

CS C1- ERM In Broader Economy
International & Cultural Issues in
ERM
An Emerging Market
Perspective

BRIC Countries

- Key Emerging Markets: Brazil, Russia, India and China
- China and India account for apprx.33% of world population of 6 billion
- Both countries have huge middle class with high purchasing power
- GDP growth rates in BRIC countries are much higher than in developed markets

GDP Growth Rates

Country	2004 (%)	2005 (%)
USA	3.50	2.75
Japan	4.25	2.50(0.8)
UK	3.25	2.75
Germany (for Euro Zone)	1.75	2.00(1.6)
France	2.25	2.50
Brazil	4.00	4.00
China	8.75	7.00
India	7.50	6.25

Growth Perspective (in terms of GDP in US\$)

Following countries will be overtaken by \Rightarrow	China	India
UK	2005	
France		2018
Germany	2007	2023
Italy		2015
Japan	2015	2032
USA	2041	-----

G6 Vs BRICs

- By 2025, BRICs will account for 50% of G6. By 2045, BRICs economies larger than G6
- By 2025, annual increase in dollar spending from BRICs would be twice G6 and four times by 2050
- By 2033, India will be third largest economy after China and USA
- Among BRICs, India will be the fastest growing economy
- As % of population, India will have highest working age population (15 to 60 yrs)
- In 2050, three of the largest four economies will be in Asia

Emerging Markets-Opportunities

- High growth rates
- Increased foreign direct investments
- Huge investments in infrastructure
- Huge middle class boosting demand
- Abundant supply of educated cheap workforce
- High potential for outsourcing work specially India

Emerging Market- Opportunities

- Disinvestments of PSUs
- Domestic/global mergers/acquisitions
- Technology up gradations
- Abundant agri/mineral resources
- Commodity markets expanding fast

Emerging Market- Challenges

- Volatile markets
- Unstable macro-economic policies
- Natural disasters
- Setback in rain dependent agri sector bring down GDP growth rates
- Currency appreciation for export led economies
- Weak infrastructure
- Slowdown in FDI/increasing int rates in USA
- Steep increase in energy cost

Survey of Risk Management Practices in Indian Companies

	Yes	No
1. Risk definition		
a. Threat to business?	95	5
b. Opportunity for profit/loss?	78	22
2. Is your business fair/highly risky?	70	30
3. Importance of Risk Management		
a. Very Important/critical	80	0
b. Marginally important	20	0

Survey of Risk Management Practices in Indian Companies

	Yes	No
4. Scope: Does RM include		
a. Strategic risk	92	
b. Market risk	89	
c. Operational risk	88	
d. Credit risk	79	
5. Do u have formal RM policy?	20	80
6. Do u risk adjust required ROR?	27	73
7. Compre. risk review ever made?	37	63

Status of ERM in Emerging Markets

- 'It is like teen-age sex where everybody is excited about it, few understand it and still fewer practice it.'
- Due to pressure from regulators, financial sector has done good work in managing specific risks but very little wrt ERM
- As the survey showed, corporate sector is way behind. Few practice EVA/RAROC
- SMEs still operate on old maxim 'Buy low, sell high. Collect now, pay later'

Cultural Barriers

- Many businesses are family owned.
- Lack of professionalism restrict role of CROs
- Faith in tradition inhibits investments in research and technology
- Regulators for corporate sector do not yet insist on risk management
- Transparency/disclosures levels improved but not yet rigorous.

Role of CROs

- Environment: High growth, Transition stage, Shallow and volatile markets (capital, financial, capital, commodities), Unstable macro-economic policies, Tardy legal system, Inadequate infrastructure, Endemic natural disasters, Rain dependent economy, Political uncertainties, Cultural barriers, Corporate Governance practices not rigorous, inadequate disclosures/accounting standards, IT infrastructure inadequate, Outsourcing backlash.

Role of CROs

- Corporates expanding to global markets, merger/acquisitions increasing, flood of IPOs/right issues, ADR/GDR, FCCBs
- Limited hedging instruments. Mainly used are forex forward contracts, interest rate swaps, futures in capital/commodity markets, options used in equity market,
- Inefficient payments system, high transaction cost. In India, RBI adopted RTGS and SEBI T+2
- Virgin fields for dynamic CROs
- Huge possibilities for high risk/high reward

Networking Opportunities

- Great need for risk management professionals
- Main responsibility to help the governments, corporates (private and PSUs) in smooth transition to global markets and to developed status.
- Great scope for co-ordination, transfer of knowledge/technology from risk professionals in developed countries to emerging markets.
- Professional bodies such as PRMIA and SOA can play useful role

Many Thanks

2005 Enterprise Risk Management Symposium, Chicago

ERM in the Insurance Industry: exploring the International & Cultural Issues

(presenting some updated findings of my PhD project)

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Agenda

- **Introducing My Research**
- **General Findings**
 - The meaning of ERM in insurance
 - Key issues in Insurers' ERM
- **Findings on the Motivation of ERM**
 - Findings (International Issues)
 - Regulations (Europe Vs US)
 - Corporate Governance (Turnbull vs. SOX)
 - Capital Adequacy Regulation (Solvency II vs. RBC vs. Basel II)
- **Findings on key operational challenges of ERM**
 - Findings (Cultural Issues)
 - A Common Risk Culture
 - A Common Risk Language
- **Conclusion**

Introducing My Research

- ✓ Research Objectives & Questions
- ✓ Methodology
- ✓ Research Model
- ✓ Data Collection & Analysis
- ✓ Multidisciplinary Respondents

Research Objective & Research Questions

Objectives

1. To understand the meaning and the objective of ERM in insurance
2. Identifying and interpreting the key differences between the theory and the practice of ERM in insurance
3. Exploring the emerging issues of ERM in insurance

(European Perspective)

Questions

Understanding

What is the understanding of ERM in the insurance industry? Is the insurance industry considers ERM as an important issue? Why?

Motivation

How was ERM evolved in the insurance industry? What are the driving forces?

Design

How does insurance industry design ERM? What are the key issues of ERM in the insurance industry? Why?

Implementation

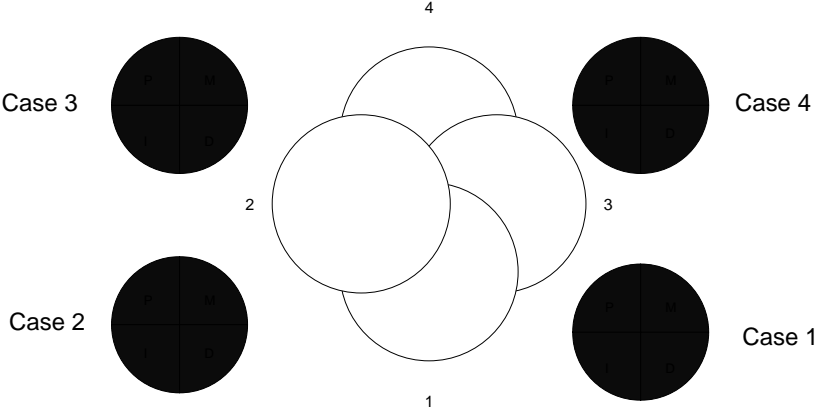
What are the key challenges to implement ERM in the insurance industry? How does insurance industry deal with them?

Performance

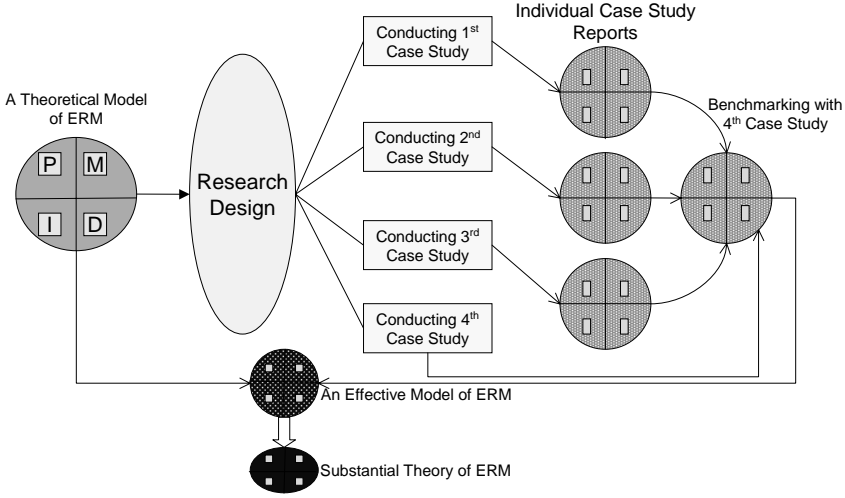
To what extent are the benefits of ERM measured in the insurance industry? What are the difficulties associated with measuring the performance of ERM in the insurance industry?

Methodology

Comparison in terms of ERM Sophistication



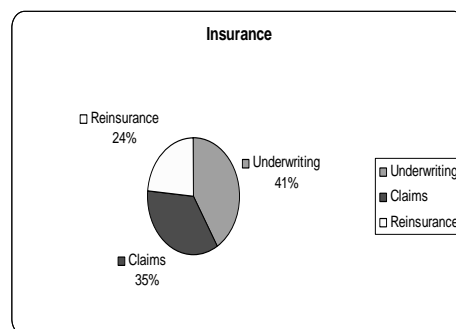
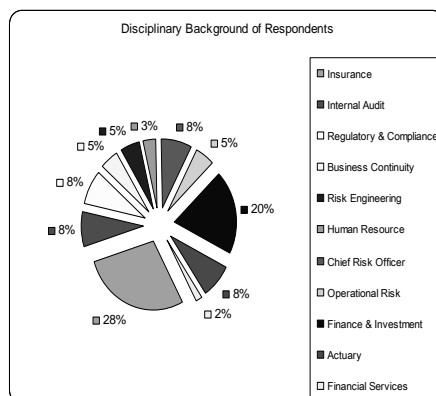
Research Model



Data Collection & Analysis

- Altogether 70 face-to-face interviews have been conducted covering four large insurers (in various locations of Europe) for last one year
- The respondents have been categorized into four groups:
 - Risk Observers
 - Risk Owners
 - Risk Takers
 - Strategic
 - Operational
- All interviews have been audio-recorded and transcribed fully
- A computer software NVivo (qualitative) has been used to process the data

Multidisciplinary Respondents

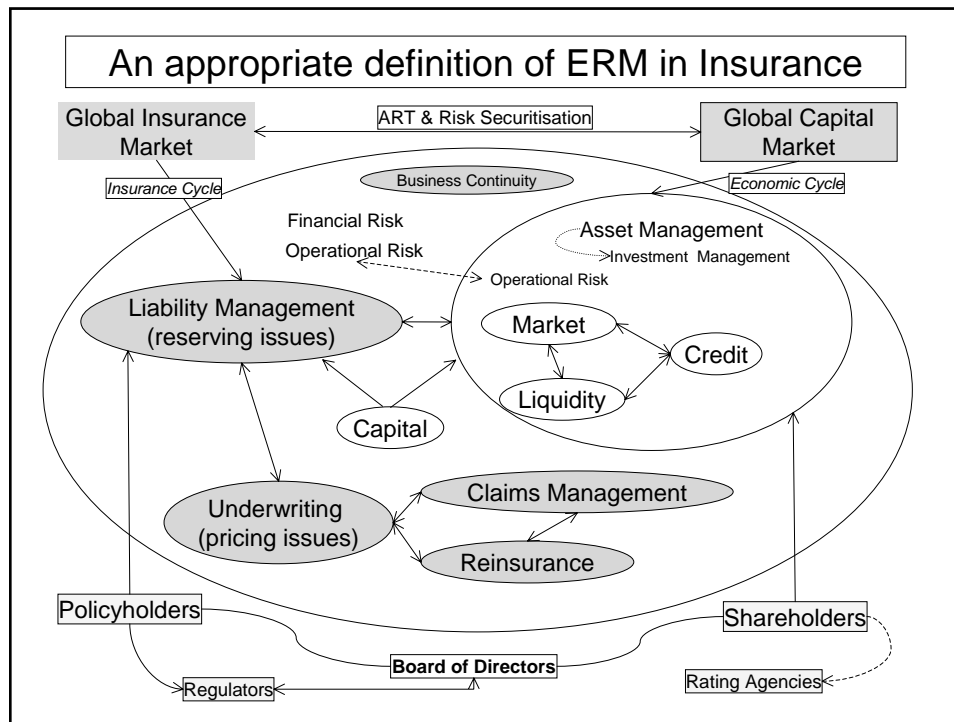


General Findings

- ✓The meaning of ERM in Insurance
 - ✓Comparing & Contrasting few definitions of ERM
 - ✓Searching for an appropriate Definition of ERM for Insurance
- ✓Key issues for Insurers' ERM

Few Definitions of ERM

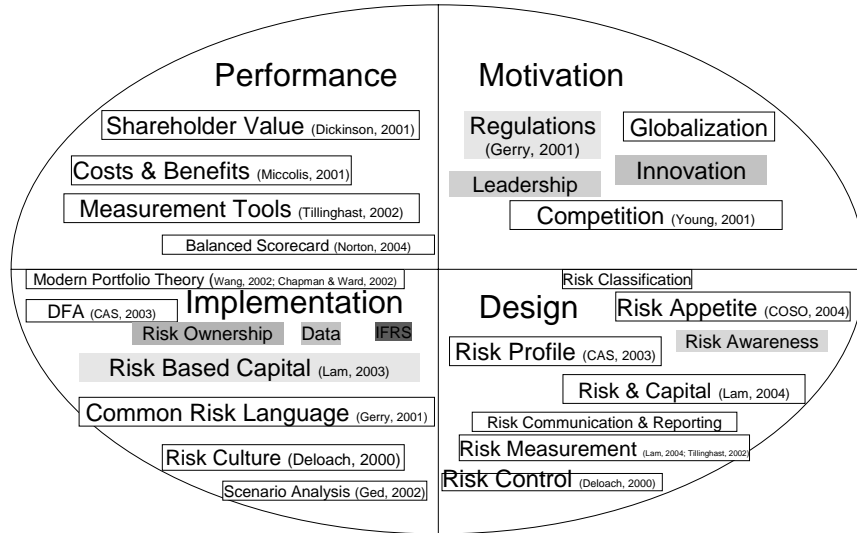
- “..... a comprehensive and integrated framework for managing credit risk, market risk, operational risks, economic capital, and risk transfer in order to maximise firm value” (Lam, 2003)
- “ ... a process by which organisations in all industries assess, control, exploit, and finance and monitor risks from all sources (i.e. hazard, financial, operational and strategic) for the purpose of increasing the organisation's short and long term value to its stakeholders” (Casualty Actuarial Society, 2003)
- “..... a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives” (COSO, 2004)
- “..... ERM for insurers' as the optimization of the dynamic relationship between risk and value throughout the insurance enterprise. It comprises: the development, implementation and monitoring of financial and operational strategies for assessing, mitigating, financing and exploiting financial and operational risk for the purpose of increasing enterprise value” (Tillinghast-Towers Perrin, 2002)
- “..... a process of defining all the risks that an organisation faces and then building a framework to not only monitor and mitigate those risks but to use risk management to increase shareholder value” (PriceWaterhouseCoopers, 2002)



Working definition of ERM for the Study

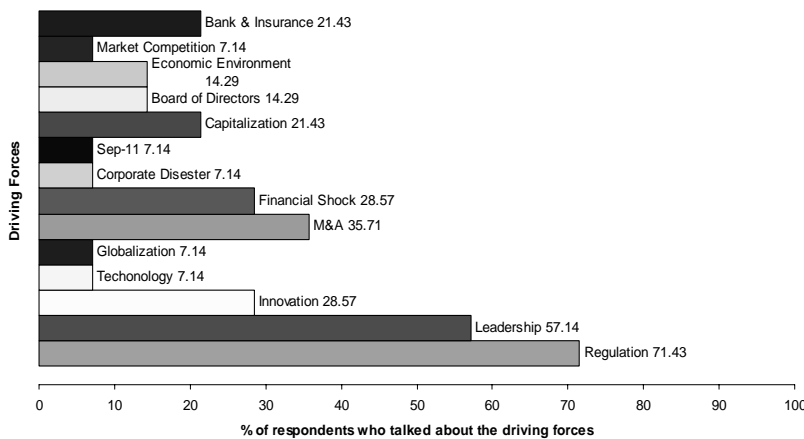
- ✓ERM is a proactive approach of managing insurance companies “all risks”.
- ✓It is not merely a management tool or a process having different steps of risk management viz. risk assessment, risk measurement and risk management as seen in TRM.
- ✓It is more likely a cultural and philosophical issue specific to any particular insurance organisation.
- ✓From a multidisciplinary perspective the overriding objective of ERM is to maximise the profit while protecting solvency of the organisation (i.e., bottom-line issues) at all time.
- ✓In order to achieve this objective ERM works to introduce and maintain a common risk management understanding in holistic term throughout the organisation.
- ✓ERM smooth out the volatile financial and operational results of insurance organisations at all stages by utilizing organisation’s limited resource in the face of competitive market and uncertain economic environment.

Key Issues for Insurers' ERM



Findings on the Motivation of ERM

Key Driving Forces of ERM

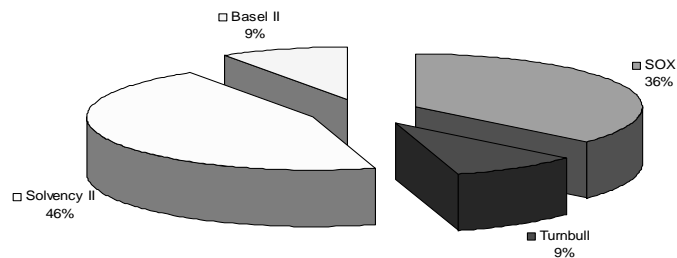


Findings (International Issues)

- ✓ Regulations (Europe Vs US)
- ✓ Corporate Governance
 - ✓ Turnbull vs. SOX
- ✓ Capital Adequacy Regulation
 - ✓ Solvency II vs. RBC vs. Basel II

The Role of Regulations on ERM

% of people referred various regulations relevant to ERM



Regulations (UK Approach)

Corporate Governance (Risk v Internal Control)

FRC Combined Code on Corporate Governance, 2003

- Principle C2: "The board should maintain a sound system of internal control to safeguard shareholders' investment and company's assets" (Turnbull, 1999)
- Provision C.2.1: "The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to the shareholders that they have done. The review should cover all controls, including financial, operational and compliance controls and risk management." (Turnbull, 1999)
- Provision C.3.2: "The audit committee should review the company's internal financial controls (*that is, the systems established to identify, assess, manage and monitor financial risks*); and unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, to review the company's internal control and risk management systems." (Smith, 2003)

The Smith Guidance, 2003 [on audit committees]

- "The company's management is responsible for the identification, assessment and monitoring the system of internal control and providing assurance to the board that it has done so ..." (Paragraph 4.6)

Regulations (US Approach)

Corporate Governance (Risk v Internal Control)

Sarbanes Oxley Act, 2002

Management Assessment of Internal Control

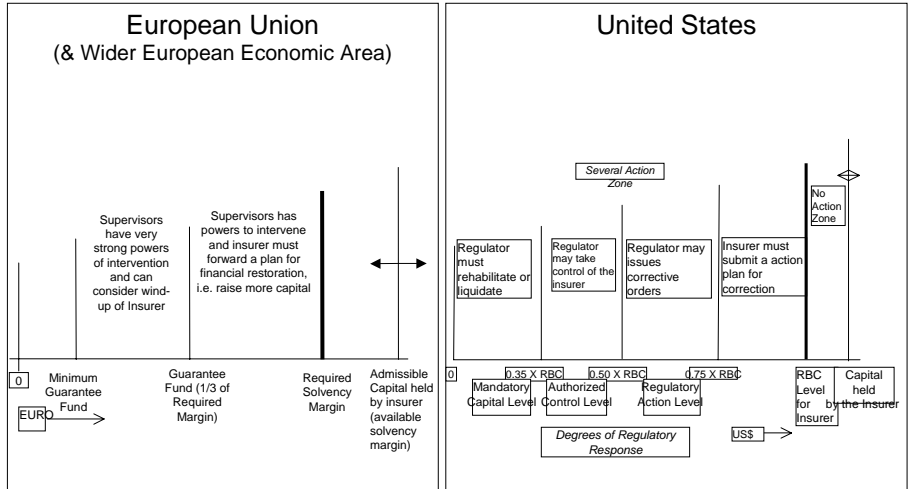
- "..... each annual report to contain an 'internal control report', which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting" (SOX, 2002: Section 404)

Corporate Responsibility for Financial Reports

- "The signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weakness" (SOX, 2002, Section 302[6])

Capital Adequacy Regulations (Risk v Capital) (Current System)

(Source: Dickinson, 1997, Also: IAA, 2004; KPMG, 2002, EC, 2002 & 2003; Sherries, 2004, NAIC, IAIS)



Capital Adequacy Regulations (emerging global solvency system) Source: BIS, IAIS, IAA

Basel II

A more risk-sensitive capital adequacy framework for banks

Three Pillars

Pillar I (Minimum Capital Requirements)
Credit Risk, Operational Risk, & Market Risk

Pillar II (Supervisory Review Process)
Bank's own Capital Strategy

Pillar III (Market Discipline)
Enhanced Disclosure

Solvency II

A solvency system that is better matched to the true risks of an insurance company

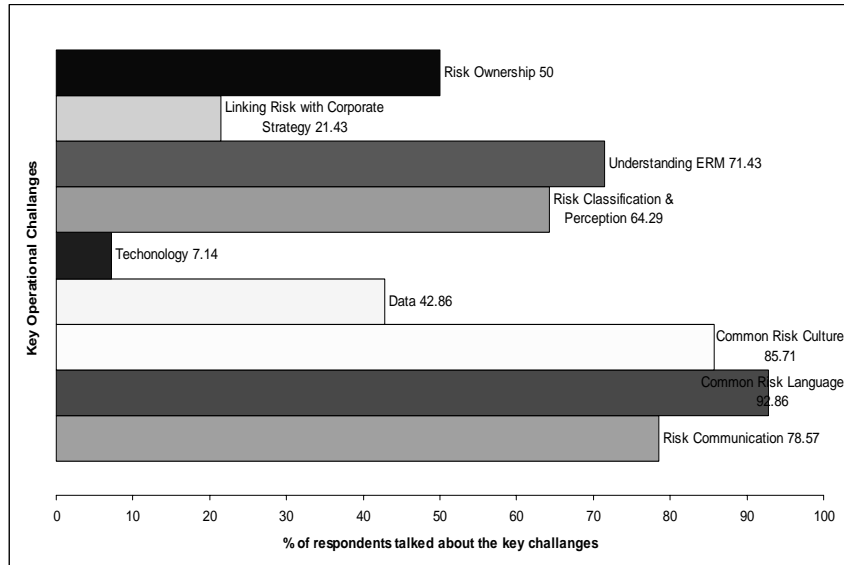
Three Pillars

Pillar I (Financial)
Regulations on minimum capital requirements, reserving and Investment: Quantitative

Pillar II (Governance)
Regulations for financial supervision on Governance Issues: Qualitative

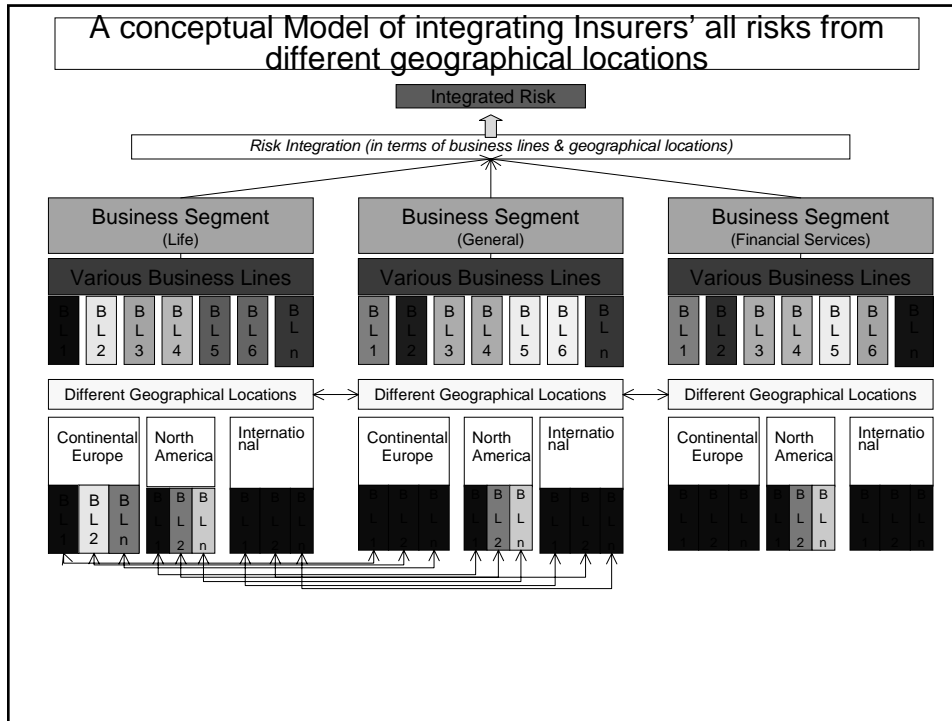
Pillar III (Market Conduct)
Transparency, disclosure requirements & competition related elements

Findings on key Operational Challenges of ERM



Findings (Cultural Issues)

- ✓ A Common Risk Culture
- ✓ A Common Risk Language



- A Common Risk Language**
- Understanding the risk landscape (for all risks)
 - An even understanding on company's overall exposure to risk
 - Measuring Risk in terms of Capital
 - Developing Business Strategy in terms of overall Risk Appetite
 - Group Risk Policy

A Common Risk Culture

- Corporate language should have the same meaning in different culture [Transparency]
- Silo to Holistic Risk Management
- Interdisciplinary Coordination
- Risk-based Performance Measurement and Rewarding System
- Harmonized Global Regulatory Framework

Conclusion

- An inconsistent understanding of ERM
- Apparently regulations drives ERM!! But
- Inconsistency between the “design” and the “implementation” of ERM
- Convergence between the “qualitative” and the “quantitative” phases of ERM
- A Common Risk Language important to develop a Common Risk Culture
- A Global Framework of ERM is far to achieve



International and Cultural Issues in Enterprise Risk Management

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ERM Symposium, Session CS C1
May 2, 2005



Agenda

- Environment
- Issues
- Recommendations
- Questions

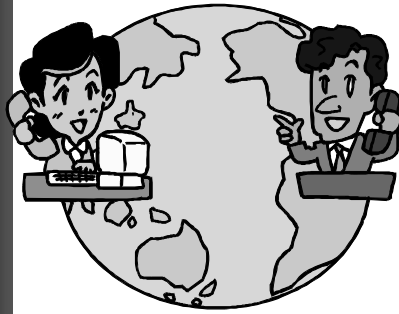
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Setting the Stage

- Enterprise Risk Management requires
 - Transparency - understanding, measuring, and reporting on business risks
 - Accountability - from the governance structure to policy setting to implementation and management
 - Process - repeatable, controlled, tested and accurate
 - Independent Verification

Setting the Stage - International



- Communication challenges
- Limited knowledge
- Often smaller management teams
- Adds a level of difficulty to the Risk Management process

Environmental Risks

- Economic and Political Volatility
 - If you think Guaranteed Minimum benefits are risky in the US...
- Rule of Law - what does the law mean and how is it enforced?
 - Argentina economic policy
 - Indonesian bankruptcy laws
 - German consumer protection



Environmental Risks

- Natural Disasters, Occupational Safety, Business Continuity
- Regulation which explicitly protects or supports locally owned competitors



Operational Risks

- Crime, Corruption, Compliance
 - Foreign Corrupt Practices Act
 - Privacy Laws
 - Patriot Act
 - Sales Practice Standards
 - Influence and Insider Trading
 - Director and Officer Risks

Operational Risks

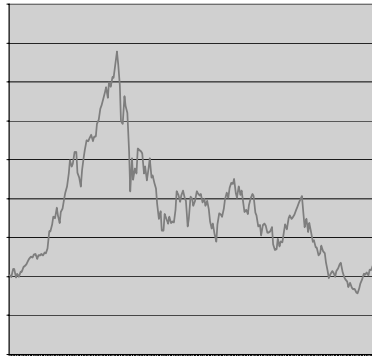
- Distribution
 - Limited opportunities for professional distribution
 - Cutthroat Competition (market share is all that matters)

Operational Risks

- Human Resource Standards
- EEO, discrimination, workplace environment
- Availability of quality staff (particularly actuarial)
- Employee protection law
- Cultural Context



Market Risks



- Credit
- ALM
- Currency
- Liquidity
- Hedging
- Investment
Limitations

Risk Management Resources

- I believe that for every hour in the HO, the sub will spend 5 - 10 hours. Usually the same people who also are working on the business plan, the monthly closes, the new product pricing, etc.
- External staffing?
- Scheduling your information requests and committee meetings

Local Ownership of Risk

- Compliance / Audit;
or
- Business Leaders?
- Although in many companies this begins as an audit exercise, it has to evolve into an ongoing business process



Diversification Value

- If we believe that the diversification into International businesses improves our risk / return relationship
 - How do you show that to Senior Management?
 - Who gets the credit for it at bonus time?
 - How can you feed this value back into your Company's strategic plan?

Practical Recommendations

- Top down risk identification
 - don't ask the sub which risks are the most critical
- Templates!
- Timing
 - think about this in detail, leave room for slippage and scope changes, then don't change it
- Text
 - keep everything (templates, source documents, controls, etc.) in the local working language, translate templates only into Home Office language

Real Life

- So you have a beautiful process, written policy, formal risk reporting, regular risk committee meetings....
- And the world changes!





Questions?