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US and Canada: An Era of Value-added Enterprise Risk Management – Executive summary

SEPTEMBER | 2022

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Executive Summary

Enterprise risk management (ERM) is an orderly or guided conduct of an enterprise to deal with risks. For insurers, ERM requires full support and commitment of the senior management. It influences corporate decision-making and ultimately becomes part of the insurer's risk culture. It is particularly relevant to the insurance industry, where it acts as a strategic decision-support framework for management. It improves decision-making and risk mitigation at all levels of the organization.

ERM in the United States (US) and Canada has evolved over the years into a complex ecosystem. About 30 years ago, it had five basic risk categories — underwriting, investment, credit, operational, and strategic, which were mostly handled and reported in silos. Today, insurance companies have fine-tuned their ERM programs to work with a single enterprise framework or policy and a joint committee with representation of senior business risk heads across the insurance value chain. Now, ERM includes additional risk categories (apart from those mentioned above), such as compliance, insurance, investment, and regulatory. ERM is delivered with a divided approach of three lines of defense: risk owners (first line), risk oversight groups (second line), and internal auditors (third line). Practitioners in each one of them responsible, accountable, consulted and informed (RACI) about their specific sphere of action in the organization. In this report, we provide a detailed review of emerging key topics where the ERM plays an important role and could bring the opportunities as highlighted by practitioners surveyed online or interviewed virtually, particularly around:

State of innovation. Practitioners are rethinking how insurance products could cater to new cohorts of consumers (millennials and beyond), while developing or finding the right talent and skills (data scientists and risk experts-actuaries) and searching for opportunities to mitigate difficulties in performing business as usual (BAU) activities and innovation simultaneously.

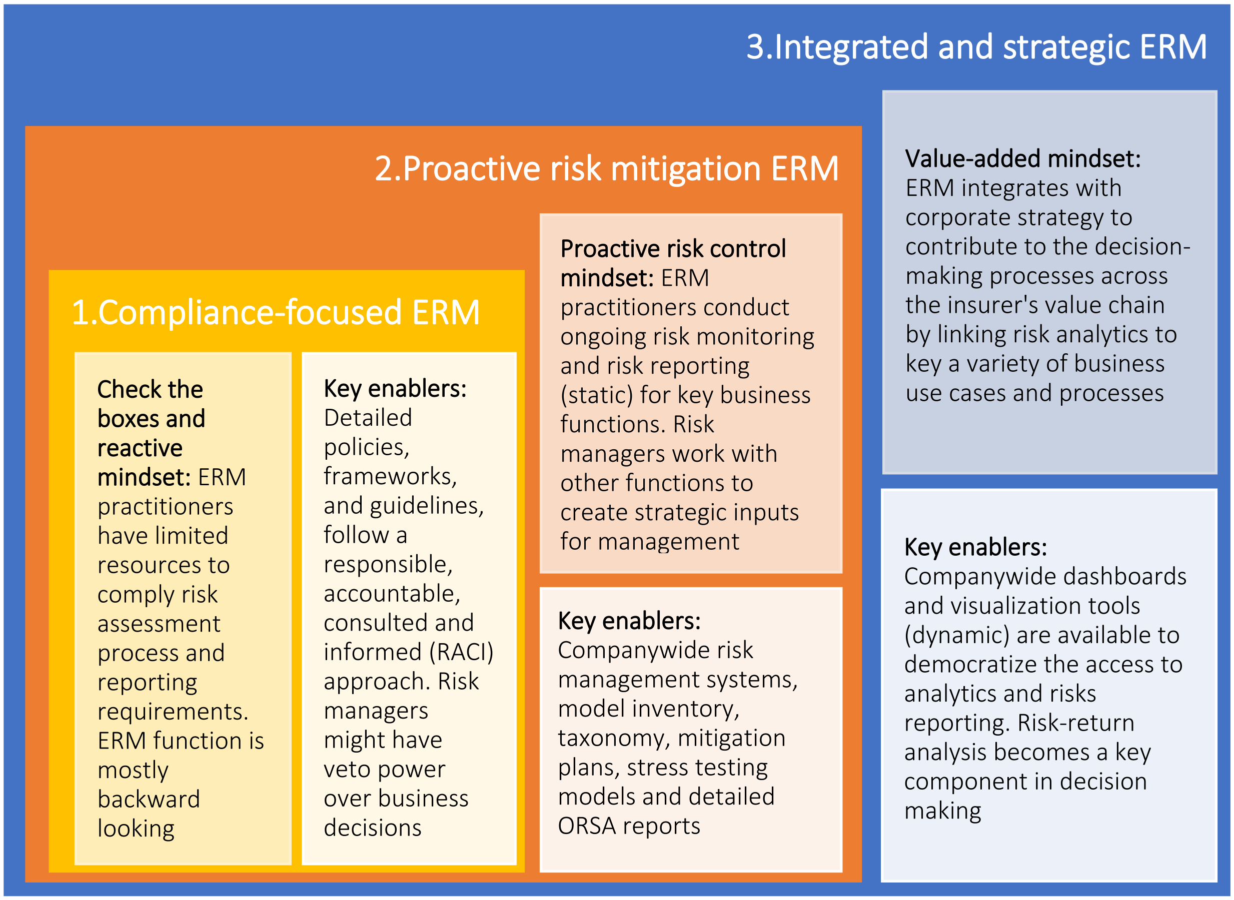
Business environment. Insurtechs, the entry of new insurance players such as Tesla Insurance, and rapid business transformation are the key topics driving the insurers' innovation agenda. Other market conditions such as inflation are not only impacting the cost of insurance claims but also increasing premiums that may lead to policy lapse. The ongoing effort to improve consumer experience (CX) and the accelerated model change workflow/process emanating from adoption of artificial intelligence/machine learning (AI/ML), coupled with the prevailing focus on ethical use of AI/ML, are relevant topics to both insurers and ERM practitioners.

Insurance regulatory environment. Slow and complex adoption of regulations at the local entity level, reporting challenges at the corporate level (International Financial Reporting Standards, or IFRS reporting and aggregation), and differences between federal and local (state/province) regulations, for example in US the New York Department of Financial Services (NYDFS) already requires regulated entities to look at climate change risk while other regulatory agencies may not.

The mentioned sections from this report land in the realm of ERM in multiple forms, ranging from self-contain projects (e.g., adoption of accelerated underwriting using AI/ML) up to a major overhaul (e.g., financial impact of climate risk). To gain corporate-wide buy-in and increase value to deal with these initiatives, the ERM program must be built around the prevailing risk culture within the insurance company; controls, measurable risks, metrics, and actionable data; and analyses and assessments that truly reflect the insurer's risk management. In other words, it must be commensurate with the strategy and operating model adopted by the senior management and Board of Directors.

Additionally, Insurance companies are exposed to a variety of key risk factors (Table 3), to perform a proper risk assessment, the ERM practitioners review that the organization's objectives and strategy remain on course and relevant to the market. The ERM function should not be taken by granted under the belief that three lines of defense would do the work automatically, ERM practitioners could take an active role to understand and manage the risk faced by the organization and create a strategic advantage to aid in effective decision making. The ERM views around insurance risk categories may drive the companywide risk culture. More importantly, the availability and adoption of enablers play a key role to operationalize the ERM policies. From this perspective, the steps towards and integrated and strategic ERM may be segmented as shown in the following figure.

Figure 1:
STEPS TOWARS AND INTEGRATED AND STRATEGIC ERM FUNCTION



Source: Prepared by the Authors from practitioners interviewed. "Transforming Enterprise Risk Management for Value in the Insurance Industry", McKinsey, July 22, 2016, https://www.mckinsey.com/, "Insurance Enterprise Risk Management Practices", American Academy of Actuaries, July 2013, https://www.actuary.org/

There is no 'one size fits all' approach towards achieving an integrated and strategic ERM function — approaches vary depending on factors such as the organization's size, type, complexity, and risk culture. However, a highly integrated, enterprise-wide risk culture could be achieved through the adoption of best-practices and enablers at the ERM function to transform the risk mindset to better serve the business strategy.

1. Compliance-focused ERM. Minimum approach towards the ERM practices.
2. Pro-active risk mitigation ERM. Intermediate approach towards ERM practices where certain business functions have developed ongoing risk monitoring with static metrics and practitioners use companywide accessible risk systems, e.g., model inventory systems and certain risk metrics.

3. Integrated and Strategic ERM. Matured approach towards ERM practices where practitioners create and protect value[1] in the business decision-making and companywide strategy.

Some of the building blocks towards integrated and strategic ERM include:

Risk assessment: The ERM journey for the insurers includes focus on assessing compliance risk and setting-up of an acceptable degree of readiness to react appropriately to new regulations. To respond to new regulations, the ERM policy set forth by the organization is both backward and forward looking, the ERM policy is set up to avoid repetition of previous occurred incidents and the prevention of future ones. In some cases, the risk functions may have the authority to veto a business decision if it violates a risk policy. For example, a business decision may conflict with prevailing risk policy practices around AI/ML or climate risk best practices, in such situation the risk function can veto the business decisions.

Risk measurement: Once insurers establish a compliance focused ERM policy framework to meet the internal needs of the organization and improve the ability to respond to the adoption of upcoming regulation and statutory requirements, the overreaching risk appetite statement, risk limits and governance help in the enhancement of the Own Risk and Solvency Assessment (ORSA) report to use it as an extension of the ERM objectives. In addition to this, risk functions can work with other business functions to help in the risk measurement of capital requirements and stress testing. For instance, key risk indicators or other important metrics are designed based on the insurers' level of maturity or the development of their risk management infrastructure, to set limits/ thresholds for emerging risks such as cyber risk, climate risk, and inflation risk. This is done to measure and understand the insurers' appetite for such risks.

Risk monitoring and reporting: Both static (point in time, e.g., quarterly) and dynamic (centralized and on-demand) risk monitoring is followed by Insurers in US and Canada as they respond to emerging topics, e.g., AI/ML and climate risk adoption. Some insurers have developed a cross-functional governance framework for AI/ML systems that addresses issues such as explainability, transparency, data quality, ethics, fairness, and legal compliance (refer to Sec. 3.1.3). Many insurers have also included the legal and compliance team in their ERM and MRM committees to monitor the impact of increasing regulatory requirements. For example, as new guidelines such as the disclosure of climate risk in line with the TCFD (Task Force on Climate-Related Financial Disclosures) framework. Climate risk can materially impact the insurers' ability to meet policyholder obligations. Hence, many insurers are integrating climate risk into internal processes for assessing effectiveness of their ERM monitoring and reporting capabilities.

Value addition process with ERM:

Insurers with mature ERM functions have less difficulty to understand emerging and unexpected uncertainties while protecting value for the organization, e.g., included pandemic scenarios in their stress testing scenarios before the Covid-19 pandemic emerged. Also, have a balanced focus in bringing value to identify events that are most likely to damage the organization (a curated list of risk factors by risk category – Table 3), in simple terms, thinking more about immediate risks such as crossing the street instead of being bitten by a shark at the beach. Once the risk limits and appetite are aligned with the business strategy are finalized, an insurer's options to improve its risk and reward position include modifying exposure or coverage, changing prices or expense structure, and modifying claim management practices. The ERM function could develop an understanding of the corporate strategy and the ability to enhance the value to the organization.

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[1] Christian Bongiovanni, Luca Pancaldi, Uwe Stegemann, and Giambattista Taglioni, "Transforming enterprise risk management for value in the insurance industry", McKinsey, July 22, 2016, https://www.mckinsey.com/business-functions/risk-and-resilience/our-insights/transforming-enterprise-risk-management-for-value-in-the-insurance-industry (accessed on July 28, 2022)

- **Value creation:** The ERM function creates value by integrating ERM with the corporate strategy. The function becomes a sought-after thought partner, enabling business management to weigh risk-reward implications and potential risk trade-offs in strategic and operational decisions. To become a strategic thought partner, the ERM function must be able to create comprehensive solutions (e.g., economic-capital models) needed to drive business decisions and to link advanced risk analytics to key business processes. ERM program to obtain corporate-wide buy-in and genuinely add value, it must be built around analysis and metrics that are truly reflective of the company's risk culture. In other words, it must be in line with how senior management wants to run the company. Insurers that embrace a Continuous Improvement Cycle and establish an ERM process that is built on a best practice foundation will unlock value creation across their organization – helping them overcome many of the speed, data, and process duplication challenges common at the insurers.
- **Value monitoring:** ERM must quantifies and manage the risk through rigorous risk response planning and ongoing risk monitoring using data and metrics. For instance, ERM must quantifies risk exposures using scenario planning and stress testing to equip leadership with the data points needed to understand a range of potential outcomes (e.g., best case, expected case, worst case). In addition, ERM can then leverages risk-return analysis to understand where to make risk mitigation investments and how much to invest. Instead of telling leadership a risk (e.g., pandemic or cybersecurity) is a top risk, ERM should use a data and analytics driven narrative to support risk-informed decision-making by the top management on how much and where to employ or prioritize resources to manage risk exposures.
- **Value protection:** At this stage, enterprise risk tolerance and risk limit monitoring drive the ERM approach to incorporate the strategic treatment of risk, which involves the evaluation and effective management of the relationship between risk and reward (risk-return optimization) as the organization pursues its values and goals. The overall ERM policy is very advanced in the organization which involves strong ongoing communication of risk function with other business functions. Risk managers are very proactive in setting up policies to effectively handle future risk incidents and the risk functions help other business functions to create strategic inputs for top management. Moreover, a transparent and structured risk management process directly aligned to the company's objectives bring the greater awareness of threats, opportunities, and greater predictability of the performance to the top management objectives.

An additional aspect that has driven the relevance of ERM for insurers is the regulatory oversight and credit rating agencies' increased interest in insurers' ERM policies, practices, and controls. For example, credit agencies' rating assessment may trigger a downgrade as part of their qualitative overlay if there are deficiencies in the insurer's ERM practices. Furthermore, insurers are focusing on innovating their business models to ensure their ERM practices are aligned with the evolving market.

The insurance business will continue to evolve going forward, and its resiliency will hinge on ERM practices and practitioners' efforts toward formalizing their approach to successfully navigate the emerging risks and drivers, particularly around cybersecurity, inflation, AI/ML, and climate risk. ERM, in the short term, will also have to respond to the new wave of models in which AI and ML play a crucial role, raising expectations of better model risk management (MRM) and enterprise-wide use of models. Insurers are looking to continue investing in talent, technology, cybersecurity defense, and governance. And ERM will continue to be a facilitator/enabler to navigate innovation, business, and regulatory environments.

Author's note: The methodology employed in the preparation of this report combines literature review, independent research, practitioner interviews (virtual face-to-face sessions), and an online survey of respondents. The authors of this report have included in each section, key opinions of the practitioners interviewed. A conclusions and supplemental sections are provided at the end of the report, particularly on the methodology used, followed by an acknowledgement of the practitioners interviewed virtually. Finally, the results of the online survey of practitioners are presented, with additional details on the risks faced by the ERM function and its focus.

Unless otherwise specified in the report, all amounts are expressed in the United States dollar (USD).