


Enterprise Risk Management (ERM) For Small Insurers

Buzz Word
or
Wave-of-the- Future Word?

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ERM for Small Insurers

- Sources
 - N. Hill—3 SOA Small Talk Articles
 - N. Hill—Risk Mgt. Journal Article
 - James Lam Article, RMA Journal, 6-2010
 - Mark Anquillare Article, National Underwriter, April, 2010
 - Max Rudolph, FSA, SOA Presentation, 102008

ERM for Small Insurers

- ERM—Recent Interest
- In Part from Financial Crisis
- SOA—Concern that ERM Should Be Actuarial Dominance

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- SOA Definition—“Discipline...organization assesses...monitors risk from all sources ...increas(e)...organization’s...value....”
- Definitions in Other Professional Organizations Also

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- Other Organizations Interested in ERM
 - Risk Management Association (Banks)
 - Treadway Commission (COSO, Internal Controls)

- No Actuarial Dominance Yet

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- Insurers Assume Risks
 - Assets—Provide Less Than Projected Interest and/or Appreciation

 - Liabilities—
 - Require More Cash Flow Than Projected
 - Timing of Cash Flow Worse Than Projected

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- Revised Historical
 - Label—Could've Been Risk Assuming Companies

 - Advertise--"Get ___ Risk Assumer, It Pays"

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- Proper Risk Management—Key to Survival AND Prosperity

- How to Manage—Properly Apply ERM



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- BOD and Senior Management Must Buy In to ERM Importance
- ERM Importance Must be Communicated Down Through the Organization



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- Most Insurers Know Importance of Managing Assets and Liabilities
- Many Insurers Know That This Constitutes RISK Management



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- Many Insurers Haven't Focused on Importance of ENTERPRISE Risk Management



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- Identify Risks
 - Financial
 - Investment
 - Legal/Regulatory
 - Sales
 - Other

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- Try to Prioritize Risks
- Focus on Highest Risks 1st
- Special Focus on Threatening Risks

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- Special Focus on Threatening Risks
 - Threat to Solvency
 - May be Emerging Risks
 - Not “End of The World”
 - Limit=Budget/Resources

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Examples of ERM

- Underwriter's Risk Selection Can Be Affected if He Knows ERM Is Involved
- Claim Mgr's Claim Monitoring Can be Affected if He Knows ERM Is Involved
- Marketer's Sales Approach Can Be Affected in Similar Fashion

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Actuarial Steps

- Propose Chief Actuary be Chief Risk Officer (CRO), If Separation Needed
- Use Phrase "ERM" FREQUENTLY in Communications with BOD and Senior Mgt

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Actuarial Steps

- Project Total Company Performance—Use as Tool of ERM
- Insert Label Ties to ERM

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Total Company=All Pieces

- Current Inforce-Runoff
- New Sales
- Interest on C&S
- Basis-Statutory, GAAP, As Appropriate

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Actuarial Steps

- Projections for Actuarial Opinions and Asset Adequacy
 - Serve as Bases for ERM Projections
 - Possibly Show More Alternatives for ERM

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Actuarial Steps

- Convey Projection Implications to BOD and Senior Mgt
- Worst End—Maximum Risk/Maximum Appetite for Risk
- Most Products—Worsening Results in Range Appear Gradually

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Actuarial Steps

- Describe Worst & Best of Ranges as “Remote” or “Stretch.”

- Decide if Worst Case Includes Out of Business.

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Actuarial Steps

- In Reports, Assign Probabilities of Occurrence
 - CTE or Confidential Level—Define
 - Reserves—Sometimes 70%
 - Reserves +RBC—Sometimes 90%

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- One Board member, large insurer
- Demand-Reserves =99.9999% Confidence of Adequacy
- Confidence Must Be
 - Sensible
 - Communicable

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Actuarial Steps

- For Non-Actuaries
 - Qualitative, not Quantitative
 - Considerable Explanation for Qualitatives
 - Actuarial Image as One Businessman
Communicating with Another

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Actuarial Steps

- Models Used in Projections
- Model Output in Reports Must be Comprehensible by Non-Actuaries

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- Model Output for Regulators & Auditors
 - Must be Auditable
 - Must Tie to Reality

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Actuarial Steps

- One/More Individuals (Actuaries) Must Understand Models in Minute Details
- NO BLACK BOXES

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Goal—Insurer (BOD, Senior Mgt)
Comfortable with Projected Impacts of
Projections

- If Not, Plans to Mitigate Impacts
- Act Quickly

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Actuarial Mitigation Steps—Liabilities & Cash Flows

- Modify New Production (Less Statutory Surplus Strain)
- Reinsurance
 - Formal Plans
 - What Types

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Liabilities/Reinsurance

- Which Reinsurers
- What Assets to Be Ceded
- What LOCs or Trusts
- Additional Projections—Reinsurance Cost & Recapture Periods

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Mitigation/Assets

- Consider Derivatives, Swaps, Hedging
- Consider Insurer Staff Sophistication
- Consider Investment Manager Aid
- Projections Include How Devices Perform

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Terms Recently Tied to ERM

- Systemic Risk
 - Somehow, AIG="Insurance"="Systemic Risk"
- New Federal Insurance Office to Study Systemic Risk
- NAIC Representation

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Systemic Risk—What Is It?

- If Occurs Within One, Surely Spread to All
- Risk that Can't Be Mitigated by Being Spread
- Can't Identify, But "Know"

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Economic Capital (EC)

- More Than RBC (To Identify the Weak)
- $EC = \text{Required Capital for Given Portfolios of Assets/Liabilities}$
- Multiples of RBC or Separate Calculations/Formulas

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Economic Capital

- How to Compute?
- Tie to Present Values of Profits on Inforce?
- Use Best's "BCAR"?

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Economic Capital

- Discussed for Banks Also
- NAIC WG—RBC Studies, But EC Now on Back Burner

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Solvency Modernization Initiative Task Force (SMI) of NAIC

- Numerous Working Groups
- Study ERM, EC, Statutory Accounting
- So Far, Not ERM or EC

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Recently Used Term—"Silo"

- Non-communication/hostility Between Departments/Affiliates
- ERM Implementation Often Tied to Elimination of "Silos"
- No Buzzword Once Defined

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Recent Negatives, Banks, AIG

- Horrendous Results
- Can Actuaries Learn from These?
- Valuable ERM Lessons

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“The Quants”—Wall Street Stock Traders

- Self Term—“Financial Engineers”
- Stock Picks From Formulas/Computers
- Bets on Which Stocks Up or Down
- No Fundamentals

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Negatives—“The Quants”

- 2007—Stock Sales to Offset Housing Losses Undid Quant Models
- No Stock/Housing Model Links
- \geq Arrogance at Work

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Negatives—“The Quants”

- Senior Management Out of Loop
- Mesmerized by High-powered Modeling
- No Detailed Ranges of Projections
- Zero Stress Testing

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Banks' Approaches

- Numerous Articles on “Risk Management”
- Pointing Out Need to Improve
- Little Mention of ENTERPRISE Risk Management

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Recent Insurance Industry Reactions— Anquillare Article, National UW

- ERM Required
- His Definition Includes “Ability to Manage Risk Across the Enterprise...”

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Insurance Industry—Obstacles to ERM
Remain—Aon Study

- Small % of Risk Mgrs Rate Selves as Advanced in ERM (7%)
- Over 1/3 of Risk Mgrs Polled-- Barely Getting Started w/ERM

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Aon Survey—Barriers to ERM Within An
Insurer

- No Senior Management Sponsor (31%)
- Lack of Tangible Benefits & Communicating Need (67%)
- Lack of Skills & Implementation Plan (62%)

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Aon Survey

- Appoint ERM Leader
- Title Less Important Than Position Recognition
- Have Leader Report to BOD (I disagree)

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Rating Agencies Now Interested in ERM

- Request Written Plans for ERM
- Uptight from Recent Experience
- No Best Practices Established

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How Banks Are Doing—James Lam Article
His 2003 Predictions Compared to Insurers
Today

- ERM as Industry Standard—NO
- CROs Prevalent—NO
- Audit/Risk Committees—NO, At Least for Small Insurers

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Lam Predictions from 2003 Tied to Insurers

- Economic Capital Will Be Standardized Unit of Risk Management—NO
- Market Value Accounting—NO, At Least for Statutory
- Risk Education A Part of Corporate Training—Not Readily Observable

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Lam Article—Today, Tied to Insurers

- Internal Risk Culture is Key
- No Policies/Controls for Every Situation
- Management Must Communicate Importance of Monitoring Risks & Communicating

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- Recent Bank Approaches
- Risk Management
- Important, But Too Narrow
- ERM Is Key

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What Can Small Insurers Do?

- Watch for Regulatory ERM Requirements
 - ERM Reports, Procedures
 - Required EC, New RBC, Even PBR

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What Can Small Insurers Do?

- New “Cutting Edge”
 - Software, Calculations
 - Demand Value Demonstrations
 - Interact—Risk Profiles, Existing Assets, Liabilities, AND IT Systems
 - Insist on Comprehensibility

ERM for Small Insurers

Manage on ERM Basis

- Compensation/Bonus on Overall Enterprise Basis
- Preclude ENTERPRISE Conflicts
- >Short Term Results
- Budget/Resource Limitations
- NO SILOS

ERM for Small Insurers

- Identify Risk Profiles, All Assets/Liabilities
- Formal Identification Often Required

ERM for Small Insurers

- Deal with Risks

- Within Appetite/Aid Insurer—ACCEPT
- Within Appetite/Neutral, Negative—MITIGATE or AVOID
- Seek Optimal Combination Risk/Reward

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- Understand Risks

- Rank Alternatives by Profitability
- Take Highest of These

- Approach Consistent with Risk Profiles

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- Designate ERM Leader(s)/CRO(s)
- If Culture Not Yet Ready for ERM
 - Crisis Management is Possibility
 - Encourage Frank Discussion of ERM

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- Extend Approach Throughout the Enterprise.
- “ERM” Can Complete the Goal—
Solvency?
Growth & Prosperity