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Is your ERM delivering?

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A far-reaching new PricewaterhouseCoopers study¹ has found that many European insurers' enterprise risk management (ERM) programmes may be failing to keep pace with mounting risk pressures, escalating commercial challenges and more exacting stakeholder demands. Robert Borja, Jan-Willem Deurvorst and Mark Train look at how making ERM more integral to the business could help to deliver the anticipated benefits of a more informed and assured basis for decision-making and strategic execution.

IS YOUR ERM DELIVERING?

From financial market volatility to climate change and geopolitical instability, insurers are facing an increasingly complex and uncertain risk and commercial environment. The pressure on returns is likely to be heightened still further by capital constraints, the softening of premium rates and the slowdown in the economy.

In the face of these challenges, an increasing number of European insurers are developing a more systematic and holistic, enterprise-wide approach to risk management, aimed at strengthening control and providing a more incisive risk-adjusted basis for strategic evaluation. In today's tough business environment, the potential benefits include reduced losses, more effective use of capital and the ability to identify and swiftly capitalise on what may be limited and hard-to-discern opportunities.

However, ERM programmes cannot work in a vacuum; they need to be relevant to, and integrated into, every aspect of the business to make a difference. The need for effective embedding has been amply demonstrated by banks' recent experience of the credit crisis. It is notable in particular that many institutions

What makes ERM work?

- Effective alignment of strategy and risk appetite;
- Timely, reliable and consistent risk identification, measurement and monitoring;
- Effective communication of risk to decision-makers and appropriate escalation of issues for action;
- Understanding of risk concentrations, correlations and their potential implications, based on effective risk analytics and underpinned by regular validation, calibration and adjustment
- Ability and readiness of senior management to understand and, where necessary, challenge underlying risk assumptions;
- Consistent implementation of risk management practices and standards across businesses and geographies; and
- A culture that builds risk considerations into performance objectives and management in key areas such as business unit targets and individual incentives.

that had developed what they believed were robust and sophisticated ERM capabilities still suffered severe losses. What marked out companies that largely avoided these problems was the timely, rigorous and consistent identification, communication and consideration of risk across the decision-making and risk-taking chain (see box above). For insurers, a similar commitment to

making risk integral to the business is likely to be critical in realising the full commercial value of what for many has been a considerable investment in ERM.

Raising the bar

Further impetus for the development of ERM within the European insurance industry is coming from its growing



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¹ '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.

importance within rating agency financial strength evaluations and the approaching move to risk-based prudential regulation under Solvency II. Analysts and investors are also taking an ever-keener interest in the risks insurers are running and the risk-based measures that indicate how effectively these risks are being managed and translated into rewards.

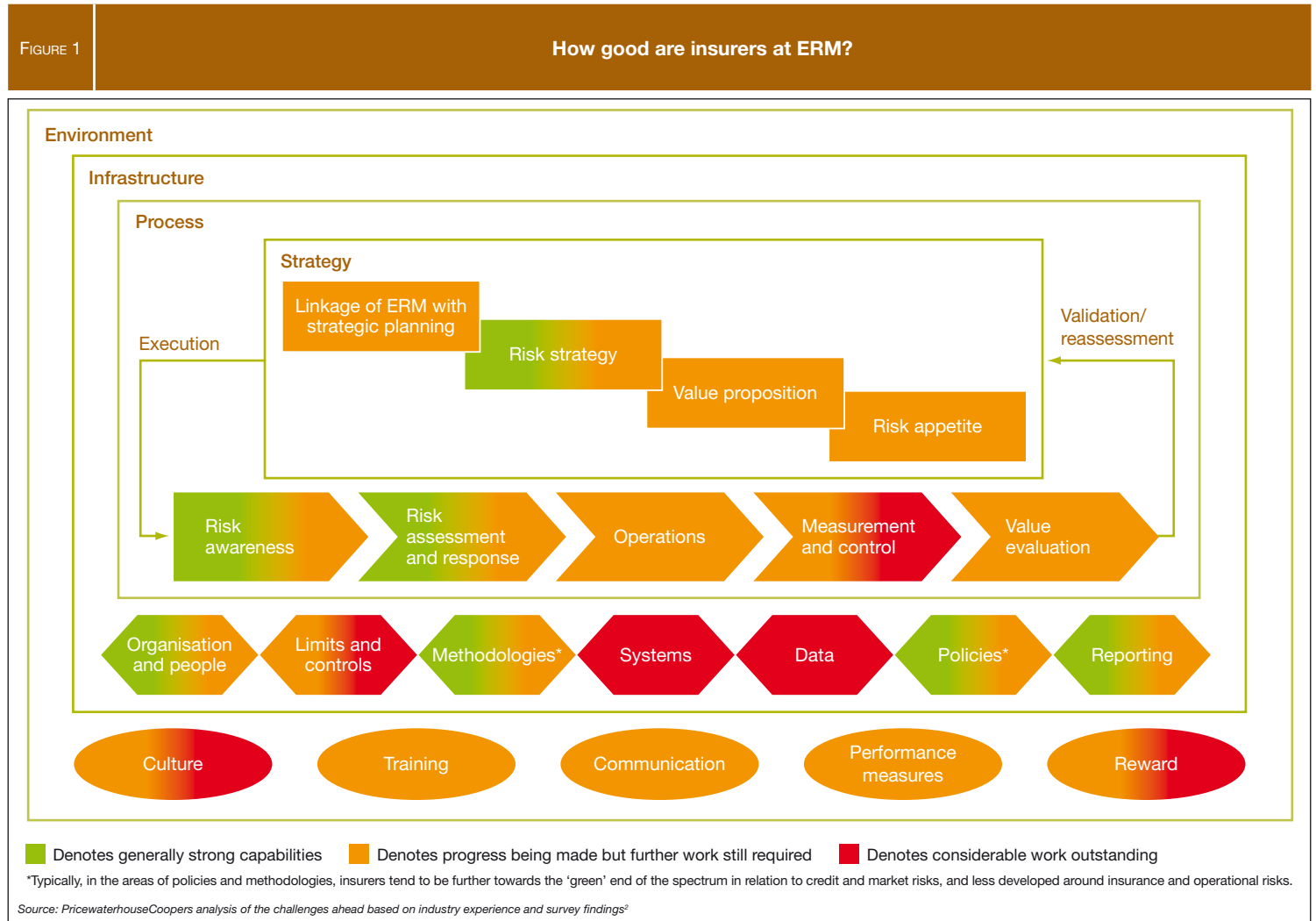
Alongside the demands of a rapidly evolving risk and commercial environment, these more exacting stakeholder expectations are raising the bar for ERM, including the depth of risk understanding, rigour of control and extent to which risk considerations are embedded into business planning and capital allocation.

Fit for purpose?

To help judge how effectively insurers' ERM programmes have developed and judge where further work may be required to meet this rising bar, PricewaterhouseCoopers recently carried out one of the most detailed studies of ERM ever carried out in the insurance industry. The follow-up to an

earlier report, published in 2004, the latest study draws on an in-depth survey of more than 50 insurers, more than half of whom are major international groups with annual revenue of more than €3 billion.

Half of the respondents have operations in Europe and one-third are based in the European Union (EU). The sample



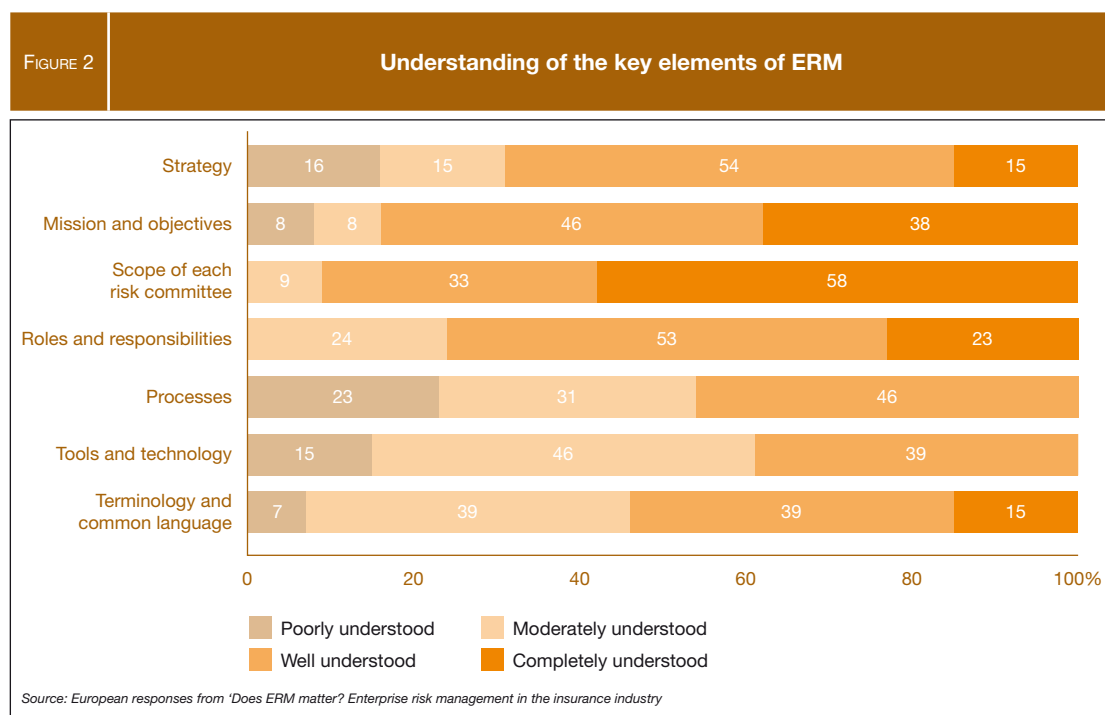
2 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008.



brought together a balance of life, non-life and composite companies, along with a selection of reinsurers. What emerges from the findings is that while ERM is an increasing board-level priority and insurers have generally made valuable progress since 2004, further development is likely to be required in a number of significant areas (see Figure 1).

Most notably, the extent to which ERM is integrated into frontline decision-making is often limited. Nearly half of European participants report that risk considerations are not fully integrated into strategic planning. There also appears to be a surprising lack of alignment between the corporate risk appetite and risk-taking on the ground. The articulation and application of the risk appetite are critical in defining and enforcing the amount of risk a business is willing to accept in the pursuit of value and are therefore key cornerstones of the effective embedding of ERM. However, nearly half of European participants do not align changes in strategic direction with their risk appetite. Moreover, business units within more than 80% of European respondents do not base their risk tolerances on the broad risk appetite and tolerance levels set by senior management.

The operational application of ERM also demands that limits and controls are rigorously monitored and enforced. However, most European respondents do not have procedures for limit



monitoring and exception approval and nearly 70% accept that the enforcement of limit thresholds is not operating effectively. The communication, escalation and risk-learning procedures for breaches in limits may also be insufficiently proactive and systematic. Only around 30% of European participants have early-warning systems to detect when volumes are approaching the maximum threshold and less than 40% have processes for identifying and analysing why limits are breached.

Underlying difficulties often include a lack of clarity about how ERM should be structured and governed. Ideally, business units should assume primary

responsibility for the risks they take in line with the overall risk appetite and standards set by the ERM team. As Figure 2 highlights, however, the mission, terminology and roles and responsibilities are not clearly understood within many organisations.

Clearer definition and establishment of roles and responsibilities and closer interaction between risk and business teams could help to make better use of the risk management activities that are already in operation across the business. However, less than half of participants report a high level of interaction between risk and business teams in the definition and monitoring of key risk and

performance indicators and the aggregation of risk across different categories.

In addition, there appears to be insufficient interaction in how risk limits and objectives are set and enforced. Poor collaboration between risk and its partners in the business can create confusion about who 'owns' risk and how it should be managed. More broadly, it may mean that risk management is seen as someone else's job and that ERM is not really relevant to them.

Further problems stem from the often poor quality and reliability of risk information and analysis. Less than 30% of European respondents believe that their risk

data and systems are good or excellent. Nearly half recognise that their risk information does not adequately support their risk objectives and less than 10% believe that the communication and escalation of risk information across the organisation is very effective.

The general lack of confidence in model outputs is especially noticeable. Barely a quarter of European respondents discern that their economic capital modelling provides substantial value in defining their risk appetite, setting risk limits or improving strategic planning. Nearly three-quarters do not believe that their economic model output has gained full acceptance from business units or influences day-to-day decision-making. This is especially surprising as this buy-in will be critical in meeting rating agency

expectations and securing accreditation for the use of internal models under Solvency II.

Building confidence in the model analysis requires credible data and a reliable infrastructure of governance, operation and validation. However, more than 60% of European respondents believe that the control environment surrounding data input and the use of their models is no more than moderate or weak. Again, the rigour of model governance is a key regulatory and rating agency evaluation criterion.

As discussed in the article on pages 22-26, bringing risk considerations into the forefront of business planning and performance management would also ideally require integrated measures ('common language') that bridge risk and finance; yet most participants accept that the alignment of risk and financial metrics is limited at best.

In today's risk environment, there is clearly a danger that poor information or 'blind reliance' on complex models could generate false confidence and encourage a company to accept too much risk. Equally, limited risk insight could lead to an overcautious approach in which an insurer assumes too little risk or ties up capital that could be better invested elsewhere. The key tests of an organisation's ability to deal with these challenges would include the quality, timeliness and reliability of its risk assessment, the effectiveness of aggregation monitoring and its confidence in its ability to use its risk analysis to identify commercial opportunities. Our survey highlights that further work may be required across all these areas.

As Figure 3 highlights, less than 50% of European respondents report that consistent criteria are in place to assess identified risks. The development of a coherent

portfolio view of the threats and opportunities facing the business is likely to be difficult without such assessment. Moreover, while more than half of European respondents now have a process to identify emerging risks, less than 40% are quite confident and none fully satisfied that it is operating effectively. The ability of respondents to identify and respond to emerging opportunities is called into question by the fact that only around a half use risk/reward considerations in making decisions about whether to seize opportunities. Less than 20% have a process to align their assessment of emerging opportunities with their risk appetite.

The way forward

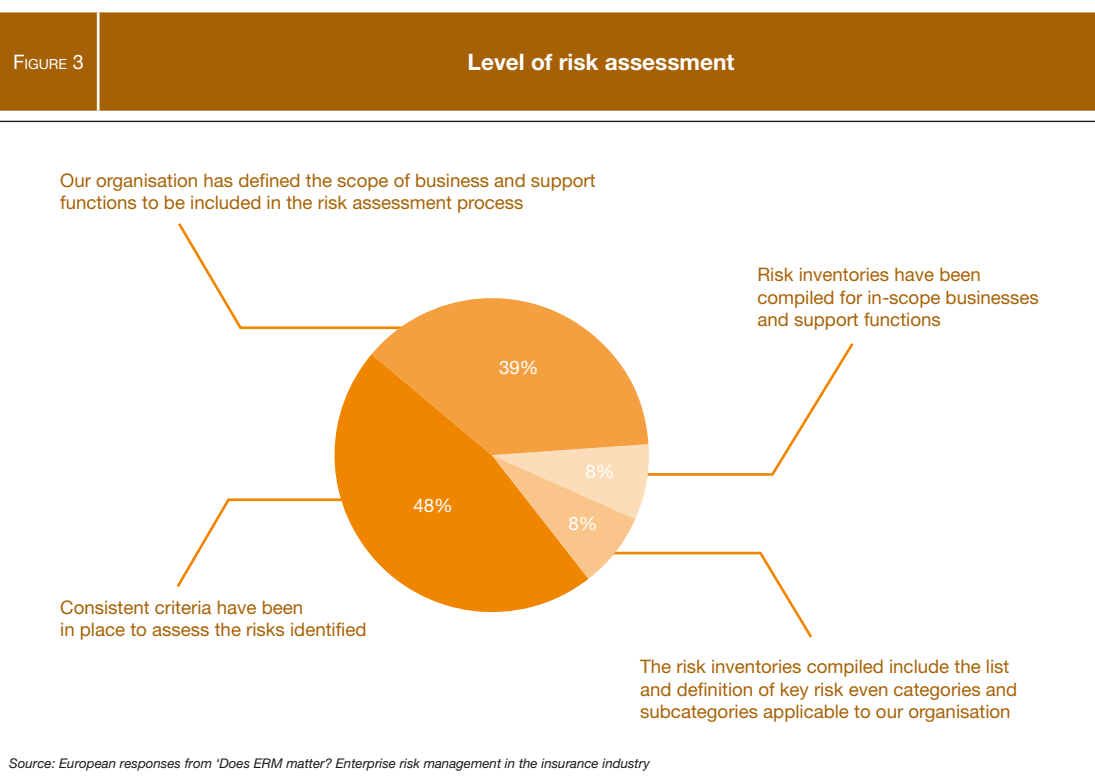
Naturally, we would not expect to see fully mature ERM programmes at this stage. ERM is still a relatively young management discipline and key components





ranging from risk modelling to risk-adjusted performance management present challenging new frontiers for many organisations. It is therefore notable that our survey reveals a strong commitment among respondents to further progress in their ERM programmes and confidence in its ability to enhance value in the future. For example, most European participants expect to achieve better allocation of capital and changes in strategic direction as a result of implementing economic capital modelling and aligning it more closely with decision-making, if indeed they have not done so already.

However, risk pressures, commercial challenges and stakeholder demands will continue to escalate. As our survey underlines, ERM needs to be embraced by risk-takers rather than just risk professionals, if it is to equip insurers to meet this rising bar and deliver the payback. Embedding ERM into day-to-day decision-making and risk-taking activities is likely to be



a tough challenge for many companies, demanding important changes in the way they 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 be relevant to them. □

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