Lessons from the Financial Crisis for Directors and CEOs of Insurance Companies©

by Jean-Pierre Berliet

The present crisis in global financial markets has created an impression that enterprise risk management (ERM) has failed broadly to protect the safety and soundness of the financial system as well as that of many institutions, including insurance companies.

It is ironic, however, that the crisis is often attributed to failures of risk management in leading commercial banks, investment banks and credit guarantors that were once viewed as pace setters in the use of "best practices" in risk governance and risk management.

Results speak for themselves: Bear Stearns and Lehman Brothers have disappeared; Fannie Mae and Freddie Mac have been nationalized; in the insurance industry, XL and The Hartford have had to raise significant amounts of equity to restore their capital strength; AIG has been partially nationalized while other leading companies such as MetLife and Prudential are rumored to have approached the U.S. Department of the Treasury about the possibility of receiving aid under the financial rescue plan that is being implemented. Meanwhile Wells Fargo, Bank of America and Berkshire Hathaway have been able to complete strategic acquisitions or investments that will serve them well in the future. Looking at outcomes, it is clear that some companies were stronger and better prepared. They have done comparatively well.

So what went wrong? What lessons can directors and CEOs of insurance companies learn from the crisis? What can they do to help their companies become more resilient?

Companies that appear to have withstood turmoil best have been disciplined about:

- Managing strategic risks,
- Holding sufficient capital and
- Aligning interests of shareholders and managers.

Their discipline demonstrates that they have been taking risk governance and risk management seriously.

Managing Strategic Risks

It is not enough for insurance companies to understand and manage the financial risks of their business that can cause insolvency. They need also to manage external "strategic" risks to their business. Strategic risks result from events that can undermine the viability of their business models and strategies or reduce their growth prospects and damage their market value. Strategic risks include changes in competitive dynamics, regulations, taxation, technology and other innovations that disrupt market equilibrium. They also include events and changes in other industries that can impact adversely the going concern viability and financial performance of insurance companies.

Until the present crisis, many insurers did not think much about their dependence on the efficient functioning of credit and other financial markets or the overall safety and soundness of the banking system. Now they do. Although the sub-prime mortgage crisis and resulting credit market meltdown can be viewed simply as market risk events, they should be seen as the combined, unexpected but theoretically predictable result of design weaknesses in institutional and regulatory arrangements and changes in financial technology.

From this vantage point, the near collapse of the financial system resulted from:

- Pro-cyclical effects of capital regulations under fair value accounting standards,
- Explosive growth of outstanding derivative contracts, especially credit default swaps and
- The redistribution of housing finance risks (especially sub-prime) across financial institutions on a global basis, facilitated by securitization.

Together, these factors combined to create a time bomb. That it exploded is no market risk event, but rather a failure of risk management.

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The explosion could have been anticipated. Had CROs not abdicated their responsibilities to rating agencies and conducted appropriate due diligence, toxic securities would not have found their way to their balance sheets. Similarly, fundamental changes in the characteristics of mortgage products and the creditworthiness of the customer base should have been examined closely. Such examination would have diminished the attractiveness of CDOs as investments, have reduced their spread throughout the financial system and have prevented or reduced the losses of capital that caused confidence to collapse and market liquidity to vanish.

Insurers, however, did not understand that risks to the financial system were elements of their strategic risk. Strategic risk elements embedded in the financial system are difficult to mitigate. They create dependencies among businesses that undermine diversification benefits achieved through underwriting of a multiplicity of risks and exposures. They have a tendency to hit all activities at the same time.

In this area, prudence is the source of wisdom. Companies that have had the discipline not to underwrite exposures that they did not understand, or invest in financial instruments or asset classes that they could not assess to their satisfaction (e.g., tranches of securitization backed by sub-prime mortgages), have withstood the crisis comparatively well. Some of these companies are benefiting from the weakness of their less thoughtful and less disciplined competitors. For example, Warren Buffett's decision to create a financial guaranty insurer recently and to resume investing in U.S. companies appears perfectly timed to capitalize on opportunities created by the weakness of established competitors and the steep fall in the market value of many companies.

Methodologies for identifying, measuring and managing strategic risks are in their infancy. Since there are no established conceptual frameworks to guide analysis and decision making, building resilient portfolios of insurance businesses and protecting them from strategic risks is a challenge. In their oversight roles, directors and CEOs can help company executives by re-examining the appropriateness of traditions, conventions and modes of thought that influence risk assumption decisions.

They should demand that company management:

- Conduct periodic defensibility analyses of their companies' business models and strategy, including consideration of weaknesses in institutional arrangements of the financial system. Such strategy review must also focus on the identification and monitoring of emerging trends with adverse effects on competitive advantage and pricing flexibility (loss of business to competitors, emergence of new risk transfer technologies or product innovations, regulatory developments, etc.) that can reduce company valuations sharply and rapidly.
- Reassess periodically the company's strategy for controlling performance volatility and achieving a balance between risk and return through specialization in risk assumption, diversification (e.g., across lines, industries, regions or countries), ceded reinsurance or structural risk sharing and financing vehicles such as captives or side-cars.
- Assess the possibility for disruption of business plans caused by events that reduce capital availability or flexibility in capital deployment.
- Develop appropriate responses through adjustment in capabilities, redeployment of capacity across lines of activity, change in limits offered, exclusions, terms and conditions, ancillary services provided, lobbying of lawmakers and regulators and participation in industry associations.
- Hold executives accountable for discipline in under writing and investment decisions.

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Because the insurance industry has been highly regulated, many insurance companies have not developed a deep strategic risk assessment capability. They need one urgently.

Holding Sufficient Capital

The issue of how much capital an insurance company should hold beyond requirements set by regulators or rating agencies is contentious. Many insurance executives hold the view that a company with a reputation for using capital productively on behalf of shareholders would be able to raise additional capital rapidly and efficiently, as needed to execute its business strategy. According to this view, a company would be able to hold just as much "solvency" capital as it needs to protect itself over a one-year horizon from risks associated with the run off of in-force policies plus one year of new business. In this framework, the capital need is calculated to enable a company to pay off all its liabilities, at a specified confidence level, at the end of the one-year period of stress, under the assumption that assets and liabilities are sold into the market at then prevailing "good prices." If more capital were needed than is held, the company would raise it in the capital market.

Executives with a "going concern" perspective do not agree. They observe first that solvency capital requirements increase with the length of the planning horizon. Then, they correctly point out that, during a crisis, prices at which assets and liabilities can be sold will not be "good times" prices upon which the "solvency" approach is predicated. Asset prices are likely to be lower, perhaps substantially, while liability prices will be higher. As a result, these executives believe that the "solvency" approach, such as the Solvency II framework adopted by European regulators, understates both the need for and the cost of capital. In addition, they remember that, during crises, capital can become too onerous or unavailable in the capital market.

They conclude that, under a going concern assumption, a company should hold more capital, as an insurance policy against many risks to its survival that are ignored under a solvency framework.

The recent meltdown of debt markets, however, made it impossible for many banks and insurance companies to shore up their capital positions. It prompted federal authorities to rescue AIG, Fannie Mae and Freddie Mac. The "going concern" view appears to have been vindicated.

Directors and CEOs have a fiduciary obligation to ensure that their companies hold an amount of capital that is appropriate in relation to risks assumed and to their business plan. Determining just how much capital to hold is fraught with difficulties, however, because changes in capital held have complex impacts about which reasonable people can disagree. For example, increasing capital reduces solvency concerns and the strength of a company's ratings while also reducing financial leverage and the rate of return on capital that is being earned; and conversely.

Since directors and CEOs also have an obligation to act prudently, they need to review the processes and analyses used to make capital strategy decisions, including:

- Economic capital projections, in relation to risks assumed under a going concern assumption, with consideration of strategic risks and potential systemic shocks, to ensure company survival through a collapse of financial markets during which capital cannot be raised or becomes exceedingly onerous
- Management of relationships with leading investors and financial analysts
- Development of reinsurance capacity, as a source of "off balance sheet" capital
- Management of relationships with leading rating agencies and regulators
- Development of "contingent" capital capacity.

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The integration of risk, capital and business strategy is very important to success. Directors and CEOs cannot let actuaries and finance professionals dictate how this is to happen, because they and the risk models they use have been shown to have important blind spots. In their deliberations, directors and CEOs need to remember that models cannot reflect credibly the impact of strategic risks. Models are bound to "miss the point" because they cannot reflect surprises that occur outside the boundaries of the closed business systems to which they apply.

Aligning Interests of Shareholders and Managers

Separation of ownership and control creates conflicts of interests between managers and owners. To mitigate this situation, companies expend much effort to develop and implement incentive compensation systems that align the interests of managers and shareholders. The present crisis demonstrates clearly that such arrangements are imperfect: large incentive payments were made to many people in companies that have performed poorly or even failed. There has been a public outcry.

But there is nothing really new in misalignments of incentives, or weaknesses in incentive designs that produce harmful results: they exist in every company to some degree. In a typical situation, managers are concerned about minimizing financial and career consequences of not achieving their objectives. If the situation requires it, managers will exploit every opportunity to change their operating plans to achieve their targets. They will seek and capitalize on opportunities to convert unreported intangible assets, such as market share, product or service quality, product leadership, plant productivity or customer service responsiveness into current profits by postponing and reducing related expenses. Financial results will look good, and they will be praised for accomplishing their objectives. Actions that they took, however, accelerated uncertain future income to the present period while undermining the company's competitive capabilities and reducing the sustainability of its performance. This is dangerous. Mitigating this form of moral hazard is difficult because its effects are not readily apparent.

In insurance companies (and banks), business managers have even greater opportunities to "game" incentive plans: they can increase reported business volume and profit in the current period by slightly underpricing or increasing risks assumed. This approach to "making the numbers" is particularly tempting in lines of coverage in which losses can take many years to emerge and develop; it is also particularly dangerous because losses from mispriced policies, especially in lines with high severity/low frequency loss experience, can be devastating. Similarly, investment officers can invest in assets that offer higher yields to increase portfolio performance, while involving risks that can result in significant capital losses later.

Based on these observations, Directors and CEOs of insurance companies need to work with management to:

- Link incentive compensation payments to the ultimate outcome of business written rather than to current profits (especially when fair value accounting standards cause immediate recognition of profits on contracts).
- Establish and empower an internal control and audit function to verify that managers' actions are aligned with business strategies and plans.
- Verify the integrity of underwriting and investment decisions, in relation to explicitly approved guidelines and processes.

The present crisis has demonstrated how unbundling of risk assumption businesses can increase moral hazard by redistributing risks, gains and potential losses across originators, arrangers of securitization transactions and investors/risk bearers.

Reconstruction of incentive programs and establishment of appropriate oversight and enforcement mechanisms are needed to reduce moral hazard and restore confidence

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in the financial system, including insurance companies.

Conclusion

In the aftermath of the present crisis, directors and CEOs of insurance companies should demand that management enhance the effectiveness of ERM frameworks and processes. Greater progress will be accomplished by companies in which directors and CEOs work with management to:

- Add a strategic risk management component to capital deployment and risk management processes,
- Increase capital held to support the value of their companies as "going concerns" and
- Reshape incentives to align interests of shareholders and managers.

Regulators, rating agencies, investors, clients, politicians and citizens will be watching.

Note: See "Increasing the Usefulness of ERM to Insurance Companies," by Jean-Pierre Berliet, in the newsletter of the Joint Risk Management Section of Society of Actuaries, Casualty Actuarial Society and Canadian Institute of Actuaries, August 2008 and at: http://www.soa.org/library/newsletters/risk-management-newsletter/2008/august/rmn-2008-iss13.pdf

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