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The Case for Enterprise Risk Management in Insurance

Manage risk, change your business, create value, achieve your objectives



March 2017

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Mazars' Insurance and Risk subject matter experts contributed to this report by identifying the ERM trends and challenges facing insurance firms, and highlighting the steps insurance companies must take to establish risk-based business models and create value by adopting an ERM strategy.

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- Reviewing business plans and aligning them with risk/return profiles
- Reviewing economic capital models and capital allocation
- Designing the appropriate ERM target operating model
- Defining areas of quick wins to create better risk/return value
- Aligning risk appetites with business plans and capital management
- Enhancing current risk management processes
- Enhancing risk decision-making processes at each segment of the business plan
- Improving the treatment of risks and establishing a structure to track decisions throughout their implementation

- Enhancing risk/return profiles against the business plan
- Enhancing the risk MI in line with performance, tolerances and capital management

For more information about our actuarial and ERM services, and how these might benefit your insurance business, please contact:



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1. Executive summary

In the insurance industry, while enterprise risk management (ERM) is a concept that's often talked about, it remains somewhat misunderstood and under-utilized. Increasingly, however, major macro forces are making ERM an essential part of insurance companies' ongoing operations, specifically:

- A heavy pipeline of inbound regulation.
- Volatile markets and a difficult global macroeconomic environment.
- Rapidly evolving technologies and customers.
- A host of disruptive forces on the horizon.

Against a backdrop of low interest rates, volatile markets and depressed returns, ERM can offer insurers a better, more robust approach to managing risk, enabling them to release significant trapped value. Insurers should now create virtue out of necessity, moving beyond regulatory compliance to develop cost-effective, flexible and forward-looking ERM for the future, realizing the benefits of an enterprise-wide approach to risk management.

ERM provides value in three main areas: a) strategic strength (an enhanced outward- and forward-looking ability to manage risk and do better business); b) new insight (thanks to the vast amounts of data insurers have to process, and the new technology they must embrace); and c) managing the problem of operational risk (OpRisk) to increase insurers' resilience and effectiveness.

But many insurers run another risk: of not properly implementing ERM – which can prove highly detrimental. Success with ERM requires preparation, integration, cultural change and the right people in place (increasingly the right Chief Risk Officer [CRO] – a role taking on growing strategic importance). With the correct approach, ERM can be more than just a talking point. It can change your business.

To succeed in the next five years, insurers will need to seize the opportunity in 2017 to start the strategic transition from compliance to ERM in the way most appropriate for their business, and under the direction of the CRO.

This report examines the changing nature of risk, and the changing nature of ERM – as well as its growing importance as a way to generate real value for insurance companies. It also identifies the key steps insurers must take to successfully adapt to the strategic transition they will have to make.

The time to seize the ERM opportunity is now.

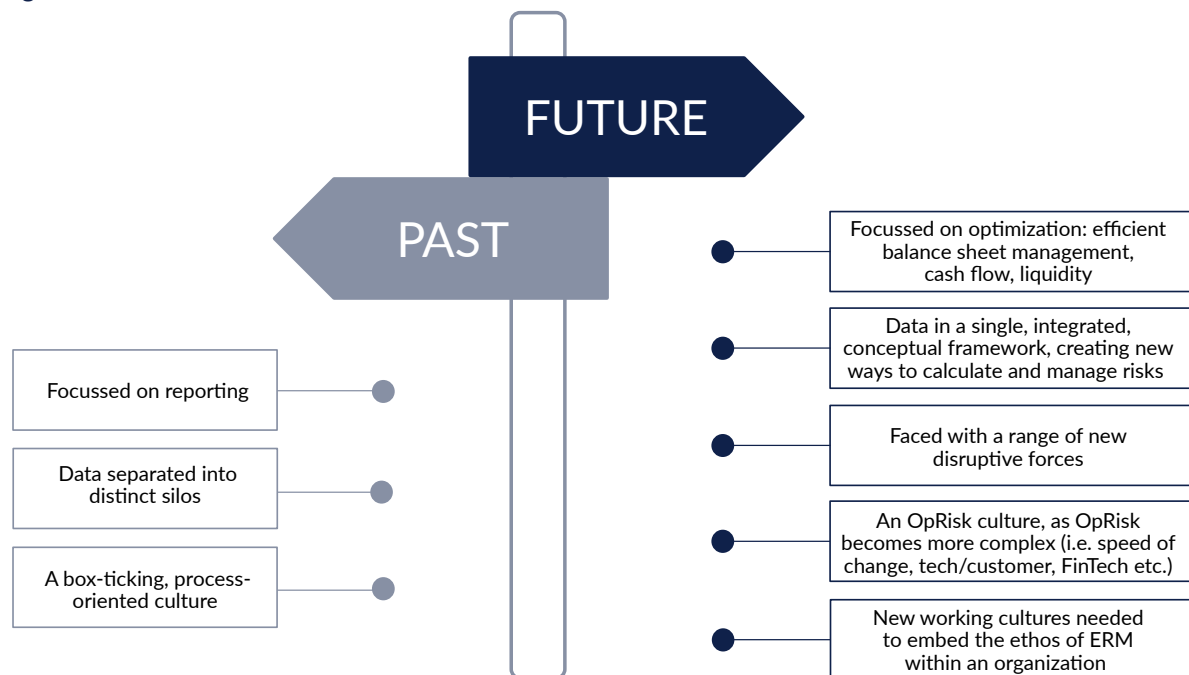
(For this report we interviewed a number of insurance professionals around the world for their insights into trends in the industry, and the current state of ERM programs. Selected quotes appear throughout).

2. The road to ERM

Changing world, changing risks, changing needs

Insurers' stable business models, which have survived and thrived for generations, are under increasing pressure. The next decade will be a turbulent one for many insurers (see Figure 1), across all areas of their business, from delivering strategy, to managing solvency and profits, to data gathering and analysis, to managing OpRisk and defining their risk culture.

Figure 1: Future focus for insurers



Source: Chartis Research

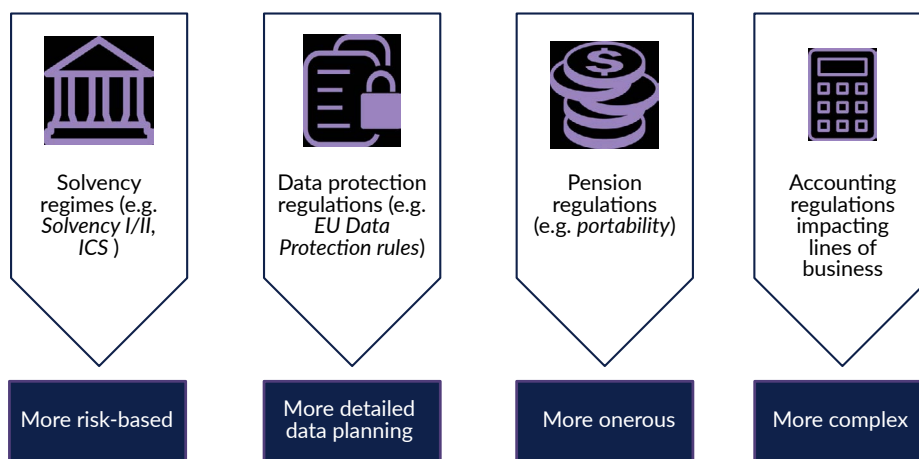
Regulation, geography, macroeconomics and digital transformation are key factors putting pressure on insurers, and creating more hostile market conditions. (Key structural differences between the life and non-life sectors are also affecting the way insurers tackle risk. For more detail on these structural dynamics, see the appendix). For many in the insurance sector, unlike their colleagues in the banking industry, some of these developments are relatively new territory. Firms now need to rethink the way they operate, and must be able to predict and adapt to risks that are becoming more complex and disparate. For this, they need a new approach.

Regulation: coping with the next wave

Insurers have not escaped the wave of regulation affecting the financial services industry, notably solvency legislation, which for many has had a profound effect. But regulation in other areas – which is becoming more risk-based, complex and onerous¹ – is also impacting the way they operate (see Figure 2). And given the intrinsic, 'backwards-looking' nature of regulation, it tends to reflect past waves of disruptive risk, rather than new, inbound issues. So considerable regulatory change is likely in the wake of new transformative trends such as cyber-insurance and the onset of driverless cars, creating further demand for insurers to adapt.

¹ In terms of providing flexibility for pensions, for example.

Figure 2: More regulations for insurers



Source: Chartis Research

'We truly believe that the right – the only – way is to combine the regulatory view of ERM and the opportunity it can create.'

Interview respondent

Macroeconomics: forcing insurers to take more risks

A number of macroeconomic developments are pushing insurers to increase their appetite for risk, opening them up to lower-rated assets and non-traditional options:

- Falling investment rates globally. A 2016 'low for long' stress test conducted by the European Insurance and Occupational Pensions Authority (EIOPA) on 236 insurance firms tested the effect of extended low interest rates on their business. The results indicated an aggregate fall of 18% in the total excess of assets over liabilities in the baseline².
- Massive pressure on fixed-income investments from historically low yields.
- The search for yield, encouraging a move from government bonds to high-rated corporates (see box).
- A growing reliance on underwriting return, and reduced exposure to equities.

Hunting yield

In Europe, which has a 10-trillion euro insurance industry, firms starved of yield in Western bond markets are turning to emerging market debt for the higher returns they need. Similar activity is happening in Japan, where companies have been driven overseas for several years by near-zero yields, and a recent swing into negative interest rate territory has seen more investments shifting to foreign bonds. Many insurers have been moving into non-core fixed-income products such as emerging market debt, high-yield debt, private credit and even lending.

² <https://eiopa.europa.eu/Pages/Financial-stability-and-crisis-prevention/Stress-test-2016.aspx>

Geography: siloed by regulation

Insurers around the world face common pressures from regulations and the low-yield environment. But the global insurance market is effectively siloed into regions governed by local regulators. Structural, historical and cultural factors will also play a part in shaping the way that different insurers tackle risk management.

To give a sense of the different dynamics insurers face in different countries, we have summarized some notable highlights from three countries: Turkey, China and Slovakia. All are worth highlighting here: Turkey because of its relative technological advancement – it has one of the most sophisticated mobile financial services environments in the world – and China because of its size and importance in global markets, and its relevance as a hub for financial technology. In Slovakia, most insurers are part of bigger global firms, creating structural issues, both in dealing with regulation and in developing approaches and systems for risk management.

- In **Turkey**, the insurance market is dominated by local concerns (such as the need to implement broad-based disaster insurance cover following severe earthquakes in 2011). Regulation is also focussed on statutory accounting, setting Turkey apart from its European counterparts by prioritizing accounting rules over solvency regulations.
- In **Slovakia**, most insurance companies tend to be part of bigger international groups, which govern the way they approach legislation, risk management, technology systems and so on. Many companies were also state-owned until fairly recently, and are still hampered to some extent by old ways of doing things.
- In **China**, the marketplace is controlled by a few key players, and the mis-match of assets and liabilities is considered a sizable risk.

ERM as a tool for change

Most of the recent movement toward ERM in insurance has been driven by regulation – specifically solvency regulation, such as Solvency II in the European Union (EU) and its equivalents elsewhere. But, against a background of fluctuating and uncertain market conditions, ERM is increasingly being seen as a source of value for firms, as they move from focussing on tactical issues, to complying with regulations, to taking a strategic approach to enterprise risk management, and driving better performance.

ERM describes ‘...a holistic framework approach to identifying, defining, quantifying, and treating the risks from all sources facing an organization for the purpose of increasing the organization’s short and long term value to its stakeholders.’³

ERM represents a significant evolution of traditional risk management techniques, encompassing all areas of an organization, and looking across the overall set of risks that result from the interrelated processes, people and structures that exist across an insurance company.

Effective ERM is about protecting and creating value: it provides value by integrating and aligning risk-related elements, functions and roles within a company, such as risk strategy, risk management processes and risk infrastructure. Structurally, it works by bringing together risk managers and isolated

³ Source: International Risk Management Institute. For an alternative definition, see the Society of Actuaries (SOA) at <https://www.soa.org/Files/Newsroom/news-erm-fact-sheet.pdf>

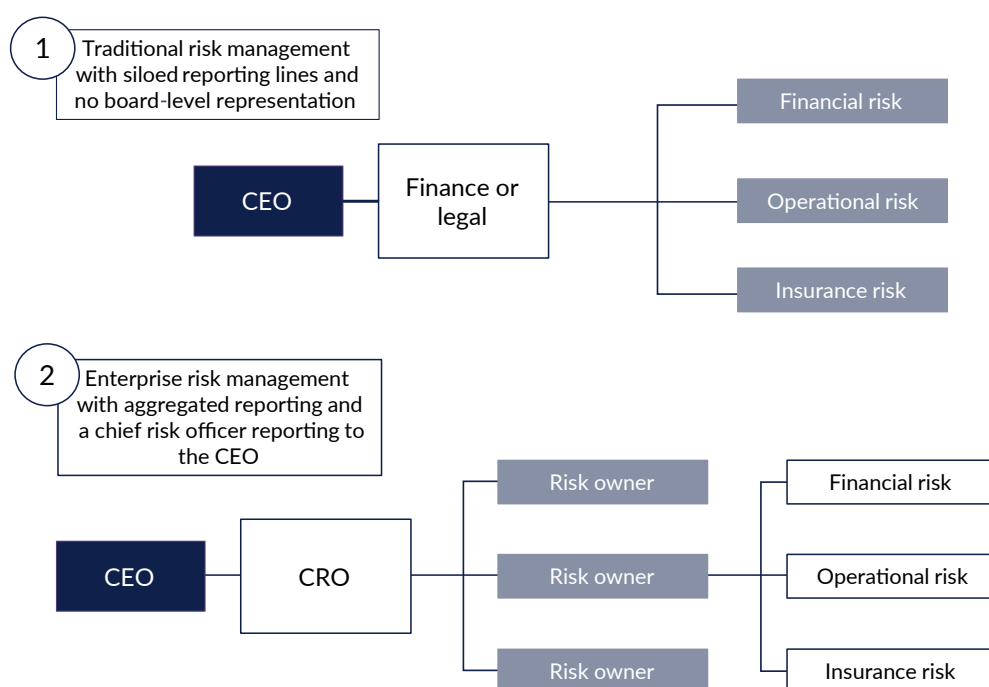
lines of reporting, and delivering aggregated information to a board-level role such as the chief risk officer (CRO) (see Figure 3).

Insurance firms – of any size – with an ERM framework embedded in their business are much better able to ensure that their risk profile is aligned with their risk appetite and their expectations for return. They can also proactively monitor and assess potential emerging risks, and exploit or mitigate them to detect, protect, maintain and create value.

'While they have all the information they need, in a lot of companies it's in different databases, so bringing it together into a way that can be easily reported to support better decisions is a huge challenge.'

Interview respondent

Figure 3: Simplified ERM framework



Source: Chartis Research

3. New value; fewer old habits...

New value

In short, ERM gives firms a better understanding of their risks, and enables them to generate more sustainable profitability. In recent years, there have been well-documented examples of firms that have gone into liquidation because they have effectively mismanaged their balance sheets. These scenarios might have been avoided had they possessed connected risk management systems and processes. Importantly, such an understanding of risk across a firm could also improve its credit rating, and by extension reduce its cost of business, driving tangible business benefits.

Opportunities to create value from ERM are emerging in three broad areas, summarized in Figure 4:

- Strategic value.
- New insights.
- OpRisk management.

'No longer are companies questioning if they should address ERM. Instead, they are determining how they tackle it. ERM just needs to sit higher up on their list.'

Interview respondent

Strategic value

ERM can help insurers:

Manage their risk, by:

- Creating a sustainable risk/return strategy, rather than one driven by solvency ratios.
- Integrating IT risk management throughout enterprise governance, risk and compliance systems.

Do better business, by:

- Heading off the threat posed by new market entrants, particularly digital startups.
- Improving the quality and clarity of the way they report risks to the C-suite. Where appropriate, they can also benchmark the quality of managerial decision-making (something that is already happening in the banking industry).

New insights

By using the data captured through ERM regulatory reporting practices, insurers can:

- Create a 'joined-up' view of the risks they face, and actionable insights aligned to risk strategy and capital management.

- Drive second-order business benefits, including:
 - New products, linked more closely to customer needs.
 - Cost reduction.
 - An enhanced ability to adapt to fast-moving market changes like the UK's Brexit vote.
- Ease portfolio optimization.
- Drive better capital calculations.

'There could be better data about what's going on in the marketplace. There could be better information about what's coming down the track for claims. That's really what people are missing.'

Interview respondent

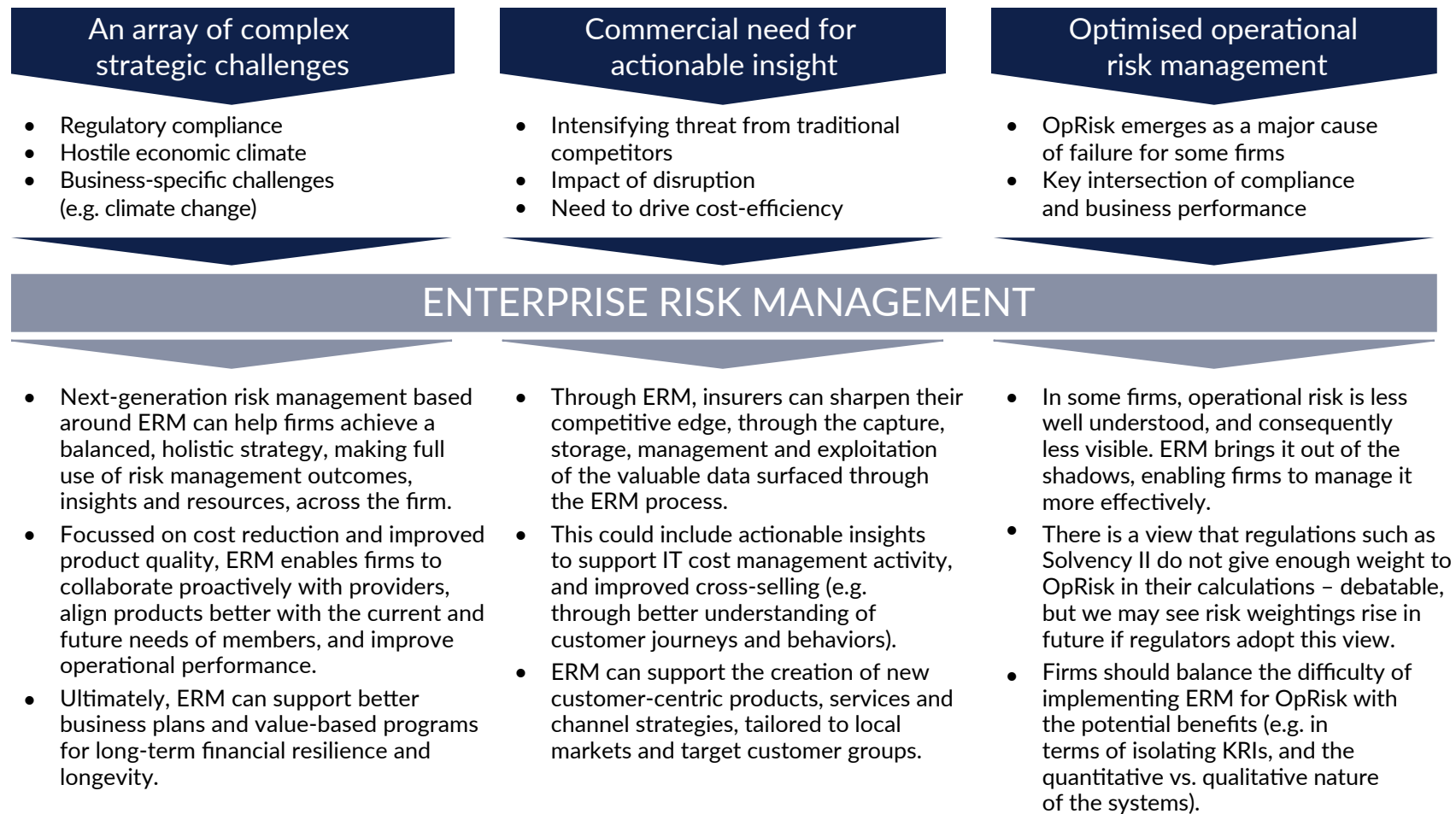
OpRisk management

Two of the traditional challenges of OpRisk have been in the ad-hoc and interlinked nature of events, combined with the difficulty of creating theoretically complete OpRisk portfolios. ERM can help insurers consolidate, connect and integrate various risk components (such as solvency capital requirements [SCRs]) with other governance and compliance components (such as regulatory change management, internal audit, IT risk management and vendor risk management).

'The biggest risk is OpRisk. In the past, it has contributed to companies going under. That comes down to ERM; at the heart is OpRisk.'

Interview respondent

Figure 4: The benefits of ERM



Source: Chartis Research

Take a step forward and lose old habits

Insurance companies are starting to take note of ERM. In our experience, however, even the forward-thinking institutions are, in the main, still only scratching the surface of what ERM can deliver.

There are also challenges, especially around the regulatory focus of ERM. Firms can quickly slip back into 'box-ticking' mode, simply to comply with relevant regulations. Once ERM's supporters and champions have shifted their energies into other areas, post-implementation review and renewal can be problematic. And if systems are tuned too closely to regulatory reporting, at the exclusion of all else, this could lead to highly volatile reporting on a day-to-day basis (such as in the calculations of a firm's SCR, for example).

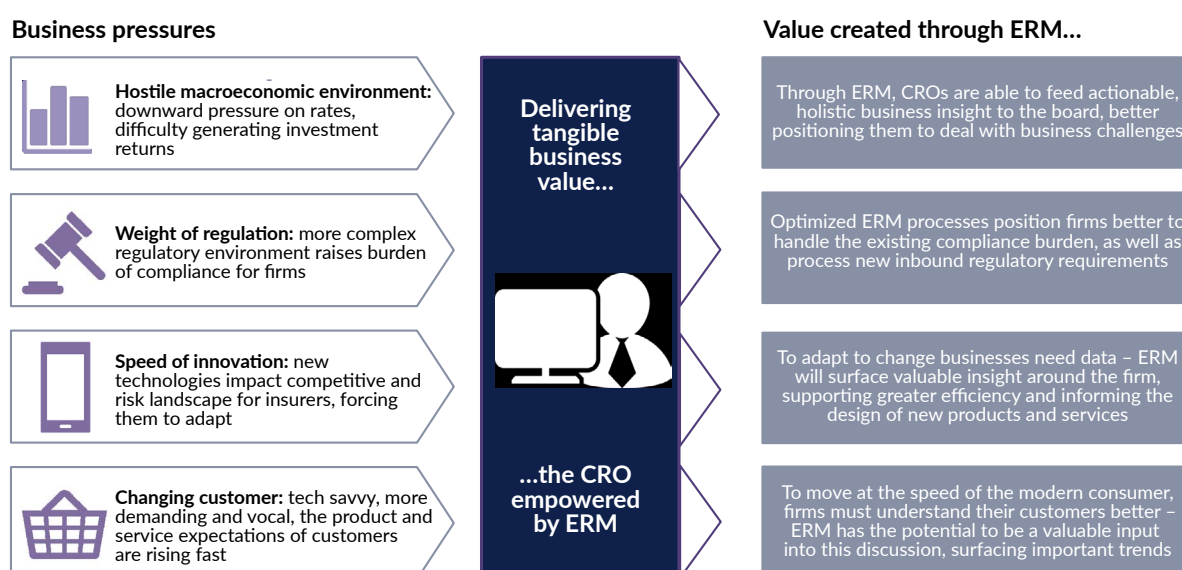
For insurers to unlock all the benefits of ERM, they need to apply it to the current and future risks that will influence their short- and long-term fortunes. These include customer expectations, the attitudes and behaviors of key customer demographics, the move toward analyzing the risks affecting individual policyholders, and the rapid growth of technology and fintech, with its strong impact on price competition. If businesses want not only to survive, but to capture opportunities and bring about profitable growth, they must be able to anticipate, react and adapt to change.

People power

Successful ERM needs the right people in place, from top to bottom. As risk moves from the back office to the boardroom – from a transactional role to a strategic one – board members must be better informed about risk and its implications.

In particular, the CRO's time has come. With the right skills, and the right combination of tools, the CRO is the best orchestrator of ERM – coordinating people, processes and strategy to create one risk-focussed entity that drives real value. Figure 5 summarizes the CRO's role as orchestrator and driver of the benefits of ERM.

Figure 5: ERM and the CRO as business enhancer



Source: Chartis Research

4. Spotlight: the evolving role of the CRO

A spectrum of capabilities

The CRO's role has changed in parallel with the massive investment among insurance companies in risk-driven regulations. Until recently, the CRO's remit was often risk in the context of regulation – a role that was often siloed, with little connection to the overall business. But the CRO's focus is changing. In essence, the role has developed through three stages:

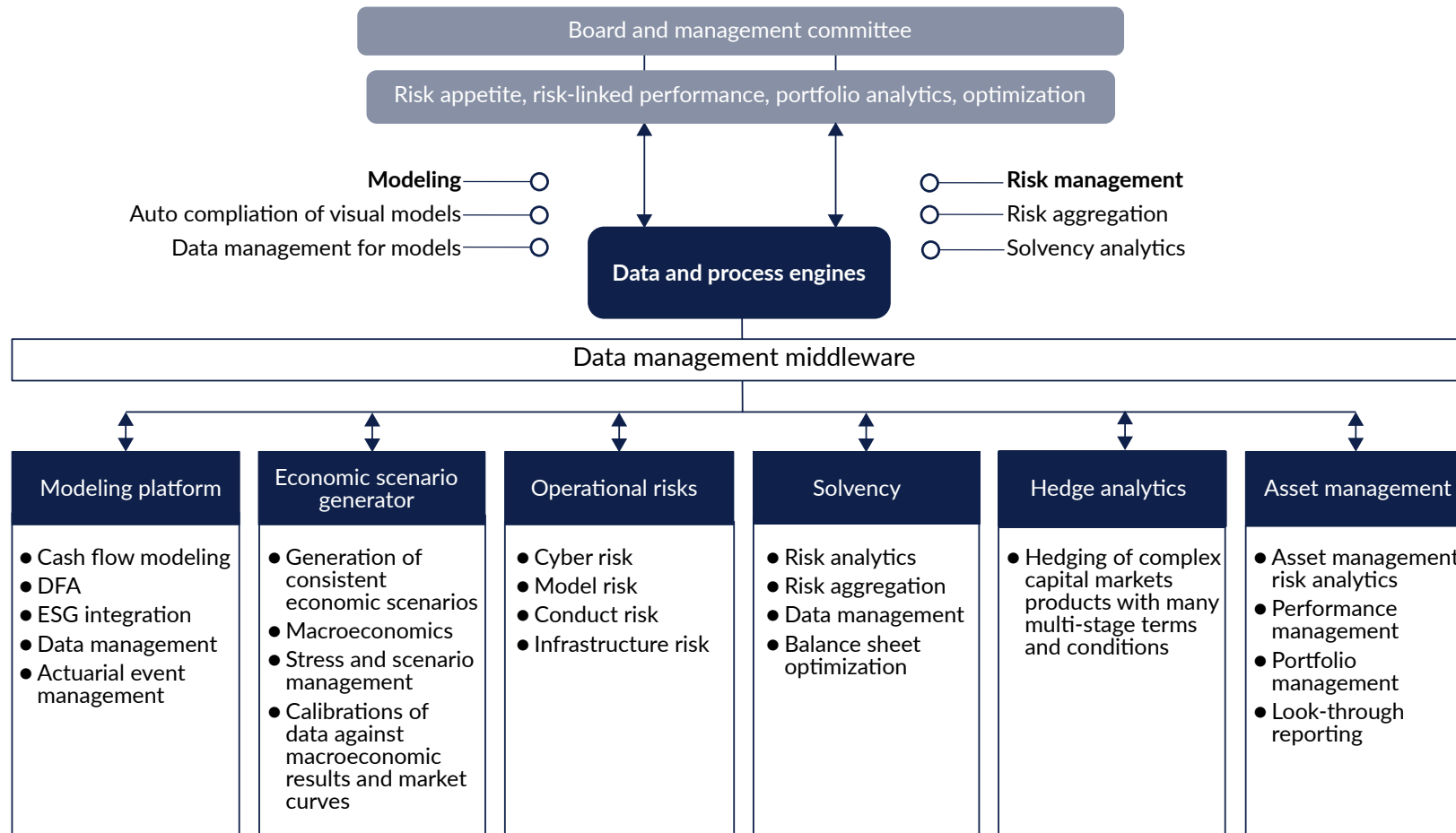
- **Stage 1: Compliance checker**, with a remit focussed on regulatory compliance.
- **Stage 2: Risk advisor**. As the regulations have become more risk-sensitive, CROs (because of their better sensitivities to risk) have seen their role broadening to take on more of an advisory aspect.
- **Stage 3: Business enhancer**. At this point the CRO optimizes the data, technology and infrastructure put in place in many companies to achieve real strategic value. In many cases achieving this involves technical knowledge and a complex set of skills. An additional dimension, as we have already explored, is the growing requirement for ways to mitigate OpRisk, much of which is coming from changes to the overall business environment (such as the rise of digital technology, cyber attacks, model risk and so on).

As the CRO's role has expanded to encompass a broader remit of skills and requirements, insurance risk management technology is moving beyond modeling and asset liability issues into a broader definition of risk. However, leading vendors are only gradually embracing ERM capabilities, and from fundamentally different directions. Nevertheless, as Figure 6 shows, CROs can now sit in a 'strategic layer' in the firm, using a range of technology tools to achieve the right risk management approach for their organizations.

'A powerful CRO should direct companies' attention towards efficient risk management...A good CRO can increase risk management, but we maybe won't see them for several years.'

Interview respondent

Figure 6: The CRO has access to a range of technology tools



Source: Chartis Research

5. Making the change

Where to focus

To maximize the value generated by ERM, pay as much attention to the way you implement it as to the decision to implement it in the first place. Table 1 summarizes some of the operational, cultural and regulatory factors insurers should consider as they move toward effective ERM, and lists the key actions to take to ensure a successful implementation.

Broadly:

- Make ERM a positive, proactive force that pushes your business forward by providing a holistic view of risks, responsibilities and opportunities.
- Adopt an ERM program that becomes a fully integrated part of the business, injecting a risk and reward mindset into day-to-day activities across functions.
- Align culture, people and systems with management's strategic priorities, financial and operational imperatives, and business performance drivers.
- Establish accountability at all levels of the organization, and embed ERM into the employee lifecycle, from recruitment through retirement.
- Ensure visibility: into markets, into customers' future needs, into risks, into opportunities, and into obligations. Your business strategies and decisions are more likely to succeed if they are informed from the start by a thorough, balanced examination of all applicable risks and regulatory/ethical considerations, whether around new products and services, new geographies, new business models, new third-party relationships, or planned acquisitions or divestitures.
- Spearhead the effective use of technology across all risk functions, and across the business at large to create a single enterprise view.
- Re-position risk activities to help your organization hit its strategic priorities and other operational/financial imperatives. Do this by prioritizing the business risks that align to specific business performance drivers, whether related to operations (e.g., customer satisfaction, key resource retention), finance (e.g., earnings per share, return on invested capital), or strategy (e.g., strategic transactions, market share), as dictated by the needs of the company, taking into consideration the macro and micro environments in which it operates.

The time for ERM is now.

Table 1: The key steps to achieving ERM in insurance

Focus area	Challenge	Recommended approach
Board-level support and preparation	Before embarking on an ERM program, board members and senior managers must be clear on what they expect to gain from their business strategy, and whether they understand exactly what's involved in managing and mitigating risk.	To manage investments, identify risks in advance. When businesses fail to prepare, they often encounter issues that were never considered in pre-operational risk planning: surprises that can mean the difference between success and failure for new high-risk investments.
ERM data model	Developing an ERM data model is a challenge for many insurers that have not established processes to bring all the components of ERM into the core data model, based on their strategy and expectations.	Start to build ERM data models, and take advantage of any achievements from your regulatory transformation efforts.
Balance sheet management	Firms have historically steered their balance sheets like oil tankers, responding to slow tides. ERM will allow them to move more like speedboats.	Use your new agility to make faster capital predictions and respond more effectively to market changes, by integrating finance, risk and performance measures.
Future regulations	Solvency II was just the beginning; overlapping measures such as IFRS 4 Phase II and IFRS 17 will complicate matters further.	Prepare for the disruptive impact of fresh global regulations, by conducting a strategic review of your infrastructure and business processes.
Cultural and organizational change	Changes in attitudes to risk are cascading through organizations, shaping company culture in new ways. A change in culture is not only better for risk management, it's better for business. It's now no longer enough just to be more risk-aware, ticking the appropriate box.	Risk professionals must have the skills and capabilities to drive new thinking about risk. They must bring together depth of risk management processes and actuarial expertise, with a breadth of knowledge and experience across aspects of the business such as data management, data quality, GRC, actuarial tools and business planning. Board members need the capabilities to define their risk strategy and take action on the content and information that ERM makes discoverable. The aim of all ERM programs should be to infiltrate every division in a company, so that risk management is more than an idea – it's a given throughout the entire enterprise. Establishing a risk appetite within the business plan is not only important for current operations, but also for future risk/reward decisions.

Focus area	Challenge	Recommended approach
Talent and expertise	Insurance firms will need to meet the growing demand for talent in the areas of managing, analyzing, predicting and discovering insights from the complex data now available to modern corporations.	Everyone needs to understand the levers that drive profitability and move the company forward. Without the expertise and business knowledge of those actively and even passively involved in the ERM program, the results will be mediocre.
Internal vs. standard model	Regulatory one-size-fits-all models continue to be a challenge for insurers keen to take advantage of their ERM programs.	Firms with internal model approaches are at an advantage when it comes to realizing the benefits of ERM. With internal models, and efficient risk-based economic capital, you can align ERM with your business plans and performance management, conduct scenario analysis as part of your portfolio construction, and test extreme (but plausible) events to develop your investment and underwriting strategies.
Geographic focus	The operating environment is fragmented.	To secure the full benefits of ERM, global organizations must create a 'group reporting structure' that captures interactions across jurisdictions centrally, while also maintaining local structures to satisfy the requirements of local regulators. Insurers must also be able to react to the specific requirements of individual lines of business in individual markets. In the motor insurance sector, for example, driverless cars may be treated differently in different countries, and these variations must be accounted for in local and group-level ERM programs.

Source: Chartis Research

6. Appendix A: Structural differences – life vs. non-life

The life and non-life insurance sectors have distinct risk management requirements, which will influence the value of ERM (see Table 2).

Table 2: Risk management for life vs non-life insurance

	Non-life	Life
Focus	Protection	Protection and investment
Markets	Linked to wholesale markets such as Marine, Aviation and Transit	Assets and liabilities linked to capital markets
Risk models	Complex, and linked to specific models (such as health, motor insurance, etc.)	Simpler risk models
Primary risks/threats	Operating practices and technological disruption	Market volatility and the macroeconomic climate (such as the shifting outlook for long-dated and guaranteed annuities)

Source: Chartis Research

Life insurance

To diversify their risk and generate yield, life insurers are increasingly restructuring their business around protection products, but this is making their balance sheets more complex. To compound the issue, Solvency II has shifted the focus among life firms toward a more closely risk-based view of their individual solvency, whereas previously risks on the liabilities side were managed at a less granular level of detail.

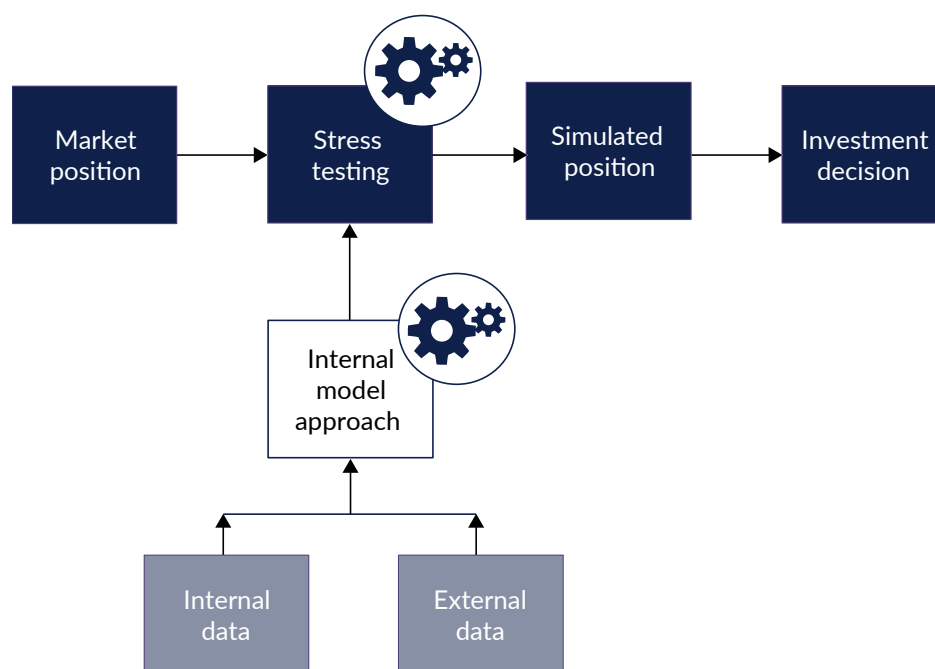
The hunger for yield is especially acute among life insurers, which offer long-term policies such as pensions, often with income guarantees of as much as 3.5% a year. By taking new investment risks, and to achieve the investment objectives they have set themselves, life insurance companies will need new, agile strategies and capabilities (stronger investment skills and capabilities, better investment monitoring tools and faster decisions based on insightful and reliable analysis).

In this context, the need to carry out tactical analysis and move quickly is vital, strengthening the argument for integrated, ERM capabilities (such as the internal model approach). Unified data management that incorporates assumptions and multiple sources of risk enables stress testing to simulate the effects of market positions and determine the risks associated with investment decisions (see Figure 7). This is particularly useful in today's unpredictable environment.

'Lots of people went down the internal model route because it was fashionable. But it cost huge amounts; millions in some cases. But in some cases, it has worked.'

Interview respondent

Figure 7: Using the internal model approach and stress testing to drive investment decisions



Source: Chartis Research

Non-life insurance

The capital management drivers are less pronounced in non-life insurance, but a number of potentially disruptive trends are affecting the sector:

- The impact of climate change (particularly in terms of flooding, for example) as a driver of general insurance products, services and pricing.
- Changing customer buying patterns, which mean that insurers must engage with their customers in different ways and in different places (at the point of sale, for example).
- The ongoing evolution of technology, and its potential impact on competition – in terms of both existing drivers for competitive advantage, and the emergence of new ones.

ERM with a role beyond reporting will enable non-life firms to be resilient and robust in the face of potential disruption.

7. How to use research and services from Chartis

In addition to our flagship industry reports, Chartis also offers customized information and consulting services. Our in-depth knowledge of the risk technology market and best practice allows us to provide high-quality and cost-effective advice to our clients. If you found this report informative and useful, you may be interested in the following services from Chartis.

For risk technology buyers

If you are purchasing risk management software, Chartis's vendor selection service is designed to help you find the most appropriate risk technology solution for your needs.

We monitor the market to identify the strengths and weaknesses of the different risk technology solutions, and track the post-sales performance of companies selling and implementing these systems. Our market intelligence includes key decision criteria such as TCO (total cost of ownership) comparisons and customer satisfaction ratings.

Our research and advisory services cover a range of risk and compliance management topics such as credit risk, market risk, operational risk, GRC, financial crime, liquidity risk, asset and liability management, collateral management, regulatory compliance, risk data aggregation, risk analytics and risk BI.

Our vendor selection services include:

- Buy vs. build decision support
- Business and functional requirements gathering
- Identification of suitable risk and compliance implementation partners
- Review of vendor proposals
- Assessment of vendor presentations and demonstrations
- Definition and execution of Proof-of-Concept (PoC) projects
- Due diligence activities.

For risk technology vendors

Strategy

Chartis can provide specific strategy advice for risk technology vendors and innovators, with a special focus on growth strategy, product direction, go-to-market plans, and more. Some of our specific offerings include:

- Market analysis, including market segmentation, market demands, buyer needs, and competitive forces
- Strategy sessions focussed on aligning product and company direction based upon analyst data, research, and market intelligence
- Advice on go-to-market positioning, messaging, and lead generation
- Advice on pricing strategy, alliance strategy, and licensing/pricing models

Thought leadership

Risk technology vendors can also engage Chartis to provide thought leadership on industry trends in the form of in-person speeches and webinars, as well as custom research and thought-leadership reports. Target audiences and objectives range from internal teams to customer and user conferences. Some recent examples include:

- Participation on a 'Panel of Experts' at a global user conference for a leading Global ERM (Enterprise Risk Management) software vendor
- Custom research and thought-leadership paper on Basel 3 and implications for risk technology.
- Webinar on Financial Crime Risk Management
- Internal education of sales team on key regulatory and business trends and engaging C-level decision makers

8. Further reading

- *RiskTech100® 2017*
- *Buy-Side Risk Management Technology, 2016*
- *Data Integrity and Control in Financial Services 2016*
- *Global Risk IT Expenditure in Financial Services 2017*
- *Spotlight: quantifying cyber risk in financial institutions*
- *Risk Data Aggregation & Reporting Solutions 2016*

For all these reports see www.chartis-research.com.