

Risk Governance For Insurance Enterprises

May 2, 2005

2005 ERM Symposium

Casualty Actuarial Society

Society of Actuaries

The Professional Risk Managers International Association

Jean-Pierre Berliet

 **ERNST & YOUNG**
Quality In Everything We Do

Evolving Requirements for Risk Governance

- Increased scrutiny by investors, regulators and rating agencies is causing Boards of Directors to take a more active role in corporate governance
- Evolving regulatory requirements (e.g., 303A, FSA Prudential Source Book) are making Boards of Directors responsible for oversight of risk governance
 - Identification and control of financial and operational risks
 - Implementation of appropriate management and control processes
 - Development of risk measurement and reporting infrastructure
 - Establishment of compliance processes

The CEO and CFO Role in Risk Governance

- Pressure will continue to increase for CEOs and CFOs
 - Risk exposure can cause a material impact on reported financial results
 - Risk emergence demonstrates weaknesses in control environment
- The CEO and CFO must satisfy themselves and the audit committee that:
 - Risk management processes and controls are effective
 - Risks that can have a material impact are disclosed appropriately
 - Execution of risk management complies with regulatory requirements and risk tolerance expressed by the Board of Directors
 - External auditors will provide an unqualified opinion

Risk Governance is a “C Suite” issue

Risk Governance: Managing Risk Concerns of Regulators, Rating Agencies and Investors

Oversight activities by Boards of Directors and company risk management processes need to be aligned with the concerns of these major constituencies

Governance Framework	Risk Governance Constituencies		
	Regulators	Rating Agencies	Investors and Analysts
Risk focus	Insolvency	Default	Value loss
Primary risk mitigation	Capital adequacy	Cash flow and liquidity	Sale of stock
Remedial action	Assume control	Downgrading	Change CEO/management
Board oversight focus	Risk profile and solvency standards	Asset quality and volatility of financial performance	Risk tolerance and volatility of financial performance
Management focus and processes	Exposure management and capital generation	Strategy execution	Risk management and control processes

Risk Governance: Oversight by Boards of Directors and Risk Management by Executives

Oversight and execution roles need to be clearly separated

Governance Elements	Board of Directors	Executives
Responsibility	Oversee	Execute
Risk tolerance constraints	Approve	Develop
Risk policy	Approve	Develop
Risk measurement	Set scope and requirements	Develop infrastructure and perform measurement
Risk reporting	Monitor	Report
Risk management	Assess and challenge	Develop and execute strategy
Compliance	Assess overall effectiveness and CEO performance	Deal with exceptions Take corrective actions

Meeting Risk Governance Requirements

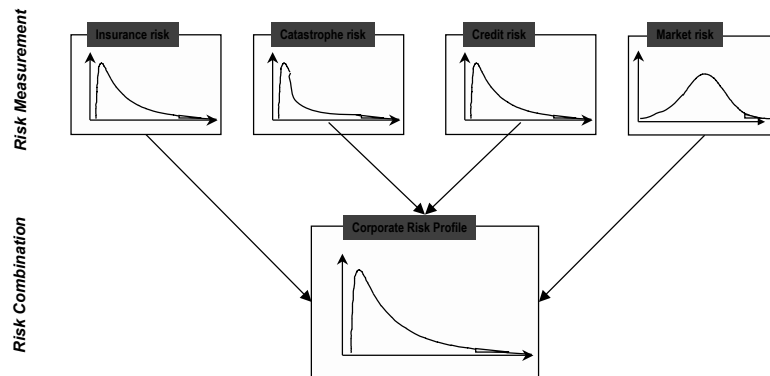
CEOs and CFOs of insurance companies must:

1. Assess the risk policy and risk tolerances including whether the outcomes are appropriate
2. Assess the risk management processes and controls, and their effectiveness and compliance performance
3. Address weaknesses by
 - Changing risk policy and risk tolerances
 - Correcting deficiencies in risk management processes and controls and verifying compliance

At a minimum, insurance companies must meet “acceptable standards” of performance; as these standards become more stringent, many companies are seeking to meet a “best practices” standard

Risk Governance Challenge: Developing the Corporate Risk Profile

A bottom up risk analysis is required to determine which risks to measure and to develop the corporate risk profile. The analysis is conducted by management and approved by the Board of Directors



Risk Governance Challenge: Developing Risk Tolerance Constraints

A combination of statistical and financial measures is needed to set the risk tolerance benchmarks that meet the concerns of regulators, rating agencies and investors

Statistical Measures

- Probability of ruin
- Value at risk
- Expected policyholder deficit
- Conditional tail expectation
- Variance
- Semi-variance

Financial Measures

- Earnings at risk
- Embedded value at risk
- Surplus decline
- Risk-based capital (RBC) margin decline
- Best's Capital Adequacy Ratio (BCAR) decline

Risk Governance Challenge: Selecting Performance Metrics

A combination of metrics is needed to evaluate risk-return trade-offs

Current Financial Metrics

- GAAP/statutory earnings
- Return on equity/return on surplus
- Risk-adjusted return on capital (RAROC)
- Return on investment

Emerging Metrics

- Economic value added
- Total business return or shareholder value added
- Economic profit
- Embedded value at risk
- Value of new business and return on embedded value

Risk Governance Challenge: Aligning Risk Management With Root Causes of Risk

Insurance companies must control risk exposures associated with business processes and strategies

Risk Category	Financial Risk		Strategic Risk	Operational Risk		
Risk Type	Insurance Guaranties and Embedded Options	Investment (Credit, Market and Liquidity)	Competition Regulatory Changes Product Markets	Business Management	Business Continuity	Control Failure
Core Business Activities	Underwriting Claims	Asset Management ALM	Strategic Planning	Strategy Implementation	Risk Prevention Insurance	Operations Management
Risk Measurement and Management	Risk Accumulation Credit Product Design	Asset Portfolio Hedging Product Design	Strategic Planning Capital Redeployment and Business Strategies	Capacity and Expense Management	Risk Mitigation Transfer Financing	Control Process Reengineering Recovery Planning
	Asset/Liability Management					

Risk Governance Challenge: Focusing on the Most Important Risks

- Regulators, rating agencies, investors and analysts expect the C-Suite to focus on financial risk because it is the most direct cause of:
 - Default on obligations to third parties
 - Loss of value for investors
 - Regulatory interventions
 - Changes in management
- Management of financial risks is well developed
- Methodologies, processes and tools available to manage strategic and operational risks are comparatively rudimentary
- For these risks, external constituents expect the C Suite to provide observations and sound judgment

Risk Governance: Action Plan for Management

1. Assess status of risk governance and management relative to financial risk
 - Acceptable standard
 - Best practices
2. Identify and assess strategic and operational risks, many of which have barely begun to emerge
3. Develop an overall risk governance enhancement plan
 - Oversight charter for Board of Directors or audit committee
 - Role and responsibilities of internal and external auditors
 - Risk management responsibilities of management
 - Risk governance framework
 - Scope
 - Relationship to other corporate processes
 - Specification of risk tolerances
 - Risk policy
 - Compliance verification

Risk governance processes spanning all activities are becoming a compliance requirement

Assessment of Risk Governance and Management

- The CEO and CFO of a NYSE-listed company must conduct this assessment. To avoid charges of negligence, others should as well.
- The review is best conducted by an independent third party and must include:
 - Board of Directors' oversight mandate and process, including a review of independence
 - Relevant regulatory guidance (NYSE)
 - Development and appraisal of key elements
 - Risk tolerance
 - Risk policy
 - Effectiveness of the risk management infrastructure and processes
 - Risk exposure monitoring
 - Risk measurement
 - Risk management processes and controls
 - Appropriateness of outcomes
 - Identification of weaknesses and remedial action steps

Enhancing Risk Governance

- The CEO and the CFO must plan how to meet more stringent risk governance standards
- Ernst & Young can help develop and execute the long term plans needed to meet future requirements in all key areas:
 - Methodology and risk measurement
 - Infrastructure development
 - Risk management processes and controls
 - Return and risk tolerance benchmarking
 - Compliance verification
 - Assurance

**Expect today's "best practice" to become tomorrow's
"acceptable" standard**

Emerging Best Practices: Risk Measurement

- Comprehensive risk reporting infrastructure
 - Risk policies
 - Financial risks
 - Operational risks
 - Mitigation and control strategies
- Stochastic measurement and aggregation on complete range of outcomes for financial risks
- Increasing focus on control of selected components of operational risk to protect franchise value

Emerging Best Practices: Risk Management

- Linkage of risk limits, risk measures, risk management and strategic decisions to the volatility of reported financial results
- Extensions of risk analysis over multi-year horizon for evaluation of alternative risk capital and risk management strategies
- The next advances are taking place in the area of operational risk
 - Business processes
 - Regulatory compliance
 - Reputation

Risk Governance: Implementation Steps

1. Building the risk measurement infrastructure
 - Risk policies and procedures
 - Global asset and liability data warehouses
 - Analytical tools
 - Software
 - Control processes
2. Measuring risk and developing the corporate risk profile
 - Agreement on risk measurement methodology
 - Measurement of risk exposures
 - Risk modeling and aggregation
 - Risk analysis
 - ◆ Solvency analysis
 - ◆ Volatility of performance
 - ◆ Linkage to risk management strategies

continued

Risk Governance: Implementation Steps

3. Risk reporting and monitoring
 - Quantitative and qualitative measures of risk exposure
 - Changes in risk profile and risk management strategies
 - Effectiveness of processes, procedures and controls
 - Compliance verification
 - Resolution of exceptions

Conclusion

- Risk governance regulations are causing insurance companies to take a more disciplined approach to Enterprise Risk Management
- Best practices are emerging in Europe
- Audit committees and senior management of insurance companies in the US need to prepare themselves to meet higher standards of practice