Risk Management

March 2008 – Issue 12

Research Report: Linkage of Risk, Capital and Financial Management

by Aaron Halpert and Leslie Marlo

The functions of risk management, capital management and financial management are three vital areas of an insurance company. Each of these functions individually is critical for the ongoing viability of an organization, and each has often existed in a vacuum. Increasingly, the concept of linking such functions has gained traction, with the recognition that such integration may add value to a company.

Some of the impetus for insurers to demonstrate linkage stems from regulatory and rating agency sources. Regulatory compliance often drives actions in the financial services industry, and the banking industry is already measuring and managing risks to comply with Basel II. For European insurers, the advent of Solvency II—loosed fashioned after Basel II—is not far away, and the International Associations of Insurance Supervisors also has a solvency project underway. Meanwhile, rating agencies are asking pointed and detailed questions about companies' risk management practices, and going on record that they will consider internal capital models when evaluating capital adequacy.

Beyond compliance, however, are a number of benefits that will result from linkage; in theory, certainly a more integrated environment should lead to better decision making, and therefore, better key performance indicators. It is possible that a company could point to a strategic capital decision made in a risk-aware environment that directly improves financial results. But less tangible benefits are equally valid, from an improved understanding of risks and their true costs to the ability to measure individual business units' contribution to the overall organization to greater transparency in results.

How do the functions connect with one another? Full linkage involves recognition of the risks facing an organization and their impacts both individually and in the aggregate on capital needs. Through quantification of risks and capital impact, well-defined strategic decisions can be made. Linkage occurs as a risk-aware culture considers risk metrics in conjunction with performance measures throughout all decision points of the organization. Ideally, this is a process that is truly ingrained throughout the organization.

The CAS-CIA-SOA Joint Risk Management Section commissioned KPMG LLP to explore the processes and infrastructure that would allow a company to properly coordinate risk, capital and financial management in a manner that is efficient and effective. Based on our research, including interviews with a number of insurance companies of varying size, product distribution and corporate configuration, several effective practices have emerged relative to implementation of a linked environment. These include:

1. Development of a corporate oversight committee, representing senior management commitment to implementation of an integrated environment. For linkage to be successful, a cultural shift must occur wherein senior management "buys in" to the value added from the process.

2. Development of a framework, specifying how the goal of linkage will be accomplished. This includes decisions regarding consistent terminology and definitions, risk appetite, hurdle rate and performance measures to be used throughout the organization.

3. Risk identification and assessment, key to the understanding of the organization's risk profile. This should emphasize material risks at the individual business unit as well as at an aggregate level, both before and after risk mitigation activities.

Aaron Halpert, ACAS, MAAA, is a prinicpal at KPMG LLP, in New York, NY. He can be reached at *ahalpert@kpmg.com.*

Leslie Marlo, FCAS, MAAA, is senior manager at KPMG LLP in Pennsylvania. She can be reached at *lmarlo@kpmg.com.*

4. Actual linkage of risk, capital and financial management through the use of economic capital modeling and performance measurement on a risk-adjusted basis.

5. Education and communication throughout the organization and including the Board of Directors and Audit Committee. This allows for an environment wherein different areas become cognizant of how their actions impact others.

In theory, the implementation of a linked environment may sound more attainable than it does in practice. Any number of challenges goes along with the benefits, and often they may seem insurmountable. These include resource constraints from both monetary and personnel perspectives, the difficulty in effecting a cultural shift to a new way of considering risk, capital and financial management either from senior management or from risk owners at the functional level, and a myriad of technical issues that are still unresolved within the industry. Even those companies that have begun implementation—those who are technologically sophisticated—consider there to be room for improvement in modeling. There simply is not enough data or knowledge of distributions to adequately model certain risks. The list of challenges is long enough to seem overwhelming, yet our research shows that value is gained from breaking off manageable pieces within the process.

For an insurance company just starting out, the following practical suggestions are worthy of consideration:

1. Establish buy-in and direction from senior management and the Board of Directors, while allowing risk owners at the functional level to participate in shaping the process.

2. Establish a well-defined framework for linking risk, capital and financial management. As the implementation proceeds, it is important to see that strategic decisions are in fact being made on a risk-adjusted basis using the defined framework.

3. Recognize that certain components of the process are already in place. Every business unit identifies and evaluates risks in some manner; build on this rather than starting from scratch.

4. Keep it simple, at least at first. Start with the most material risks, basic financial metrics and economic modeling commensurate with the organization's resource constraints.

5. Become familiar with best practices but realize there is no one right approach and that integration of best practices can come over time.

In the real world, many companies are on their way to achieving an integrated state, while many others are just starting out. A whole spectrum of companies lies in between. Many challenging tasks exist, and numerous components must be considered. But it is possible to break down the tasks into smaller, simpler pieces. While the tasks are admittedly difficult, those who have already embarked on the process are finding the benefits worthwhile.

KPMG LLP would like to thank those who contributed to our research, including all of the company personnel who agreed to share their thoughts on the state of linkage at the companies and in the insurance industry.

We further thank the members of the Project Oversight Group which oversaw the completion of this report for the CAS-CIA-SOA Joint Risk Management Section: Linda Chase-Jenkins, John Kollar, Scott Orr, Max Rudolph, Frank Sabatini, Robert Schneider, Steve Siegel (SOA research actuary) and Jeanne Nallon (SOA research assistant).

The full report may be found at:
http://www.soa.org/soaweb/research/risk-management/research-linkage-rm.aspx
The views and opinions are those of the authors and do not necessarily represent the views and opinions of KPMG LLP. ✦

> **Linkage occurs as a risk-aware culture considers risk metrics in conjunction with performance measures throughout all decision points of the organization.**