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Enterprise Risk Management for Smaller Insurance Companies

Large insurers tend to have specialized staffs, with pricing actuaries separated from reporting actuaries both physically and culturally. Small and mid-sized insurers have actuarial staffs that do it all. This requires a team of detail oriented generalists, a true oxymoron. These actuaries price the products, develop the projections, and complete any regulatory reporting that is necessary. Managements often use senior actuaries as key members of their team, and this often leads to long and fulfilling careers.

The goal of enterprise risk management is to make better decisions regarding the overall risks taken by a firm. This means looking at specific risks holistically, across all business lines, as well as aggregating risks across the enterprise.

What's in it for me?

Why should small company actuaries, already stressed by regulatory burdens and increasingly complex models, embrace enterprise risk management (ERM)? In many ways the profile at smaller firms I described means that the actuary is already highly involved in ERM without calling it that. Leadership teams at small firms are asked to address all risks and talk through issues as a group. The senior actuary is typically one of the primary go to employees for financial issues, providing peer review capabilities for the CEO. These teams are tackling ERM, but when an external stakeholder like a rating agency asks about the firm's ERM process the question might be left blank or given an incomplete answer. This is partly due to newness to the subject for the external stakeholders. The way the question is asked does not elicit a full response. There are generally so many things to discuss during an annual visit that developing ERM with small firms rarely makes the cut for the live presentations.

In many ways, suggestions for small insurer ERM parallel that of larger firms. Identifying and prioritizing risks taken, developing strategies to manage them, and most importantly using this information to improve decision making does not vary in concept. It is the implementation that is different. While large firms will involve many people from a variety of units, small firms can accomplish much of the project with a small group sitting together for a much shorter period of time. This is more efficient but other means must be used to instill the risk culture throughout the organization.

ERM Framework

With limited resources, actuaries must plan in advance how to best leverage an ERM framework to help meet the needs of other projects as well. Principles-based approaches to reserves and capital requirements are right around the corner and serve as an excellent example of how ERM and other projects can leverage each other to accomplish multiple tasks. Model improvements can be made in a base model that is then used for many tasks, including pricing, cash-flow testing, and strategic planning. Using one base model will save time when others ask you to explain the differences between them. The AAA is also developing tools to help practitioners meet the new regulatory requirements of PBA. Know what is available. For example, the AAA interest rate scenario generator provides a safe harbor for regulatory purposes as well as a learning tool for internal decision making as modelers get more comfortable with stochastic analysis. Using it first can provide an opportunity to better understand the nuances of a firm's business.

Risk Identification

The first step is to identify risks taken by the insurer. These will vary based on lines of business and investment philosophy. Major categories might include strategic, operational, credit, insurance, and interest rate risks. There are several tools being used in the industry that can provide a jump start. Each risk should be assigned to the person accountable for managing it. In some instances this will be a committee, but this should be the exception rather than the rule. Don't make this a bigger project than it really is. Develop a relationship with the internal and external audit teams to capture all risks and avoid duplication of effort. The firm's business team already knows its risks. Just write them down. Sit down with the risk owners to determine the likelihood and severity of each risk, both before and after any mitigation efforts. Each risk should be defined, with current status and any plans to manage it differently documented and updated at least annually. This process will help to prioritize which risks are discussed at the board level.

Key Risk Indicators

Key risk indicators should be developed for each risk. Many will be existing metrics, but what I have found is that most firms focus on lagging indicators collected as part of their reporting process. For example, mortality is measured by claims paid. Firms need to search for leading indicators that help drive business decisions prior to claims being higher than expected. In this case, perhaps indicators relating to underwriting class or mix of business by age will help the risk owner improve the risk management process.

Aggregation

Aggregation of risks is important but has no standardized answer. A risk manager can use the NAIC RBC formula to anticipate marginal impacts of future decisions or can ignore the diversification benefits and be conservative. Looking at risks holistically requires you to think about aggregation and how the risks fit together. Including capital as part of an insurer's pricing discipline, making this part of a broad ERM strategy, allows more consistent decision making.

Communication

Communication efforts will eventually determine the success or failure of an ERM framework. External stakeholders such as rating agencies and equity analysts can provide some consistency standards to help the risk manager get started, but the primary customer of ERM efforts are internal senior management and the board of directors. Don't develop ERM just to meet a rating agency requirement. Look at what others are writing in their public documents. Think about your current efforts and how you can grow them iteratively over several years. This way you have a story to tell during each visit with a stakeholder, and your game plan can evolve and improve over time. Enterprise risk management is a process, not a project. It enters the culture of the firm. Without a strong risk culture a firm is kidding itself and everyone else that it has a useful ERM framework in place. It is just busy work at that point.

Risk Culture

Once the basics of an ERM framework are in place, you will find that risk owners will have their own ideas about how to improve the process. That is when you know the risk culture is taking hold. In ERM nirvana, everyone would wear a button saying "I am a risk manager." This implies that the culture must be both top-down, with strong leadership from the board and senior management, and bottom-up with entry level employees comfortable being a part of the risk management process.

Advanced ERM techniques involve financial modeling and deepened risk culture. Techniques to improve forecasting results can include looking at scenario planning, stress testing, stochastic modeling, and emerging risks. Thinking about potential events, without dwelling on them obsessively, can give an insurer a leg up on its competition. Improved risk culture requires skeptical analysis, with business plans challenged and a hearty discussion/debate encouraged. How many companies wish they had these types of discussions prior to selling secondary guarantees on variable annuities or universal life products?

Outside Help

At small insurance companies you rarely find all of the expertise you need to develop and implement an ERM framework. Consultants are available to help, from someone who can be available for questions all the way to a consulting team that develops an economic capital model. Each firm is unique, but most will need someone externally to challenge assumptions and business plans. Look for common sense, strong ethics, and a willingness to share all opinions. Politically that is very difficult to do from inside a company where future advancement is desired. Cost is always an issue, so don't be afraid to ask how much a consultant will cost. A firm needs to consider issues like consistency with other projects where they might be dealing with a consulting firm, availability, and how embedded they want a consultant. An external view could be provided by a Chief Risk Consultant or someone who feeds ideas to the internal Chief Risk Officer.

Oversight red flags

Small insurance companies often have one area, often the investment department, where no one else in the firm has adequate knowledge to provide oversight. This is a red flag and should be addressed. There are external sources available to provide this service if it can't be developed internally.

Summary

In today's volatile world insurance companies need an ERM framework in place to help manage risk. The path taken can vary, but iterative movements to improve risk culture and risk identification can lead to an optimization of the balance between risk and reward. Better decisions are made and value is added.

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