up? Do we just go home and ignore it and hope it goes away, or do we sit down and look at it?" For a pandemic, you can look at it as four different things that all interact. Your assets are going to go down because everybody's going to stay at home. There will be other problems within the supply chain. Claims are going to go up for a life insurance company. Your employees are going to want to work from home or just not come in at all. You're going to have the counterparty risk with your reinsurers come into play. I don't think that anybody gets enough information from the reinsurer to know whether the reinsurer will survive or not.

And if you can come up with a game plan to at least try to address those in advance, it gets you thinking about: OK, we looked at that from a pandemic standpoint. Well, what are some other emerging risks where we could try to have a similar game plan?

Bob: It has been argued that one of the greatest challenges in developing an ERM culture within a firm is in typical budget mentality and incentive compensation. Incentive compensation motivates individual behavior and ultimate performance. ERM is really ERRM—enterprise risk and return management. How do we balance and integrate the two?

Max: Going forward we need to see many more risk-adjusted measures used for incentive compensation across multiple years.

Larry: I think ultimately we want to get to Utopia where you literally can sit down with the board and the CEO and have a conversation on risk appetite. Some firms want volatility in hopes of getting longer-term ROEs that are higher and therefore are willing to take that volatility. Some companies just can't handle volatility and extensive uncertainty for whatever reason and so when you're less willing to take risk as a risk appetite, then you're really going to have to figure out from an operational excellence perspective how you are going to get your margins so you can make appropriate returns. Risk appetite has always been a difficult discussion with the top guys. It's not so much that they don't understand it, but more so they struggle to put a nail in the coffin and say this is how we're going to do it. My point has always been: If you can't pick a risk appetite, indirectly, you already have one. The profile of your business already has a certain appetite that you may or may not like. No decision is a decision—and senior management has to realize that.

Dale: I contemplate this question at times trying to draw again on the analogy of the personal finances. Picture the situation where you and your family sit down around the kitchen table and try to decide what to do with the next available dollar, and then draw the analogy of how senior management and boards of directors face similar decisions. In your personal financials, there's always the question of: Where should I put the next extra dollar to work? In a savings or investment plan? In my mutual funds? Or do I put it into my certificate of deposit? Should I instead use the dollar to reduce my liability instead of increasing my assets? Should I pay down my mortgage, pay down my car loan, or maybe if I have a liability of trying to send kids to college, I might try to pay that down. This 2010 budget cycle, I'm sure, will be the most interesting that we've seen in probably quite a while as corporations decide whether dollars should flow to increase the revenues and assets of a corporation or instead take some time to decrease some potential liabilities. ERM processes are helping make those decisions with a little bit more education behind them.

Max: Hopefully the regulators are paying more than lip service to ERM right now. Historically they have looked at capital requirements in a couple different ways. Some companies were actually forced to give capital back to stake-

holders and today they wish that they hadn't been forced to do that. The regulators probably wish they hadn't been forced to do that. So there's some type of a happy balance there between how much capital you need to hold and how much you don't want people to hold.

Larry: I think there's a trend of holding more capital and that risk has been previously underestimated. I mean you see where 400 percent RBC is the new 300 percent RBC. There's definitely a trend at S&P, Moody's and Fitch, toward wanting and desiring more capital. So I think you're seeing some companies out there that are going out and getting capital, even though it's expensive. I think ERM becomes all the more critical going forward because capital dollars are going to be higher and it's going to be tougher to get returns. This will have an influence on pricing.

Bob: Where do you see the greatest challenges in developing a prudent ERM culture right now in the life sector? Incidentally, what is a prudent ERM culture?

Larry: I see the whole purpose of ERM to be a holistic process that provides insight on the risk the organization is taking and it's a methodology to provide transparency on those risks with the ultimate outcome to make better decisions. You want the board to make better decisions. You also want senior management to be able to do so. There should be an open transparency within the organization. You want a culture that's open, such that one can freely talk about various risks. People shouldn't come to meetings, particularly senior level meetings, wearing a functional hat. They're wearing enterprise hats and looking for the betterment of the organization. The key is: Can you get there? And that's tough to do. Everybody likes to protect their own turf. Nobody likes to show warts in their organization—this isn't about trying to make people look bad. This is about trying to figure out what's best for the organization. It gets to your example, Dale, of a family. It's based on the notion that: "Hey, we have limited finances in the family. How can we best utilize that? How can we optimize our asset and liability mix and so forth?" Same thing within an enterprise.

Dale: Two key adjectives come to mind that make a good culture. One, is that it is "informed," at least at a basic level across the organization. How does ERM factor into our operations, our ratings, our stability and our financial strength; those types of things. Information is key. Larry used the word transparency, I think that's the second key adjective. Trying to make sure that the end goal is not to promote someone's pet project or to point a finger in saying that this division or this silo is doing things incorrectly. But rather the end goal should be that there is a transparent flow of information at the end, and probably most importantly in a company of any size, is to have someone champion it from a high level within the organization. That gets attention. It then promotes a culture where everyone is coming to the table with a risk management hat on. I think we've seen several examples, at least internally here, where marketing programs or advertisements or policyholder communications all stem from a reasonable rational risk management approach, and people are performing their jobs as they've been trained and educated to do. What also comes from that is the knowledge that risk management is also a goal of the organization, and that comes from someone championing it from a high level at the start.

Max: I would agree with Dale's comments and add communication. Transparency leads to a need for honest peer review. Without that honest peer review, you can have all the culture you want, but you're still going to have people afraid to say anything negative about a project. If you're going to optimize your results in the long run, you really need to have people with contrarian views that are encouraged to give that honest feedback even if it's negative.

Larry: And that becomes tough. I know in the organization I was in, the CEO was rather opinionated and people would always try to come to meetings trying to figure out what the CEO wanted and to support his position as opposed to coming in and providing insight to the CEO to try to steer him in the right direction. This is the process of playing politics and simply trying to figure out what people want to hear. That is not what ERM or an ERM culture is about.

Bob: Gentlemen, we talk about communication, peer review and transparency being keys to a prudent ERM culture and that it has to come from the top. This is a good point to discuss to whom you feel the CRO should report. Should he or she report directly to the board, the CFO, the CEO or someone else?

Larry: In Europe, most CROs in insurance companies and banks report to the CEO; that's just how it's evolved culturally. In the United States, for the most part, CROs report to the CFO. One company just made a significant decision and moved the CRO out from under the CFO to the CEO. That's Manulife. I think CROs ought to report to the CEO. That way he or she has a seat at the table when all the important risk and strategy decisions are being made. I think what happens when CROs report to the CFO, no matter how hard you try to make it work, stuff gets filtered down and many times decisions are made when the CFO isn't fully up to speed on all the risks. Sometimes it is too late when the CRO comes around and says, "Well, wait a minute, when you guys made this decision, did you think about this?" I think it ought to be that the CRO reports be to the board also. The board may delegate that to the audit committee and that's OK. I think the audit committee ought to have some private conversations with the CRO and say, "Hey, Larry, is there anything you want to tell us? What's really happening? What are you really seeing?" There are a couple companies I know of where that actually happens. I think that's a great practice.

Max: I agree with that for the larger companies. For smaller companies, I'm not sure they have the expense structure to support that. Then it becomes more dependent on the actual culture. If the CEO has bought into ERM, then the CRO is going to have a seat at the strategic planning table and everything else feeds off of that. If they haven't bought into it, then the person is likely to report to the CFO and get buried in even a small company bureaucracy and not get any face time. That's not very effective. At smaller companies, relative to bigger firms, the culture is really driven by the CEO.

Larry: In small companies you may see the chief actuary or even the CFO fulfill the CRO role. There won't necessarily be a separate CRO.

Max: It is a peer-review advantage at a life insurance company when you have two distinct people serving as chief actuary and CFO. They can act as peer reviewers of each other. This makes it less important where the CRO role ends up because you have multiple people who are financially savvy within the organization. If you go to a nonfinancial services company where you have a CFO and really nobody else who's a numbers person in those C level chairs at the table, it becomes much harder.

Dale: You both hit on major topics that I agree with. I see a lot of value in the chief risk officer having a direct reporting relationship to the CEO or to the board. I think a lot of information and ideas could get watered down if there were others who might have a tendency to filter the thoughts and processes. I think it's important as well to have several ERM champions within the organization—people who can ask good questions and ensure that we're viewing the same analysis from many different angles so that nothing gets missed along the way.

Bob: Gentlemen, thank you again for your time and thought-provoking discussion.

It appears from this discussion that although we have some way to go, we are beginning to see the ERM success stories develop in the industry. Not that we can pin success of ERM as a number, or a score, or a rating, but rather, we are beginning to see it in the development of ERM control cycles and in the development of appropriate discussions in Board Rooms as regards risk tolerance and appetite. In saying what's needed in a prudent ERM culture—communication, transparency, and peer-review, we have identified our continued opportunity to lead the charge. We're getting there. A

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