

Insurance

Does ERM matter?*


Enterprise risk management in the insurance industry

Executive summary

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*connectedthinking

PRICEWATERHOUSECOOPERS 

Executive summary

Can enterprise risk management (ERM) really deliver the anticipated competitive benefits? Even if it can, are insurers genuinely committed to the transformation this is likely to require in how they run their businesses?



An increasing number of insurers and other financial services businesses are developing ERM programs to strengthen the control of ever more complex risk profiles and provide a more informed and assured basis for decision-making. However, the credit crisis has highlighted systematic risk management failures within many financial services businesses. Since many of the worst-affected companies had developed what they believed were robust and sophisticated ERM capabilities, it is important to ask whether ERM can actually deliver the strategic advantages of enhanced risk control and better understanding of the extent and composition of risk-taking, and if so what attributes make ERM effective – in short, does ERM matter and if so how?

We have analyzed the results of our latest survey of ERM in the insurance industry with these questions in mind. We have also examined the findings to assess how ERM has matured since our previous study in 2004, while also gauging respondents' priorities for and commitment to further development. Clearly companies that choose to take part in such a survey are likely to have a particular commitment to ERM. However, through detailed cross-sectional analysis of the survey results, we have tried to determine how far they are prepared to go in continuing to embed ERM into their businesses and hence discern whether they genuinely believe ERM can confer competitive benefits in the long term.

In judging whether and how ERM can be effective we have drawn on analysis of the attributes that enabled some companies to minimize losses in the recent market turmoil and looked at why others proved more susceptible.² What this assessment underlines is that while ERM can, in our opinion, make a difference, it can only succeed as a sustainable and effective management discipline if it is sufficiently relevant to, consistently embedded within and fully embraced by risk-takers, rather than just group level management or risk professionals.

Is ERM fit for purpose?

Judged against the criteria of its business relevance and extent of integration into their businesses, the survey results indicate that respondents have made significant progress in a number of key ERM areas since our previous study in 2004, although considerable work still lies ahead (see box overleaf).

ERM is a strong Board priority and chief risk officers have an increasing influence on the design and monitoring of ERM. However, the necessary firm-wide understanding of the objectives and responsibilities relating to ERM remains limited and may undermine its incorporation into day-to-day business considerations. Ultimately, this lack of integration means that ERM programs may simply be perceived as an additional layer of bureaucracy within the business rather than being integral to how it is run.

Respondents believe that ERM is now more embedded into their strategic planning than in our 2004 study. However, there appears to be insufficient alignment between the overall risk appetite and the setting, monitoring and enforcement of risk limits on the ground. The quality of risk data and usability of model analysis also have some way to go before they can provide a genuinely enhanced basis for decision-making.

Are insurers committed to progress?

Naturally, we would not expect to see fully mature ERM programs at this stage. ERM is still a relatively young management discipline and key components ranging from economic capital modeling to more systematic operational risk management present challenging new frontiers for many organizations. It is therefore notable that our survey reveals a strong commitment to further progress. This includes continuing investment in economic capital modeling and greater incorporation of the

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² This assessment draws on both PricewaterhouseCoopers analysis and the findings of a number of recent market studies including 'Observations on risk management practices during the recent market turbulence', a report published by the Senior Supervisors Group on March 6, 2008 (the Group brings together senior supervisors from the US, UK, France, Germany and Switzerland).

analysis into strategic planning, along with the development and refinement of risk governance, monitoring and reporting.

However, the survey raises important questions about the extent to which these developments are being embraced by frontline teams and how far they are being driven by heightened regulatory and rating agency expectations rather than a genuine belief that ERM can significantly enhance business performance. As recent experience indicates, companies that fail to embed ERM thinking into the heart of their decision-making or simply seek to meet stakeholder expectations are unlikely to achieve their ERM objectives.

Embedding ERM into day-to-day decision-making and business activities is a tough challenge, demanding important changes in

the way companies formulate their strategy and judge, reward and communicate their performance. While the tone from the top is critical, effective ERM cannot be imposed by the Board or senior management. Business teams need to be convinced that it can help them to make more informed decisions and enhance their ability to create value if it is to matter to them. Companies need to gauge how far down the road they want to go in driving ERM into their businesses against the perceived value that can be gained from this investment.

The following report is designed to help insurers compare their own progress against industry benchmarks and identify priorities for future action. It can also help them to judge their ERM objectives against their capacity for change and hence discern whether ERM does and should matter for their particular business.



Progress in ERM

Our 2004 study of ERM in the insurance industry found that while ERM had moved onto the boardroom agenda, most respondents were still grappling with the technical and organizational challenges of implementing effective ERM capabilities. Four years on, our follow-up survey reveals strong development in some areas, although considerable work ahead in others:

Strong progress

Most respondents are at least fairly confident (44% are very confident) that they have clearly defined their risk appetite, although alignment of risk appetite and key business decisions is often limited.

Nearly 80% of respondents have a scenario- and model-building capability, compared to only around a half in 2004.

Growing influence of chief risk officer and clear trend towards Board-level ERM committee.

Some progress

Most ERM functions have at least begun to take on responsibility for setting firm-wide standards for risk management, compared to less than half in 2004.

Most respondents are at least fairly confident that ERM is embedded into strategic planning (42% are very confident compared to 4% in 2004), although the risk information, communication and organization to make this possible are sometimes less than adequate.

Nearly half of respondents are fully confident that their ERM program enables them to communicate a portfolio view of risk to senior management, compared to 36% in 2004, although some of the necessary risk aggregation is still patchy.

Nearly 40% of participants have achieved and most of the rest expect to achieve better allocation of capital as a result of developing economic capital modeling.

Nearly 70% of participants now have a process for identifying emerging risks, but only around a half of them are even fairly confident that it is working effectively (4% are fully confident).

Limited progress

A third of respondents are fully confident that they have defined clear roles, responsibilities and accountabilities for ERM, compared to 31% in 2004.

Business units within more than three-quarters of participants do not base their risk tolerances on the broad risk appetite and tolerance levels set by senior management.

Most respondents do not have procedures for limit monitoring and exception approval and more than 70% accept that the enforcement of risk thresholds is not operating effectively.

Less than 40% of respondents rate their risk data or systems strategy as excellent or good, only a marginal improvement since 2004.

More than half of participants provide regular and detailed risk disclosure to rating agencies (53% compared to 46% in 2004), but less than 30% report regularly about risk to shareholders.

Further information and contacts

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