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Bridging risk and reward: Closer alignment between risk and finance

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Bringing risk and finance closer together could enhance decision-making and provide a valuable foundation for the implementation of Solvency II and IFRS Phase II. However, full integration may be a mistake as it would blur the fundamental differences between the risk and finance functions and miss the complementary roles they play in the business. Ranjit Jaswal, James Smith and David Wong look at how to harness the benefits of closer alignment between risk and finance, while preserving their distinctive roles, perspectives and skills sets.

BRIDGING RISK AND REWARD: CLOSER ALIGNMENT BETWEEN RISK AND FINANCE

One of the earliest records of risk management dates back to around 1700 BC, when the Hammurabi Code was developed to help govern the vast Babylonian empire. Several of the laws deal specifically with the risk of default. This includes empowering a creditor to take a debtor's family into slavery to work off an unpaid loan. Some time later, medieval Florentine merchants marked the origins of modern financial management through the first use of double-entry bookkeeping.

Although risk management and financial management have come a long way since these historical beginnings, they have in many respects remained two quite distinct disciplines. In particular, finance tends to focus on the losses or profitability of the business at a specific point in time. Risk tends to be more forward-looking, exploring a range of possible options, outcomes and their implications for the business. This cultural diversity leads to different languages, ways of working, systems, data and processes. Today, however, both internal and external drivers are bringing these functions closer together.

More informed decisions

As the article on enterprise risk management (see pages 16-21) outlines, many European insurers are looking at ways to make risk a more visible and telling element of strategic evaluation, capital allocation and performance management.

Through the development and application of common metrics (common language) that bridge risk and reward, closer alignment between risk and finance is the key foundation of this risk-adjusted view of the business. In turn, the development of quantitative metrics for operational and strategic risks mean that measures that align risk and finance such as risk-adjusted return on capital (RAROC) can now provide much more coherent and comparable insights into the trade-off between risk and reward. The potential benefits of these measures include:

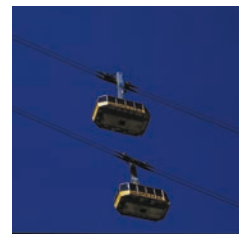
- Greater application of risk disciplines in key business processes such as strategy, planning and valuation;
- More robust financial plans and projections (for example by challenging management to consider ranges of upside and downside outcomes it requires

them to better define their appetite for risk and earnings volatility);

- A more coherent and consistent view of the business from risk and finance; and
- Better, faster and more robust decisions based on common data.

From a business perspective, aligning risk and finance would enable insurers to bring together disparate bases of management information into a 'single version of the truth'. The result would be a more precise and reliable foundation for risk selection, pricing, reserving and reinsurance strategies.

At a time when margins are coming under increasing pressure and the economic slowdown is limiting business opportunities, a more insightful risk-adjusted view could also help companies to pinpoint openings that may be missed by their competitors and target investment where it can earn its best return. For example, as insurers scale back writing amid the softening of rates, risk-adjusted measures would enable them to judge how the capital released could best be redeployed, be this through investment, underwriting other classes of business or return to shareholders. Just as crucially,



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such analysis would enable companies to demonstrate the rationale of their choice to shareholders.

However, while greater alignment of risk and finance metrics can be helpful, full operational integration would in our opinion be a mistake. Effective strategic evaluation requires the ability to formulate and challenge prospective decisions from a range of different

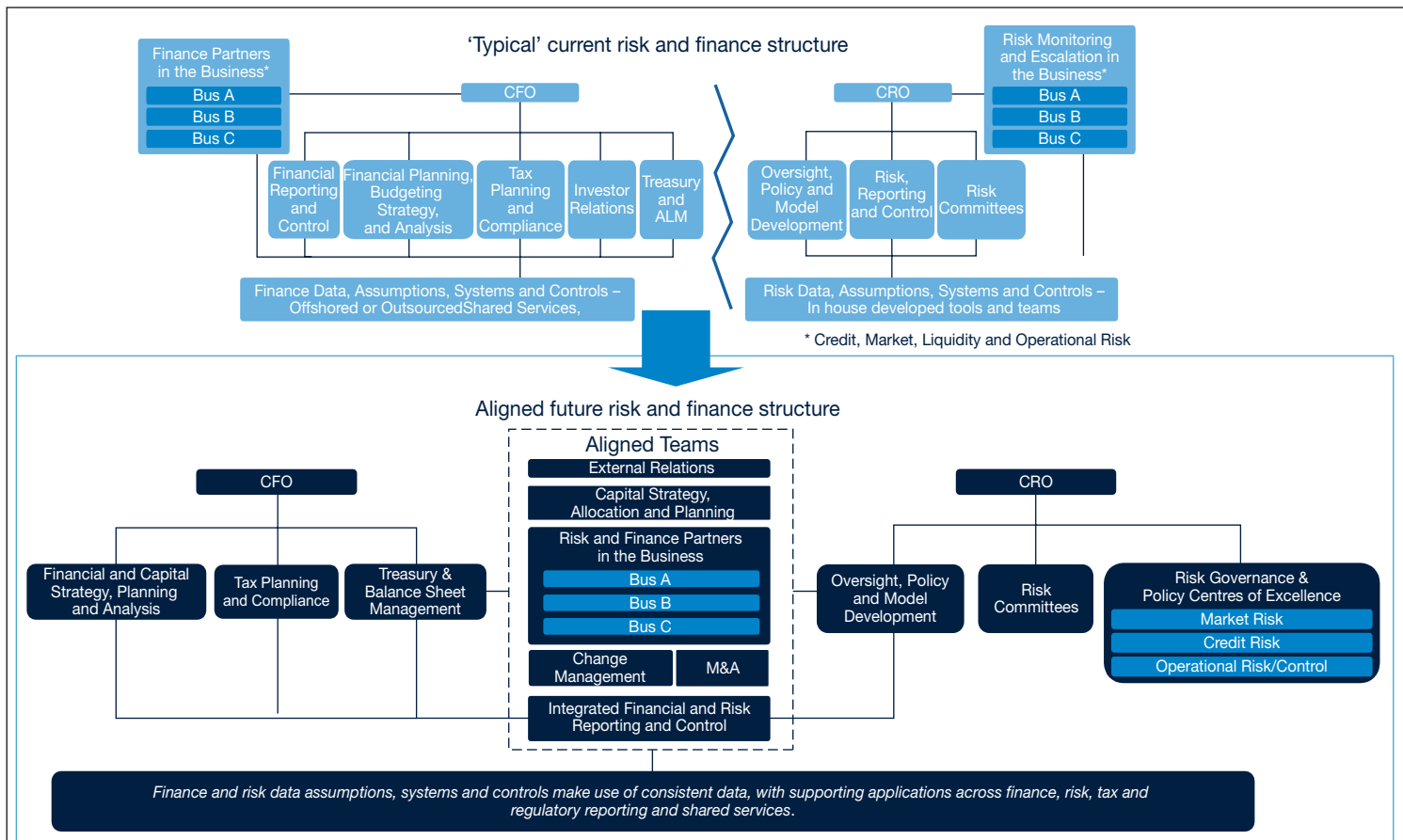
perspectives, which may be blurred within a fully integrated approach to risk and finance. It is also important to preserve the distinctive roles and skill sets of the risk and finance functions – financial management in areas such as tax planning, capital raising and financial engineering, and risk management in areas such as pricing, process improvement and the application of limits and controls.

Meeting reporting requirements

A series of new reporting developments is providing a further catalyst for closer alignment between risk and finance. Risk is already an important element of financial reporting. Under IFRS 7 ‘financial instrument disclosure’, for example, insurers must now present a management’s ‘eye view’ of the risks they run and

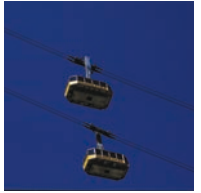
their potential impact on the business. In June 2008, the European CFO Forum¹ launched its Market-Consistent Embedded value (MCEV) principles, which are likely to set the standard for embedded value disclosure across the industry. In seeking to convey the prospective value of cash flows on a risk-adjusted and market-consistent ‘economic’ basis, MCEV is paving the way for

FIGURE 1 Example of future state with alignment of risk and finance



Source: PricewaterhouseCoopers

1. 'The CFO Forum is a high-level discussion group that brings together CFOs from leading European insurance companies (www.cfoforum.nl).



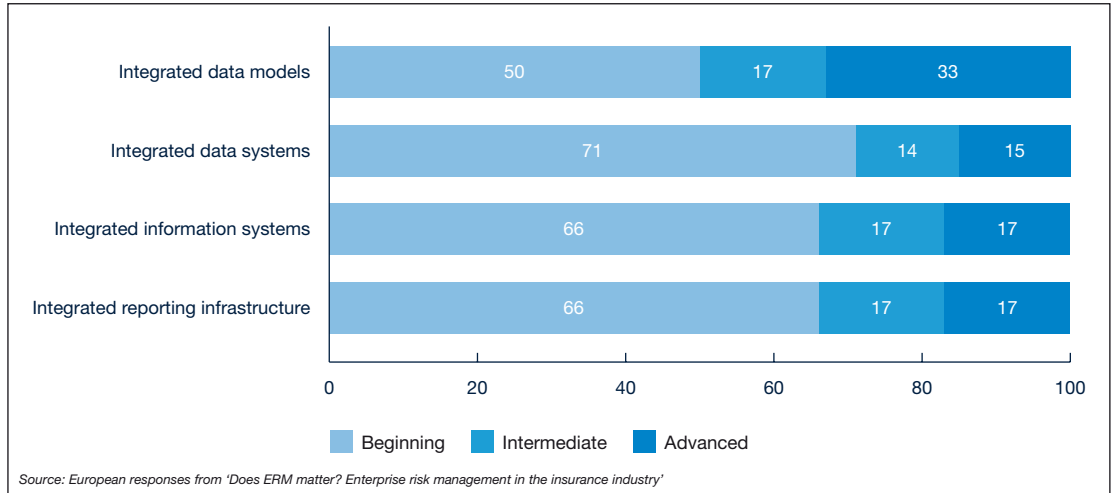
comparable approaches within the planned EU Solvency II and IFRS Phase II.

These reporting developments present considerable implementation challenges, including reconciling risk and financial data as part of the market-consistent approach to liability measurement. Under Solvency II, insurers will need to demonstrate that they use the resulting risk and capital analysis in the direction of their business (the 'use test'). Greater transparency about risk and its implications could also have critical implications for share values and the cost of capital at a time when analysts, investors and rating agencies are taking an ever-keener interest in how effectively risk is managed and integrated into decision-making. Most rating agencies now employ a similar use test to Solvency II as part of their financial strength evaluations. In turn, most leading insurers now present some form of RAROC measure in their annual reports to aid comparison with their peers and other financial institutions.

The good news is that the parallels in the timings and bases for disclosure in Solvency II and IFRS Phase II could open up cost-saving synergies in common areas of risk and finance such as data, assumption setting, modelling and reconciliation. Exploiting the synergies would allow insurers to avoid some of the costs, duplication and potential disruption of applying and managing the frameworks separately. By streamlining and improving the efficiency of the reporting process, closer

FIGURE 2

Areas where companies are looking to realise the synergies between financial and regulatory reporting and progress in achieving this



alignment could help to reduce the burden of meeting compliance obligations and hence enable risk and finance teams to devote more time to providing input into business decisions. In turn, regulatory and financial reporting harmonisation could enhance market credibility by enabling insurers to convey a single view of their business as outlined earlier, which more closely reflects the way they are run internally.

Making it happen

Closer alignment between risk and finance functions rests on standardisation and simplification of the reporting, control, modelling, transactional and data elements of risk and finance. There may also be further opportunities to leverage predictive analytics, such as stress testing risk and reward scenarios as part of the budgeting and planning process.

Figure 1 outlines how this alignment of risk and finance might be structured in practice.

While prudential and financial data requirements may differ, there is sufficient common ground for companies to consider the establishment of data warehouses or shared service centres to source and reconcile information. Data coming from around the organisation needs to be consistent. Risk and economic capital analytical systems also need to be appropriately controlled as part of bringing them up to an auditable standard.

Training, secondment and cross-functional career development could help to lay the foundations for a common understanding – finance teams need to be able to understand risk terms and issues, while risk teams should be familiar with

accounting requirements. As the operational manifestation of a risk-adjusted approach to management, effective ERM will also be critical in developing consistent firm-wide procedures for risk identification, measurement and monitoring ('informing the input'), and ensuring that risk limits and controls reflect the risk appetite and overall strategic objectives of the business ('enforcing economic behaviour').

More broadly, embedding risk-adjusted measures into the business may require significant changes in the way performance and related bonuses are judged.

In many companies this will require a shift away from targets based on short-term top-line results towards risk-adjusted criteria and long-term growth in shareholder value. It will also require risk teams to be involved

in decisions from the outset and the tone from the top needed to ensure that risk is a priority.

How aligned are risk and finance?

Alignment can be demonstrated in a number of ways, but one of the key barometers is the consistency of the metrics between risk and finance.

It is therefore notable that PricewaterhouseCoopers recent survey of ERM in the insurance industry found that only around one-quarter of respondents are confident that they have an efficient basis to link risk with other financial information.²

Greater alignment does appear to be moving up the agenda, however. Most European respondents expect to realise

synergies between financial and regulatory reporting as part of the move to Solvency II and IFRS Phase II. Nonetheless, most are only just beginning to realise these anticipated synergies (see Figure 2).

Risk and finance may already work closely together in companies that have moved to an economic basis of management reporting such as economic capital or embedded value.

The challenge ahead is how to bring the 'black box' risk and analysis up to an auditable standard for external disclosure. Insurers also need to ensure that the model outputs are understandable and credible enough to be used in the direction of the business as part of the rating agency and Solvency II use test. It is therefore significant that the recent ERM

survey found that only a quarter of respondents believe that the output from their economic capital model has gained full acceptance from business units or influences day-to-day decision-making.²

Converging destinies

Risk may be from Babylon and finance from Florence, but the demands of a fast-shifting commercial and regulatory environment are bringing the twin disciplines closer together. Although alignment of risk and finance can provide valuable operational synergies as insurers move to Solvency II and IFRS Phase, the most important advantages relate to the current business climate.

Boards and business teams need to understand risk and build it into their decisions,

not only to identify threats and weaknesses, but also to pinpoint valuable opportunities that may be missed by overly cautious or less well-informed competitors.

As available capital becomes scarcer and insurers come under increasing pressure to deliver more favourable and sustainable returns across the cycle, risk-adjusted economic measures are likely to prove evermore critical in judging opportunities, instilling risk considerations into the organisation and demonstrating the strength and potential of the business. Nonetheless, some distinction is necessary in ensuring that insurers continue to benefit from cross-challenge and complementary professional perspectives of the Babylonians and the Florentines. □

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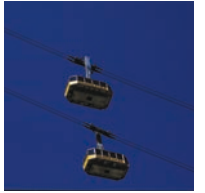
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2. 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.



BRIDGING RISK AND REWARD: CLOSER ALIGNMENT BETWEEN RISK AND FINANCE continued



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