

Enterprise Risk Management Did Not Fail in 2008

Look Deeper for the Underlying Causes

The profound financial damage that began last year has left the insurance industry looking for answers. Diligent underwriting and conservative investment strategies were not enough to prevent natural and financial catastrophes from bleeding balance sheets. Both leadership teams and key stakeholders have questioned the value of Enterprise Risk Management (ERM) frameworks, yet the conclusion that ERM failed may be hasty. After all, the insurance industry actually survived the events of 2008 reasonably well, with at least some of the credit going to their ERM efforts. Where risk management did fail, the underlying causes were deeper.

by Donald Mango

Models and ERM frameworks alone cannot protect capital from the myriad threats that carriers face. They will never replace the judgment, insights and decisions of risk management professionals. As we look forward to the balance of 2009 – and well into 2010 – the insurance industry should reflect on the lessons of last year and plan their ongoing ERM investments accordingly.

A year of significant loss

The insurance industry faced both natural and financial catastrophes in 2008, causing a spike in insured losses and depleting carrier investment assets. Both sides of the balance sheet were subjected to incredible pressure. The insurance industry spent six months revising estimates from Hurricanes Gustav and Ike upward, while the ultimate tally of investment losses from the financial crisis continued to climb. Insured losses were much higher than anticipated, and carriers have struggled to replace even a portion of the capital consumed by these events.



The net effect was an 18% drop in reinsurers' shareholders' equity, as measured by the Guy Carpenter Global Reinsurance Composite. While a handful of carriers were able to protect (and even increase) their capital, most were down, with a few losing 40% or more. Of course, the situation was much worse for the broader financial services industry, particularly the banking sector. In addition to losing shareholders' equity of more than 30% on average (which includes the effects of the Troubled Assets Relief Program), several global banks with robust balance sheets, long operating histories and unassailable reputations disappeared.

In contrast to the banking sector, the non-life insurance industry fared relatively well. There were a few high-profile casualties in the life insurance sector, but the losses were attributable to asset linked insurance and annuity products. Conservative accounting and risk management practices contributed to this relative success, but another key factor was the sizeable capital cushion with which carriers entered 2008. In fact, the most common conversation among insurance industry leaders at the start of 2008 involved how to make excess capital productive. Dividends were routine, and share buybacks abounded. Even with the aggressive return of capital to investors, carriers still generally had robust balance sheets, which helped them absorb the effects of a perilous September.



Nonetheless, it's difficult to keep this perspective when staring at a much leaner balance sheet. Whether it is pessimistically called blame or perceived as an opportunity to improve, carriers have fervently sought answers. For many, the buck stops at ERM.

Expectations and ERM

Did ERM work: yes or no? Opponents argue that this supposedly advanced thinking on the management of capital failed to keep balance sheets healthy throughout the economic crisis. Insurers losing more than 30% of their capital cannot be faulted for concluding that ERM did indeed fail. Alternatively, supporters point out that the capital was depleted because it absorbed unexpected loss – arguably a core function of insurer capital. The holistic approach to risk management meant insurers were beaten but not broken.

The difference is one of expectations, and the truth is somewhere in the middle. Those who expected ERM to provide a comprehensive, impenetrable safeguard were disappointed, while carriers seeing their frameworks as having repelled an assault on their balance sheets claim success.

In either case, there remains room for improvement. Insurers withstood a major test of their risk management capabilities, and should find ways to strengthen their ERM frameworks. The conditions for self-examination are ideal; We are looking back on the unimaginable with the benefit of some painfully earned experience. Furthermore, capital remains constrained this year, requiring companies to exercise risk management discipline in their portfolio planning.

Managing constrained capital

Going forward, the insurance industry will have to change its thinking. The crutch of excess capital has been kicked from beneath the industry's arm. Despite some recent successes in capital raising, the largesse of 2007 and 2008 is unlikely to return in the near future. The insurance industry began 2009 with sufficient capital to bear risk and operate without fear of insolvency, but the coffers were lighter than the year before. The industry is bruised and may not be able to absorb a reprise of the realized risks of 2008. A new approach to managing and measuring risk is necessary, one that addresses the full spectrum of threats that carriers face.

This implies a profound shift in how carriers understand, price and monitor risk. No exposure exists in a vacuum, as a single event could affect many lines of business or insureds. Companies need to develop their scenario modeling capabilities. This will require a degree of structured creative thinking among the management team and key opinion leaders. Last year, few accounted for the fact that a devastating hurricane would strike Galveston, Texas as a financial catastrophe shook New York, London, Hong Kong, and other money centers. Firms must start by conceiving of the scenarios that could impair balance sheets, but they must follow that with an assessment of the impact of those scenarios, as well as the projected effects of any mitigation steps. Most insurers have found the best way to do this is an internal risk and capital model.

Guy Carpenter's MetaRisk® model, for example, enables risk managers to evaluate all major risk sources: underwriting, reserving, catastrophe, credit, market, and operational. The model supports a holistic approach to risk by capturing the risk characteristics and interaction effects in one master file – thereby becoming the official risk record of the company. Once the range of impacts has been quantified, corporate risk tolerance levels can be matched with reinsurance coverage and other hedging strategies to demonstrate to stakeholders how, under a host of possible scenarios, the company's risk and capital management plan preserves the franchise.

It is important to stress that even the most advanced risk technology cannot replace the human element in risk decision processes. In fact, one could argue that over-reliance on automated logic materially contributed to the financial catastrophe in which the market is currently mired. Instead, think of this technology as facilitating the development of a risk management competency in these organizations – the emergence of a new breed of risk professional, able to use these tools, along with knowledge of the business dynamics and drivers, to provide a company's leadership with expert navigational guidance.

The road ahead

Fragmented risk management approaches are no longer viable. Threats are too systemic and pervasive to be effectively managed from silos. The world has learned an enduring lesson from the crisis of 2008: a convergence of threats, perceived or otherwise, can impair an entire industry or even economy.

In past years, the insurance industry could turn to a number of capital sources in a post-catastrophe year and restore balance sheets. In 2009, this tactic is unlikely to be effective, as the supply of capital has dwindled and the cost has increased. Instead of merely reloading on capital, the insurance industry will have to focus on making better use of the capital they have.

The key to making the most of the capital that carriers have on hand will be the adoption of an enterprise-wide understanding of risk, as well as the tools to manage capital based on the full spectrum of risks. ERM, once considered an opportunity to sustain a competitive advantage, is likely to become part of the price of admission to the insurance space.

Donald Mango is chief actuary of Guy Carpenter & Co. He can be reached at donald.mango@guycarp.com.