How to Make Sure that You Take the Right Road to Enterprise Risk Management

by Dave Ingram

"If you don't know where you are going, any road takes you there" – Lewis Carroll

Many firms have charged ahead to creating an enterprise risk management (ERM) program. Some never get to the end of the development process. Others get to the starting line, but have that unsatisfying, "Is that all there is?" feeling about their ERM. A few firms are highly satisfied with their ERM programs, but it is quite possible that satisfaction is more the result of luck than planning.

Much of this discontent is the direct consequence of a lack of clarity of direction of the ERM process. It is not enough to say that you want to manage risks. Management is the process of directing people and resources to achieve business objectives, so "risk management" cannot itself be an objective. To create a risk management program that you are happy with requires that you have both an objective and a reason or reasons for the risk management program.

A firm like an insurer, whose primary business is risk taking, needs to be clear whether it expects, over the next planning period, to: (a) grow risk faster than its capital—that is, to increase the riskiness of the firm; (b) increase capital faster than its risk, thereby increasing the security of the firm; or (c) grow risk and capital in tandem to maintain security and riskiness.

Many insurance company management groups cannot immediately say whether one or the other of those three mutually exclusive objectives is being pursued by the insurer. If that is the case, then ERM is much too complicated a next step to consider. Management needs to get straight how it sees its firm's riskiness changing as it goes forward.

Without clarity on that simple statement, management cannot form a risk appetite. And one way of defining ERM is the set of management practices that the company undertakes to keep the company's risk within its risk appetite while achieving other corporate goals. Risk appetite is the fulcrum on which ERM balances. Without a risk appetite, ERM is like a fancy new car with no tires. It cannot achieve anything meaningful because the definition of achievement is missing.

The management group is not done when it has defined this one aspect of its risk objective. There is more. The additional objectives of risk management that have been adopted by firms for their risk management programs fall into seven categories:

1. Compliance with rating agency and/or regulatory standards.
2. Measuring risk—most often for the purpose of determining the necessary amount of capital required for the risks of the firm.
3. Diversifying risk—assuring that the firm does not have any excessive concentrations of exposure to risks or methodologies that might result in the failure of the firm.
4. Loss controlling—controlling the risk exposures to control the loss potential of the business.
5. Pricing risk—exploiting risk by assuring that the margins for risks accepted are adequate to achieve desired levels of return.
6. Risk-reward steering—informing the planning process to encourage further investment in the business opportunities that produce the best combined return on risk for the entire firm.

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7. Supporting success—using the risk management insights and methods to increase the likelihood that the firm will achieve its objectives and identify new opportunities.

They all sound great. It would be hard to argue that any firm would not want most, or possibly all, of these things to happen.

However, risk management is still just a management exercise. It is being performed by people—human, fallible people. Teams of people, even risk management teams, cannot usually perform well when they are given seven somewhat different objectives to achieve.

So management will need to decide. Which of these possible ERM goals is the most important? Which are also very important, and which must therefore fall into the "nice to have" category for now?

The identification of these ERM objectives might be difficult to achieve right out of the box. But it is possible to practice this objective-setting process by identifying the risk management objectives for each of the key risks of the firm, and it is usually much easier to identify those objectives for individual risks.

In early 2011, eight insurers volunteered to attempt the process of identifying their risk management goals for a standard set of "Key Risks." These firms were from the United States, Canada, Australia, Peru, Korea, the United Kingdom, Germany and Bermuda. Most of them identified only one of these goals for each risk. In a couple of cases, they identified two.

For insurance risk, four of the firms said that their risk management goal was to assist in steering their business toward a better return for risk. One firm said that its goal was to control losses from insurance risk. Two had dual goals. One targeted both risk steering and loss controlling, and the other targeted both risk steering and risk pricing.

For investment risk, three firms had a single goal: one each for diversification, loss controlling and risk-reward steering. The other five firms all had two or three goals. Two firms targeted diversification, loss controlling and risk-reward steering all at the same time. For the other two firms, one favored diversification and loss controlling and the other risk-reward steering and loss controlling.

Only five of the firms were able to identify an objective for their operational risk. Two favored risk measurement and three loss controlling.

After identifying those goals, all eight were able to say what their ERM goals were. Three favored risk steering; two favored risk steering along with loss controlling; and another one solely loss controlling. One had three goals for its ERM function: a combination of diversification, loss controlling and risk steering.

Note that, for this exercise, the objectives of compliance and supporting success were not offered as choices and none insisted on adding them.

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With these clear goals and objectives, the risk management teams can develop the risk management capabilities that make sense for their situations. And they will not waste time and money developing capabilities that are not wanted or needed.

The firm with the enterprise-level goal of loss controlling does not need a complicated system of risk evaluation; simple stress-testing capabilities may suffice. The other seven firms did say that they wanted to do risk-reward steering, so they should be interested in developing economic capital models—the tool of choice for that objective. However, experience shows that some firms that go through the exercise and expense of developing the economic capital model find that they do not really want the risk-steering advice. They find that the risk-reward information, when they get it, ends up being their third or fourth or fifth most important consideration. They find that the risk-reward information is just not important enough for them to satisfy the Solvency II use test requirement that they felt the need to keep improving the model.

Only two of the seven firms that indicated a preference for risk steering actually had an economic capital model fully developed and were practicing the risk steering. It might make sense for them to test their management's actual interest in the goal by preparing risk-reward information based upon a less expensive method than an economic capital model.

External risk factor models, such as the rating agency models, the U.S. risk-based capital (RBC) or the Solvency II standard formula, provide one possible basis for developing trial risk-reward information. Solvency II rules provide a name for an improved process, Undertaking Specific Parameters (USP). Insurers can use the idea of USPs without necessarily following the exact Solvency II directions by simply developing their own best approximation for USPs when they feel that the standard factors are either too high or too low for their firm's actual risks.

With a low-cost estimate of risk, risk managers can quickly determine whether management now has enough interest in the resulting risk and risk/reward information to justify spending the money to improve the model.

And if not, they can go back to the question of their ERM goal and find out what management really wants them to accomplish before developing an ERM system that fits someone else's objectives.

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