Tailoring enterprise risk management strategies to the Main-Street insurer

Prepared by:

Jay Golonka, *Partner*, McGladrey LLP
816.751.1830, jay.golonka@mcgladrey.com

Discussions of Enterprise Risk Management (ERM) are often framed for a large, even multi-national company perspective. They call for the formation of a risk management department to accumulate, evaluate and quantify the material risks to an organization. In the insurance industry, these ERM efforts are vital, as state regulators and rating agencies often request ERM information from insurers to understand how an organization is accumulating and addressing its risks.

For Main-Street insurers, however, these large-company focused ERM discussions are not necessarily helpful. The typical Main-Street insurer does not have the resources available to staff a dedicated ERM department. The difference in size and scope between multi-national giants and Main-Street insurers effects more than the nature of their risk management departments, however. It also changes the very nature of the risks these very different kinds of organizations face.

So how should a Main-Street insurer think about ERM?

Start at the beginning

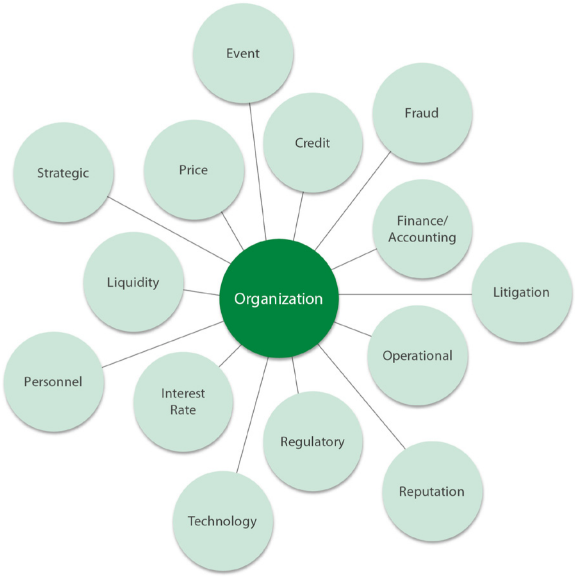
Understanding how these insurers can achieve effective risk management results starts with understanding what ERM actually encompasses. According to the "Enterprise Risk Management – Integrated Framework" as developed by the Committee of Sponsoring Organizations of the Treadway Commission, ERM encompasses:

- **Aligning risk appetite and strategy** – Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives and developing mechanisms to manage related risks
- **Enhancing risk response decisions** – Enterprise risk management provides the rigor to identify and select among alternative risk responses – risk avoidance, reduction, sharing and acceptance
- **Reducing operational surprises and losses** – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses
- **Identifying and managing multiple and cross-enterprise risks** – Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks
- **Seizing opportunities** – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities
- **Improving deployment of capital** – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation

By their very nature, insurance companies are in the business of risk. However, insurance companies often think about risk in terms of either traditional financial risks, like credit or liquidity risk, or in terms of compliance risks, like regulatory matters. They often don't consider operational or strategic risks.

For example, insurance companies carefully consider what policies should be written from a variety of perspectives. They consider how much risk is taken on (exposure amount), the character of that risk (location or nature of insured) and the rate needed to write such risk. They also consider what portion of that risk to reinsure, that is, what risks will they write to keep the customer, but not want to keep due to either the type or amount of the specific risk.

Insurers also consider the relative risks within hard and soft markets. In a hard market, they find it easier to write products at prices that adequately address the risks. In soft markets, they often must price products at lower prices, assuming greater risk for their organization.



There are other risks, however, that insurers often do not address as effectively, such as reputation risk, succession risk, catastrophe risk (for a non-catastrophe writer), personnel risk, or other non-underwriting risks taken on by the organization. These risks also should be fully considered, especially since the events giving rise to them are often unexpected and can be devastating to an organization that has not prepared for them.

An appropriate ERM framework will help insurers develop a cohesive strategy to consider and address all risks – both the financial and underwriting risks that most insurers address effectively and the various other forms of risk that many insurers do not.

Best practice ERM strategies have three key foundations. They:

- Include an integrated framework of responsibilities and functions
- Are driven from the board level down to operational levels
- Cover all aspects of risk

Developing an ERM framework based on these foundations is a four-phase process.

Phase one: Risk program development

In phase one, responsibility and accountability for ERM development and oversight is clearly delineated. Key steps include:

- Identifying the ERM champion/owner and any other team members who will assist in its coordination. While this group will play a key role in ERM efforts, it should be clear that responsibility for development or oversight of ERM responsibilities falls across the entire organization and to the board/designated committee, respectively.

- Determination of materiality, which can be based on various inputs, including regulatory concerns or ownership's risk appetite
- Confirmation of board commitment

Board commitment is especially vital, as it empowers the ERM owners and team members to dedicate time to the development of the framework. An effective way to evidence that commitment is to incorporate ERM milestones in the performance goals of the ERM champion and team members so that their contributions to this effort are measured and rewarded.

Phase two: Risk assessment and prioritization

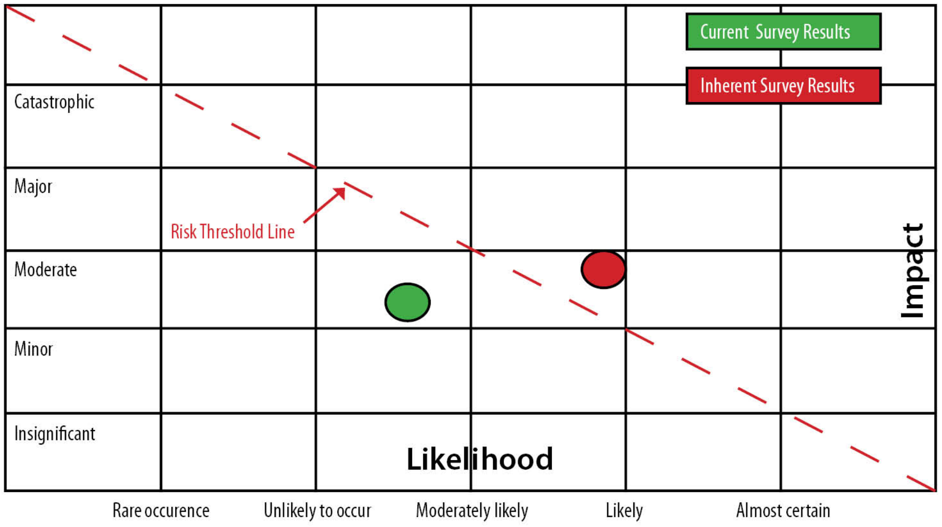
This phase focuses on identifying the organization's portfolio of risks. Specific tasks in this phase include:

- Develop, distribute and complete surveys and/or interviews with select members within the organization
- Evaluate all functional areas and compare their identified risks to industry data to ensure that the complete population of risks is identified
- Review identified risks with the ERM champion/owner and the board/designated committee to confirm the risk portfolio
- Rank and prioritize the identified risks according to:
    - Impact – The financial implications to the organization in the event the risk were to occur
    - Likelihood – The probability the risk may occur within the business

  Further ranking and prioritizing may include risk direction, scale or scope of impact, velocity or speed of risk outcomes and interdependencies of individual risks.

The following chart provides a good example of how an organization could depict their identified risk for presentation purposes:

Lack of succession planning may inhibit the company from achieving strategic goals.



- Coordinate a session with the owner(s)/team member(s)/board/designated committee to:
    - Discuss and reach agreement on risk prioritization
    - Address questions or concerns regarding risk prioritization
    - Evaluate impact and probability factors for understanding overall risk exposure
    - Discuss risks with significant deviations/spread in prioritization to gain insight on different perspectives

Phase three: Risk treatment

The third phase focuses on treatment strategies, including the following:

- Discussing and identifying mitigation strategies for the prioritized risks
- Defining the organization's risk appetite and tolerances relative to the prioritized risks
- Ensuring buy-in from the board/designated committee regarding plans of actions, improvement opportunities and next steps

If, through this process, new risks surface which have not been addressed by management in the past, this phase could encompass the development of additional plans and procedures.

Phase four: Risk validation and monitoring

The final phase is development of a validation plan that verifies the mitigation strategies are appropriately designed and work as intended. Additionally, and most importantly, an ongoing monitoring and reporting strategy must be put in place so that not only are the key risks being monitored regularly, but the organization is also continually watching for new risks and adapting their ERM framework to address them.

Most Main-Street insurers do not have extensive and deep organizational structures, so the ERM process is often confined to those higher-level individuals who are involved in most organizational decisions. Whereas in larger organizations, these decisions are spread across subsidiaries and operating locations. This fact does not diminish the need for ERM. To ensure an appropriately broad perspective on risk, Main-Street insurers should seek out input throughout the operation to help ensure that the full spectrum of risks are identified, understood and addressed.

Risks Main-Street insurers often must address

Because of their limited size, Main-Street insurers are prone to certain risks that their larger competitors are not. One is succession planning.

Consider a key position like the CFO. In a larger organization there is likely a long chain of command (CFO, CAO, controller, accounting manager) within which a successor CFO may well have been identified and groomed, or within which, at least, a person with sufficient skill and training to serve as interim CFO is waiting in the wings. For a Main-Street insurer, this is often not the case. There is likely to be a greater gap in the level of responsibility from the CFO to the next professional down the chain. Therefore, it is vital to have a plan in place to react to the loss of the CFO (and any other key executive). That plan must address both the immediate interim need, whether that is someone within the firm or an outside vendor that can provide the needed skills on a temporary basis, as well as the process for identifying and hiring the appropriate permanent replacement. Such plans are especially vital in those instances where a position is left open unexpectedly.

Disaster recovery is another example where Main-Street insurers face magnified risks. In the event of a disaster, a larger organization can often transfer functions and responsibilities to unaffected locations. But a Main-Street insurer's headquarters may be its only location. Perhaps only IT is affected. If your organization's servers were to go down, what is your back-up plan? What if your entire location was affected by fire or natural disaster? To where would you relocate operations? How would employees be notified and mobilized? The risk may seem improbable, but, unplanned for, the results would be catastrophic.

And, since Main-Street insurers often serve the markets where they are located, the risks of a disaster could be magnified by the nature of the business. In the case of a natural disaster, not only would the organization be scrambling to maintain operations, it would be doing so just as it is also dealing with a massive influx of claims.

Addressing these claims in a timely fashion will impact everything from customer retention to regulatory matters as well as financial reporting. While this example is specific to property insurers, there are similar scenarios available for almost any type of insurer.

Development of an ERM process is central to understanding these types of multi-risk scenarios and to determining how the organization would respond should certain events occur.

Own Risk Solvency Assessment (OSRA) – The next step after ERM?

ORSA is the internal assessment of the risks associated with an insurer's current business plan, and of the sufficiency of capital resources to support those risks. In other words, ORSA quantifies the potential impact of the risks identified through the ERM process.

The National Association of Insurance Commissioners (NAIC) developed ORSA, its own solvency monitoring tool similar to Solvency II in Europe. In late 2011, NAIC established an ORSA requirement for insurers with group written premium above $500 million. As many Main-Street insurers fall below this figure, they will not be directly impacted and will not have to formally provide an ORSA upon request. Main-Street insurers should, however, consider the tool from a best practices perspective. Additionally, if it is required for those larger organizations, ORSA may soon be used by regulators and rating agencies to determine how certain concepts are applied within smaller organizations.

As companies review their ERM or look to strengthen or expand on it, including quantification of their risks and exposures could provide additional information to those in charge of corporate governance as well as provide additional items for consideration for rating agencies and regulators.

The risk picture confronting Main-Street insurers differs from that confronting their larger competitors, so their ERM response should differ, too. By adapting ERM best practices to the scale and scope of their operations and the unique nature of their risks, Main-Street insurers can better prepare their organizations to face the future.

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