

Banks and Insurers: Separate Paths but a Common Destination

Practical tools and approaches in successfully implementing ERM

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April 14, 2008

□ ERM Symposium



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A Brief History: The challenge to get started....

- ❑ CRO position established in 1996; Full CEO and BoD Support
- ❑ But the CRO found:
 - Culture of (very) independent BUs
 - “Data desert” at Corporate Center
 - Little alignment among risk categories
 - “Form over substance”
 - Financial guarantees and “alternative” activities
 - Poor transparency
- ❑ Sound familiar???



Board and “C-Level” Support

- Good progress made, but a “near death experience” in 2002 led to:
 - A new CEO and a number of critical improvement actions, including:
 - A clear, unequivocal mandate to build a state of the art risk management program and embed it into the organization...with visible, full support every step of the way
 - Unquestionably, the single most important success factor was the Board and CEO support...and lots of involvement!



The CEO reaffirms the commitment...

“...a global financial services company of our size must manage its risks comprehensively... in the end, we must arrive at an integrated view. This point is shared by rating agencies and regulators, two important partners in the risk dialogue. Our response to these challenges consists in a further strengthening of our risk management function and in developing an enterprise-wide framework.”

*James Schiro, April 20, 2006 at Zurich Financial Services’
AGM*



Getting started: Development of an Effective ERM Risk Policy

- ❑ Ongoing enhancement following inception in 1998
- ❑ Detailed limits at BU level for sub-elements of Financial, Strategic, Insurance, Operational and Credit and Investment Risk
- ❑ Consistent definitions and centralized data collection
- ❑ Ownership at business/functional areas
- ❑ Compliance audited

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...development of an Effective ERM Risk Policy (continued)...

- ❑ Limits linked to the an initial enterprise risk appetite
- ❑ Risk Policy and all changes approved by the Risk Committee and full Board
- ❑ “What gets measured gets done” (Jim Schiro) had the collateral benefit of “You don’t do what you can’t measure”....as you need to report compliance with the Risk Policy limits.
- ❑ Close to the action, local “Risk Committees” review compliance and reporting...and keep management engaged at all levels.

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Agreeing the Risk Appetite is the perfect way to engage and commit the Board...

- ❑ Questions such as the following...
 - What is the worst Net Income you would accept 1 in 10 years?
 - How frequently would you accept cutting or eliminating the dividend? 1 in 20 years?
 - How frequently are you willing to accept the need to raise additional capital? 1 in 10? Or, 1 in 20?
 - How frequently are you willing to accept a ratings downgrade?
- ❑ ...are at the heart of the BoD's governance responsibilities...and will capture the imagination
- ❑ And provide the key parameters for the ERM framework and models; capital considerations more for the tail, earnings considerations more for the core

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...which allows the “Virtuous Circle” ERM Framework...

- ❑ The BoD’s agreed group risk appetite.....
- ❑ Aligned risk limits cascaded to all entities/functions
- ❑ Day to day decisions on underwriting, investments, etc.
- ❑ Monitor compliance with risk policy limits
- ❑ Integrated enterprise-wide risk modeling and analysis
- ❑ Input on stress scenarios/ non-modeled risk
- ❑ Identification of risks for mitigation/hedging
- ❑ Revise risk policy to ensure alignment
- ❑ Brief BoD on compliance, recommit to risk appetite
- ❑ And so on, and so on.....

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Cascading reports lead to an effective Risk Dashboard...for the BoD and senior mgt

- ❑ Requires a detailed, limit-based Risk Policy
- ❑ Limit monitoring systems at all levels in the organization, (underwriting & investments)
- ❑ Review of exposure/limit reporting by local Risk Committees
- ❑ Cascading reports to regions/divisions
- ❑ Risk Management undertakes correlation and aggregation analyses/stress testing & modeling

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....and an effective risk dashboard

- ❑ Will lead to reports like this one...
- ❑ A Board report in Feb 2003 summarizing uses of derivative instruments, # of transactions, outstanding deals with credit and market risk as reported to GRM risk committee, VAR of \$XXX, mark to market analysis and reasons for changes, and all with a reconciliation to risk policy limits. And this was in 2003!!!
- ❑ And today, minimal exposure to CDOs, sub-prime and other credit related investments, either through underwriting or investments

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Economic Capital as a Key Part of Strategic Risk Management...

- Implementation of Risk Modeling Platform
 - Consistent/unified approach to risk quantification
- Return on risk adjusted capital key to planning and performance/results evaluation
- ERM risk assessment reflected in economic capital calculations
- Provides incentive to lower risk profile
- Allows for more effective use of statutory capital



...and the integration of ERM and Strategy

- ❑ Analytics key to Return on Risk Adjusted Capital for planning, results and performance management
- ❑ Also for pricing, product design, reinsurance purchasing and allocation of capital
- ❑ Assessment of potential transactions

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...and for non-modelled risk – “Total Risk Profiling”

- ❑ Risk Committees at BU, Divisional and Group levels conduct Total Risk Profiling as part of planning exercise, including quarterly reports on mitigation actions. Reports cascaded upwards.
- ❑ Systematic risk identification, assessment and mitigation tool used to identify, measure and monitor risk across the Group
- ❑ Identifies, defines and assesses all types of risks, and determines optimal improvement strategies for unacceptable risks
- ❑ Aligned with strategic & operational plan
- ❑ Promotes teamwork, communication, transparency and knowledge exchange within the Group

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Total risk profiling characteristics include...

- ❑ Strategic / macro / holistic
- ❑ Top-down, unconstrained
- ❑ Prospective
- ❑ Aligned with Strategic & Operational Plan
- ❑ Acceptability focuses on long-term risk adjusted return
- ❑ Quantification in terms of economic capital and impact on financial statements
- ❑ Calculated remedial action plan (Key Tasks)
- ❑ And absolutely key, it engages management at all levels...

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Bottom line, in 2006, S&P observed.....

- ERM Adequate with potential to become Strong in the near Future
 - Risk Controls for Major risks are Adequate
 - Effectiveness yet to be proven
 - Importance of ERM to Rating is **VERY HIGH**
 - Zurich Risk Policy (1998) supports Strong ERM Culture
 - Corporate Center risk management staff & risk officers in the businesses
 - Corporate centers for Underwriting, ALM, reinsurance, financing, risk identification & accounting provide central control of risk taking
 - Strategic risk management is based on holistic view of group capital requirements
 - Economic Capital and risk adjusted return
 - Risk tolerances are under development
 - Total Risk Profiling process
 - Potential to improve based on measures ZFS has undertaken to substantially improve risk controls & set up efficient emerging risk management

...but the payoff was in 2007

- ERM Strong
 - Strong Culture (same as 2006)
 - Strong Emerging Risks Management
 - Based implementation of a structured process for profiling emerging risk scenarios in terms of triggers, consequences, actions and responsibility
 - Strong Strategic Risk Management (same as 2006)
 - Strong P&C Underwriting Risk Controls
 - Based on comprehensive underwriting guidelines, global compliance function, use of technical price as key control
 - Cat risk controls improved
 - New products face stringent approval process with CEO involvement
 - ALM is strong – reflecting use of highly sophisticated methods, regular reporting and integrated control processes

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To Do's: Realizing ERM Value

- ❑ “Walk the Talk” with embedding ERM into the corporate DNA; maintain emphasis on transparency
- ❑ Credible risk reporting and limit adherence with monitoring at all levels; local risk committees
- ❑ Realistic risk modeling with emphasis on data, aggregation and correlation modeling in stress scenarios validates the risk policy limits and linkage to enterprise risk tolerance; ownership within organizations
- ❑ Seek good, collaborative judgment and insight into the business dynamics as keys to success
- ❑ And leverage the involvement of the Board

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