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**Strategic Risk Management: The
Upside Of ERM**

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Strategic Risk Management: The Upside Of ERM

Risk management is focused directly on the prevention of losses that are outside the risk tolerance of a firm, or put more simply, the avoidance of unpleasant surprises. However, when Standard & Poor's Ratings Services evaluates the enterprise risk management (ERM) capabilities of an insurer, superior risk management will only lead to an "Adequate" ERM score if it is not accompanied by an enterprise-wide strategic risk management (SRM) process.

An Adequate score is the third ranking for an ERM evaluation and falls between scores of "Weak" and "Strong". The good news is that for most insurers an Adequate ERM score will not hurt the rating. Standard & Poor's defines Adequate ERM as a company that has a risk control system that will effectively prevent losses outside of their specific tolerances for each type (credit, market, insurance) of risk in most situations. For the first 100 insurers that have had ERM evaluations, we found that about two-thirds had Adequate ERM. There is quite a range of company practices that falls within this score. Adequate ERM insurers include those who have competent but basic risk control processes as well as companies who have complex state-of-the-art risk control systems within single risk standalone "silos." Silos exist at many levels including lines of business, departments, subsidiaries, and countries. However, one thing that they all have in common is that they have not yet fully adopted an SRM process. Individual subsidiaries within a group might even have strong SRM/ERM on a standalone basis, but if this is not co-ordinated across the enterprise, that group may only enjoy no better than Adequate ERM.

SRM is the Standard & Poor's term for the part of ERM that focuses on both the risks and returns of the entire firm. Although other aspects of ERM mainly focus on limiting downside, SRM is the process that will produce the upside, which is where the real value added of ERM lies. The insurer who is practicing SRM will use their risk insights and take a portfolio management approach to strategic decision making based on analysis that applies the same measure for each of their risks and merges that with their chosen measure of income or value. The insurer will look at the possible combinations of risks that it can take and the earnings that it can achieve from the different combinations of risks taken, reinsured, offset, and retained. They will undertake to optimize their risk-reward result from a very quantitative approach.

For life insurers, that will mean making strategic trade-offs between products with credit, interest rate, equity and insurance risks based on a long-term view of risk-adjusted returns of their products, choosing which to write, how much to retain and which to offset. They will set limits that will form the boundaries for their day-to-day decision-making. These limits will allow them to adjust the exact amount of these risks based on short-term fluctuations in the insurance and financial markets.

For non-life insurers, SRM involves making strategic trade-offs between insurance, credit (on reinsurance ceded) and all aspects of investment risk based on a long-term view of risk-adjusted return for all of their choices. Non-life SRM practitioners recognize the significance of investment risk to their total risk profile, the degree or lack of correlation between investment and insurance risks, and the fact that they have choices between using their capacity to increase insurance retention or to take investment risks.

Insurers that do not practice SRM usually fail to do so because they do not have a common measurement basis across all of their risks. The recent move of many insurers to develop economic capital models provides a powerful

tool that can be used as the common risk measure for SRM. Economic capital is most often the metric used to define risk in the risk/reward equation of SRM practitioners, but economic capital by itself does not indicate that SRM exists in an insurer.

Standard & Poor's believes that an insurer that practices SRM will, over time, tend to make choices that continually allow it to maintain and improve its underlying profitability while staying within its risk tolerance. An insurer without SRM will more likely be tempted over time to choose the strategic alternatives with lower rewards for the risks taken. Insurers with superior risk control but no SRM would not be expected to show excessive losses, and might even report high profits when economic and market conditions are benign, but may experience a level of return that languishes or even declines over time because they may not have the decision making system in place to help identify the best opportunities.

Some insurers with good risk control have a disciplined practice of capacity management. With their capacity management process, they very carefully assure that each year, they do not retain exposures that push them past their risk taking capacity. Capacity is usually defined in terms of regulatory capital ratio or a multiple of rating agency capital. These programs are not SRM for two reasons. First, they are not exactly focused on the firm's risk. The regulatory and rating agency capital formulas are by their nature broad market estimates of the risk capital of the insurer. These formulae will over-state the capital needs for some of the insurer's activity and understate the needs for others. The insurer has the specific data about their own risks and can do a better job of assessing their risks than any outsider could ever do. Second, the capacity management process does not always look at the choices to seek the optimal returns.

Other insurers have a return on capital process that uses an allocated version of the regulatory or rating agency capital formulas as the capital for each product or business. This process should be called strategic capital management. These insurers will sometimes do an optimization process on their return on capital, but Standard & Poor's does not consider this to be an SRM process either. The reason again is the lack of specific tie of the generic capital formulas to the risks of the insurers. In the worst case, this process will lead an insurer to emphasize the risks where the generic formula drastically understates the amount of capital needed. These risks will sometimes show robust returns on capital for the reason that there are reasonable risk margins that look excessive when compared with an understated capital. This was the situation when insurers took high amounts of catastrophe exposure or embedded guarantee and option risks, which were not penalized in the generic capital formulas. In the end, some insurers found that they had taken much more risk than their actual loss tolerance or capacity.

Finally, SRM allows insurers the framework to take full advantage of the power of diversification in their risk selection. They will look at their insurance and investment choices based on the impact, after diversification, on their total risk/reward profile. These insurers will also react to the cycles in risk premium that exist for all of their different insurance risks and for all of their investment risks in the context of their total portfolio. SRM is expected to provide the upside of ERM.

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