



SOCIETY OF ACTUARIES

Article from:

Risk Management

June 2009 – Issue 16

Increasing the Resilience of Insurance Companies

By Jean-Pierre Berliet

FINANCIAL CRISES are broadly recognized as an unavoidable aspect of capitalism. In the future, insurance companies and other financial institutions can do much to develop plans for mitigating, recovering from and preventing the disruptive effects of potential crises.

Because so many institutions came close to failure in 2008, it is important to ask why some companies could remain autonomous while others could not. The record suggests that companies that retained their autonomy had earned the confidence of investors as a result of superior performance over the long-term as well as by avoiding catastrophic losses during the present crisis. They were trusted with another chance, specifically the provision of additional capital to move forward (e.g., MetLife, Goldman Sachs and ManuLife); those that were not so trusted had to merge (Bear Stearns, Countrywide, Washington Mutual), were partially nationalized (AIG, Bank of America, Citigroup), or now face reorganization in bankruptcy (Lehman Brothers).

It is easy to blame chief risk officers (CROs) and enterprise risk management (ERM) for the impact of the crisis on companies, but such blame is often unfair and disin-

genuous. In few companies did CROs have the power to prevent the execution of strategies that, although fraught with risk, were pursued to deliver on investor profit expectations and management incentive targets.

Regardless of this inherent tension between risk and profit, it also appears that certain weaknesses of ERM, value-based management (VBM) and management by objectives (MBO) processes fed off of one another to make companies more vulnerable to the crisis. The VBM process helps companies compare the value contribution of alternative strategies and select a course that would increase company value, while the MBO process translates business objectives into performance targets and drives incentive compensation awards.

Weaknesses in ERM, VBM and MBO processes can derail strategies intended to mitigate, recover from or

prevent future crises. These weaknesses must be corrected so that management can act on the signals they provide. Each of these three management processes is central to one particular phase of crisis management:

- ERM to mitigation
- VBM to recovery
- MBO to prevention.

Enhancing these processes, especially through the development and use of consistent risk insights and metrics, would help insurance companies become more resilient.

MITIGATING CRISES: ERM CENTRAL TO RESTORING CAPITAL ADEQUACY

The primary objective of crisis mitigation is to realign risk exposures with risk bearing capital and to improve capital adequacy. Realigning exposures with capital (and implied “risk capacity”) enhances insurance strength ratings and the confidence of investors and customers. Without such confidence, a company’s business and franchise would erode rapidly.

In this crisis, many companies improved capital adequacy by (a) cutting expenses, (b) decreasing dividend payments, (c) discontinuing share repurchase programs and (d) selling assets and non-strategic operating subsidiaries, all to preserve or increase capital. There are few buyers during a crisis, however, and so divestitures and asset sales are at lower prices than in normal times (e.g., sale of HSB Group by AIG) and are therefore very expensive sources of capital.

Realignment strategies also involve retrenchment from businesses with substandard returns on capital. Typical outcomes are: (a) sales of blocks of business and renewal rights, (b) cessation of certain coverage types, (c) sales of entire subsidiaries, (d) changes in underwriting limits, terms and exclusions, (e) reinsurance strategies, etc. ERM risk analysis models provide a basis for assessing the relationship between capital needs and value contributions of various businesses. Without that assessment, it is hard to align risk exposures with available capital.

Estimates of capital requirements based on risk measures over a one-year horizon (typical of solvency regulations)



Jean-Pierre Berliet

is the founder of Berliet Associates, LLC., a New York area based advisory firm on strategy and risk management. He can be contacted at jpberliet@att.net.

“Achieving superior shareholder returns is critical for a company to maintain access to affordable capital.”

are not credible during a crisis because they assume that fresh “recovery” capital can be raised. Rating agencies, regulators and investors, however, know that many solvent companies cannot raise fresh capital during a crisis. Capital is only adequate if it can sustain the company’s operations on a “going concern” basis in the absence of access to recovery capital, but with credit for capital generated internally.

Companies need robust insights from ERM to assess their capital needs (on or off balance sheet, including contingent capital) and to develop effective mitigation strategies. Their ERM must:

- Measure capital consumption by activity and risk type
- Identify the relative value creation of individual businesses, with appropriate recognition for differences in risk
- Demonstrate the impact and future value creation of alternative retrenchment strategies

Through such ERM informed views of capital utilization, capital adequacy and value creation, insurance companies can chart effective crisis mitigation strategies.

RECOVERING FROM CRISES: VBM CRITICAL TO CREDIBILITY FOR RAISING CAPITAL

Once confidence is restored, companies need to focus on growing again. They cannot achieve this without first restoring risk capacity through earnings retention, raising additional capital or both.

Access to capital is a critical strategic advantage during a financial crisis. Companies with a strong reputation for value creation can raise new “recovery” capital without excessive shareholder dilution (e.g., Goldman Sachs). Others find it more difficult, or impossible, to access the public market. This makes them vulnerable to inroads by competitors or unsolicited tender offers. The primary purpose of VBM frameworks and processes is to ensure that companies consistently meet investor value creation expectations and survive crises.

VBM frameworks help managers compare alternatives, so that they can direct capital toward uses that would support the achievement of a sustainable competitive advantage,



and also create value. This is challenging in the insurance industry because competitors can duplicate innovations in product features, service delivery or operational effectiveness relatively quickly and can redirect capital at the stroke of a pen. Such competitive dynamics call for companies to compete by developing organizational capabilities that (a) are tougher to duplicate by competitors and (b) provide a pricing or cost advantage based on service quality, underwriting insights, investment performance and risk and capital management

Because risk drives capital utilization in insurance businesses, the integration of ERM and VBM frameworks is required in order to develop strategies and plans that meet value expectations. Integration rests on (a) superior insights into risk exposures and capital consumption and (b) consistent risk metrics at the level of granularity needed to achieve a loss ratio advantage (possibly on the same level of granularity as loss ratios are calculated). In practice, these insights and metrics lead to decisions to reject businesses and strategies that will not create value. They provide a foundation for:

- Measuring capital utilization by line, by market and in aggregate
- Driving a superior, more disciplined underwriting process
- Optimizing product features
- Maintaining pricing discipline through the underwriting cycle

CONTINUED ON **PAGE 8**

Increasing the Resilience... | from Page 7

- Pricing options and guarantees embedded in products fairly
- Controlling risk accumulation, by client and distribution channel
- Managing the composition of the book of business
- Driving marketing and distribution activities
- Optimizing risk and capital management strategies.

Achieving superior shareholder returns is critical for a company to earn investor trust and maintain access to affordable capital. Having access to capital during a financial crisis may well be the ultimate indicator of success for a company's VBM framework. Anecdotal evidence suggests that insurance companies that consistently trade at significant premiums over book value have such insights about risk and maintain a highly disciplined approach to writing business.

The present crisis has increased the cost of capital dramatically, but not equally for all insurers. Capital remains most affordable to those with a strong record of value creation and adequate capital as a result of good risk management. Conversely, it has become prohibitive for those with a lesser record of value creation and who lost credibility as stewards of shareholders' interests. The latter are at risk of forced mergers or liquidation, which may be punishment for not integrating ERM and VBM processes more effectively.

PREVENTING FUTURE CRISES: REVAMPING MBO TO REDUCE MORAL HAZARD

Senior management usually takes pride in its tough and disciplined approach to managing performance. This involves setting stretch objectives, rewarding managers who deliver and punishing those who fall short. It is argued that a "greed and fear" approach is necessary to motivate managers and align their interests with those of shareholders. It is not widely recognized, however, that this approach can increase moral hazard and induce managers to make decisions that reduce resilience.

In this culture, managers are incented to exceed management expectations by using all means available. This may include:

- Reducing or postponing spending on product or service quality, product leadership, process productivity or customer service responsiveness
- Under-pricing risks to increase business volume and earnings

- Taking on higher investment risks to increase current investment yields
- Under-investing in market growth, thereby increasing short-term earnings but losing market share.

Actions like these can enhance short-term earnings, but they can also undermine a company's competitive capabilities and value creation potential. This, in turn, can reduce the company's ability to raise capital and thus its resilience. The introduction of risk adjusted performance metrics into a company's control framework can help reduce the incidence of actions taken inappropriately to "game" the incentive compensation system. However, it is hard to detect moral hazard because the effects of actions taken can remain latent for years to come.

Moral hazard of this type tends to affect decisions where senior management focuses on reported financial results rather than on underlying operating success factors. Excessive, and sometimes exclusive, emphasis on financial results gives operating managers overly broad discretion to "make the numbers". In many instances (e.g., AIG, Bear Stearns, Citigroup, Lehman Brothers) such an approach to oversight invited moral hazard with serious consequences. When combined with financial leverage and risk leverage, decisions tainted by moral hazard can result in enormous shareholder losses.

Insurance companies need to revamp their MBO frameworks to reduce the risk of moral hazard. They need to establish corporate cultures in which discussions about objectives, strategies and results, while never informed by perfect knowledge and foresight, are guided by "high road" values of trust and loyalty. Revamped MBO frameworks should explicitly include consideration of risk insights produced by ERM and verification of the alignment of actions taken with approved plans and strategies.

To accomplish such a transformation of their cultures, insurers may need to link their ERM and MBO processes through the implementation of:

- Risk-adjusted financial performance metrics
- Risk-adjusted performance benchmarks, related to expectations of capital market investors
- Incentive compensation awards linked to long-term measures of business value, including indicators of operational performance, and current profits.

Since no company operates with perfect foresight, boards of directors need to grant adequate discretion and flexibility to senior management for performance management. Adjusting objectives and targets can be of critical importance when business conditions change unexpectedly. In an uncertain world, rigid enforcement reinforces greed and fear elements of corporate cultures, undermines trust, breeds cynicism and “gaming the system” and increases moral hazard by inducing behavior that can, in time, fatally weaken an insurance company.

CONCLUSION: ERM, VBM AND MBO, PILLARS OF RESILIENCE

In the aftermath of the present crisis, insurance companies need to integrate insights about strategic risks and

capital adequacy produced by ERM into VBM and MBO so that these three processes can work together as pillars of resilience. Enhancing and aligning these processes is an important “defensive” step toward ensuring continuing viability as a going concern— in short, resilience. Expect investors to demand that. ♦

Note: See “Lessons from the Financial Crisis for Directors and CEOs of Insurance Companies” by Jean-Pierre Berliet, in “Risk Management: The Current Financial Crisis, Lessons Learned and Future Implications,” published jointly by the Society of Actuaries, the Casualty Actuarial Society and the Canadian Institute of Actuaries, December 2008 and at: <http://www.soa.org/library/essays/rm-essay-2008-berliet.pdf>.

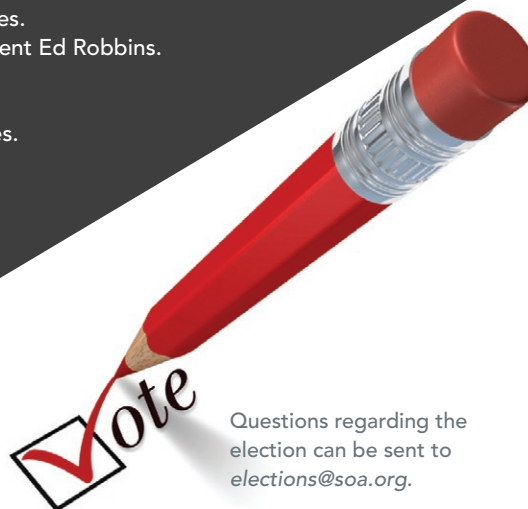
Let Your Voice Be Heard!

THE SOA 2009 ELECTION POLLS ARE JUST AROUND THE CORNER! POLLS OPEN ON AUGUST 3 AND CLOSE ON AUGUST 24 AT 5:00 P.M. CENTRAL DAYLIGHT TIME. ONLINE VOTING FOR THE ELECTION IS OPEN 24 HOURS A DAY.

Visit the SOA Web site at <http://www.soa.org/elections> to learn more about the candidates. You'll find:

- Video recorded campaign speeches by president-elect candidates.
- President-elect roundtable discussion moderated by Past President Ed Robbins.
- Photographs and biographies of Board candidates.
- Biographies of Section Council candidates.
- Entire ballots including the Board and Section Council candidates.

Let your voice be heard ... please vote.



Questions regarding the election can be sent to elections@soa.org.

Actuaries
Risk is Opportunity.®