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ERM Lessons from the Masters—the Canadian Perspective

by Max J. Rudolph

Everything should be made as simple as possible, but not simpler.

—Albert Einstein

Since 2008 the Joint Risk Management Section, jointly sponsored by the Society of Actuaries (SOA), Canadian Institute of Actuaries (CIA) and Casualty Actuarial Society (CAS), has annually conducted a Survey of Emerging Risks. As the researcher for this project, I have asked open-ended questions thought to be useful to risk managers.

In this article, I will summarize one of those questions from the 2015 and 2016 surveys and provide some perspectives for Canadian actuaries: Are there lessons learned that you would like to share with risk managers developing an enterprise risk management (ERM) framework (e.g., what worked, what did not)?

The answers reflected a generally positive view of ERM, and can be split into 10 themes.

Tone at the Top

For projects requiring cooperation between line and staff functions, support from the top is mandatory. Buy-in goes beyond the CEO to include the board, C-suite and other key stakeholders. This helps to avoid those who hope to “wait it out” until a new CEO takes over.

Since the CEO may not come from a technical background, and the board rarely spends more than a few hours on any topic, it is important that the risk manager use qualitative descriptions (telling a story) and graphics when possible.

Speed

A successful ERM process often starts slow and builds credibility rather than charging full speed ahead. Firms must prioritize their efforts and set up lots of checkpoints, confirming leadership commitment before moving on from each one.

Breadth

The process works best when the risk unit fully engages others, both staff and line, with diversified thoughts and methods. Respondents suggest avoiding extreme precision in quantification efforts. It is better to start with a five-point scale rather than a detailed model that promises more than it can deliver.

Role of the CRO

A titled risk officer continuously improves the ERM process, engaging others in the organization through leadership and communication as competencies and goals are developed. The chief risk officer (CRO) should keep it simple, initially focusing on education. The risk team adds value as a sounding board resource, giving honest feedback before projects are formalized. The primary purpose of the risk team is to work with the risk owners to understand how new opportunities impact the aggregate risk of the firm and overall objectives.

Communications

The risk team should build awareness of the benefits of ERM. It is the most important aspect of its existence, with honest insights relied on by leadership and rank and file alike.

Working with the Business Units

A successful ERM process involves line functions directly, not by completing templates with no feedback but by making it a regular part of their process. Risk owners, the primary decision-makers, trade their knowledge of specific risks in return for the risk team's understanding of how the risks interact and aggregate. The risk team should maintain its independence from the business units. Both groups should contribute to emerging risk discussions. The risk team provides oversight mainly by embedding a consistent risk process that improves decision-making and allows senior management to decide between alternative options.

Interactions

Experience teaches the risk team how risks interact, especially when such interaction varies by scenario. Risks that are normally independent can quickly become correlated during a crisis. This became apparent in 2008 when liquidity dried up in all asset classes simultaneously and when 2011 flooding in Thailand negatively impacted supply chains around the world due to manufacturing facilities for autos and electronics. Building resiliency into the system pays off during these infrequent events despite the up-front investment.

How to Make It Long-Lasting

Risk becomes part of the normal decision-making process, leveraging tools to meet regulatory needs and building both a top-down and a bottom-up approach. Dashboards that update frequently, in real time if possible, maintain interest and provide current information.

Risk management continues to evolve. Governance is maturing. Defining terms like risk appetite—with trigger levels, guardrail levels and leading indicators—is hard. Getting something done now and reviewing the process throughout the business cycle helps it to evolve and get better.

Don't forget history. Just because hyperinflation, influenza pandemics or war have not happened recently does not mean they won't happen. Current indicators related to volatility and debt levels have been contra-indicators in the past and should be monitored.

Things That Didn't Work

Creating a risk management report solely for external stakeholders is a compliance exercise. Those who rely on market forces to price risk need to expand the discussion to include cognitive biases and incentives. Contrarians are not always right, but the discussions they start can help improve the decision-making process.

Culture

A strong culture—one that considers both risk and return, and encourages independent thought—allows the process to be embedded in the business through education, while a poor culture likely ends up with reports that no one reads and knowledge that is ignored.

Wrapping it All Up

The Canadian economy survived the financial crisis of 2008 in much better shape than most of the economies around the globe, in large part due to effective risk management. However, sustainability requires diligence, and lessons learned need not become lessons forgotten. A firm should be able to reflect on past decisions and understand any role risk management had in the direction taken.

Risk managers should also remain open to change and react to new methods and products. Further, it is important to prioritize the efforts of the risk team, favoring getting something done now rather than everything done at some point in the future. Having in-depth discussions about balancing risk and reward is more important than the reports generated. Don't forget to communicate. Don't assume that external parties understand your risks better than you do. Governments have biases, and so do investors and rating agencies.

Many strategies that have been used successfully still work: diversification, risk identification and management, qualitative and quantitative methods. Each firm has its own risk culture, and it is better to "nudge" it and slowly make progress rather than push faster and lose overall support for the process.

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