

ENTERPRISE RISK MANAGEMENT



THE ERM PROCESS – AN OVERVIEW

By: Theron R. Holladay Sr., CFA

The ERM Process – An Overview

Contents of Presentation

- ERM Defined
- ORSA
- Other Regulations
- Common Mistakes
- Risk Components
- The ERM Process – With Investment Examples
- Summary
- Questions

ERM Defined

Enterprise Risk Management is the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings.

ERM Defined - Continued

- ERM Program: Everything an organization does to identify and mitigate risk.
- ERM policy: A single company document that defines and organizes the overall ERM program of an organization. This document often refers to other documents (Investment, Operation, and Underwriting Plans) in order to additionally define specific ERM Risk Policies.

ORSA

- What is ORSA: Own Risk and Solvency Assessment
- Where is ORSA Defined: NAIC's ORSA Guidance Manual
- Who does it apply to
 - Individual insurers that write more than \$500 million in premiums
 - Insurance groups that collectively write more than \$1 billion
- Requirements
 - No less than annually, conduct an ORSA
 - Internally document the process
 - Provide a confidential ORSA summary report annually

Other Considerations for ERM

- ERM is a validating component to risk focused exams
- Mitigation of risk is expected by regulators
- An ERM Program is expected now by rating agencies
- Regulators are becoming more focused on risk and often applaud proactive measures by insurance companies
- ERM is likely to be required by all insurers in the future
 - IMR/AVR
 - RBC for certain insurers

COMMON MISTAKES

- Indicating that you do not have an ERM Program
 - The ERM program includes all policies around risk
 - Be honest while demonstrating risk controls
- Adopting a Policy of Another Insurer
 - Your organization is unique and has specific risks
 - Anything within an official policy must be followed

ERM – The Main Risk Areas

Investment Risk

Asset/Liability Management
Diversification
Market/Reinvestment Risk
Credit Risk
Interest Rate Risk
Liquidity Risk
Surplus Drift

Underwriting Risk

Expenses
Persistency
New Business
Claims
Mortality
Policyholder Behavior
New Regulations

Operational Risk

Cyber Risk
Taxes
Regulatory Changes
Reputational
Fraud
Mismanagement
Employee Turnover

The ERM Process

- Encourage a Risk Focused Culture
- Designate Committees and Define Program
- Identify Risks
- Quantify Measurement Tools for Top Risks
- Identify Mitigation, Policy or Reporting Strategy for the Top Risks
- Develop ERM Policy
- Develop Specific Risk Policies within Other Documents
- Document
- Review

The ERM Process

Encourage a Risk Focused Culture

- Buy-in at the Top Level
- Lead by Example
- Encourage a Risk Focus
- Reward

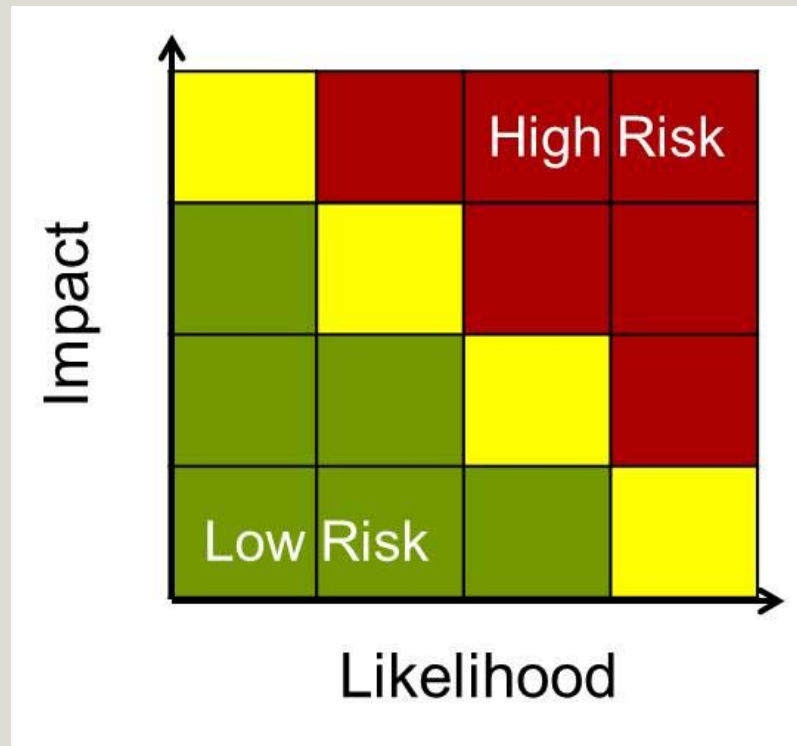
The ERM Process – Committees

- ERM Committee
 - Responsibilities
 - Chief Risk Officer
 - Risk Appetite Statement
- Sub-Committees
 - Investments / Underwriting / Operations
 - Diversity
 - Establish Base for Open Dialogue

The ERM Process – Identify Risks

- Sub-Committee Initial Risk Identification
 - Dedicated, distraction free initial meeting
 - Open “brainstorming”
 - Follow-up risk review meeting
- Sub-Committee Risk Assessment – “Heat Map”
 - Probability of risk occurring
 - Magnitude of impact upon occurrence
 - Top risk recommendations to ERM Committee
- ERM Committee Review

THE ERM PROCESS – IDENTIFY RISKS



The ERM Process

Quantify Measurement Tools for Top Risks



- Examples – Persistency Ratios, Product line profitability, Solvency ratio trends in a multi-year budget

The ERM Process - Policies

- Mitigation Strategies
 - Simple policies – ERM document
 - Comprehensive policies – Separate documents
- Event Occurrence Strategies
 - Disaster recovery
 - Cyber breach
- ERM Reports
 - Defined within policies
 - Trigger limits

INVESTMENT EXAMPLES

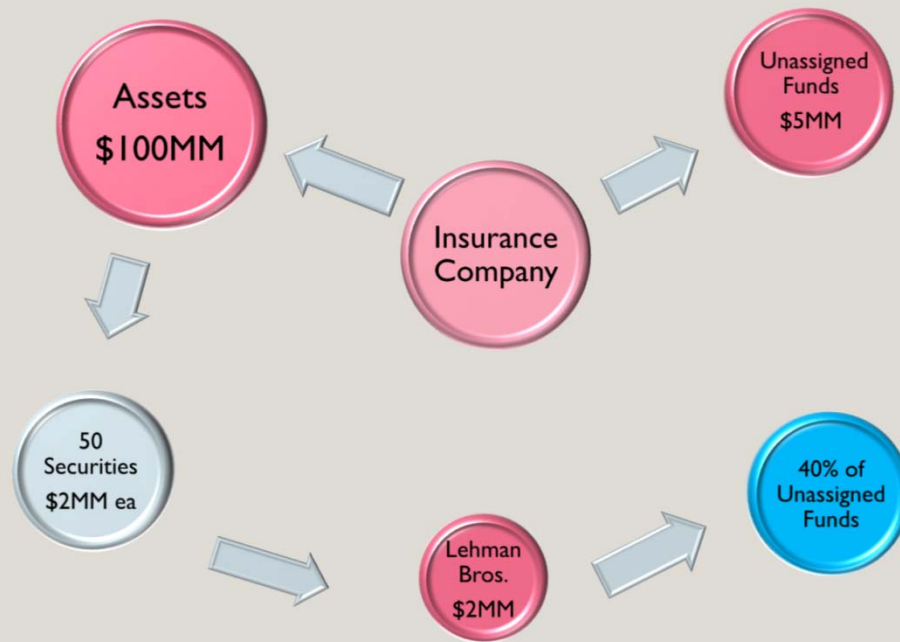
PRIMARY INVESTMENT RISKS FOR INSURANCE COMPANIES

- Many Investment Risks
 - Credit Risk
 - Opportunity Risk
 - Impact Risk
 - Interest Rate Risk
 - Liquidity Risk
 - Perception Risk
- Two Most Important Risks for Insurers
 - Diversification Risk
 - The Relationship of the Assets to the Insurance Products of the Insurer (ALM)

DIVERSIFICATION

- Diversification is Often Applied Incorrectly for Insurance Companies
 - Modern Portfolio Theory
 - Consider Accounting Principles in Diversification Policies
- Primary Reason Insurers Lost Surplus During the Financial Crisis
- Diversification Should Consider Surplus
- Diversification Should Consider AVR
- Future Regulation Changes to RBC

Diversification

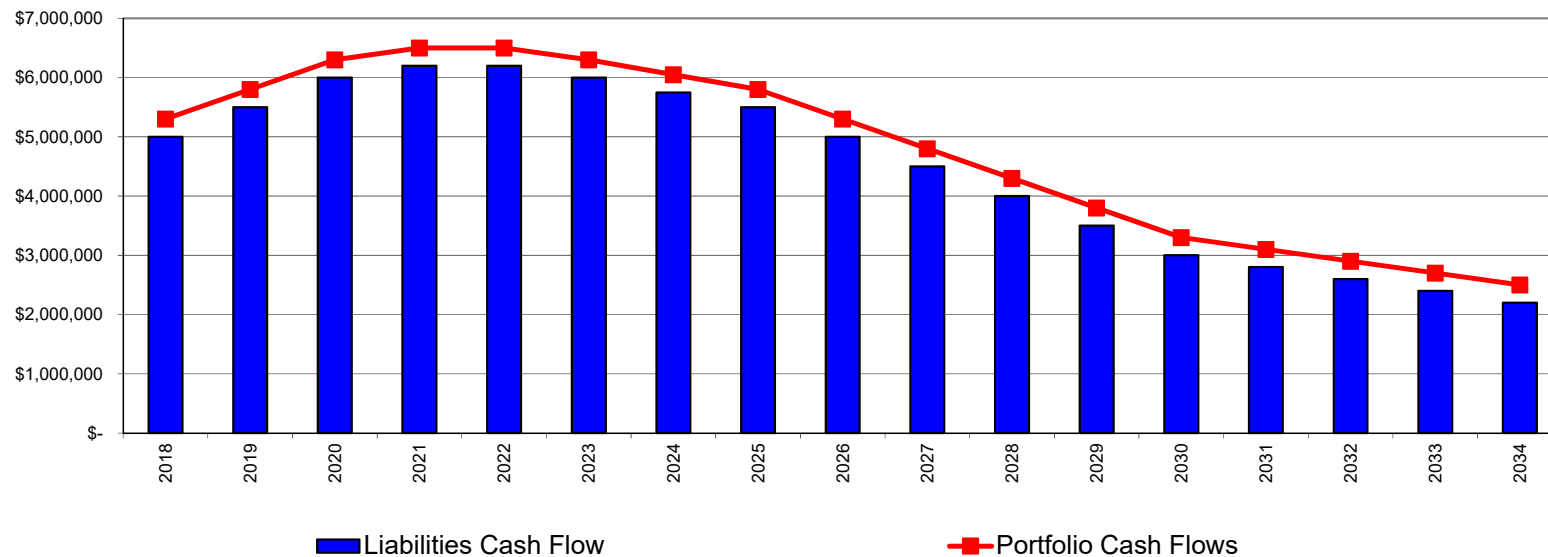


ALM RISK

- Insurance Assets Build Long-Term Surplus If
 - Products Priced Effectively
 - Assets Remain on the Books the Length of the Insurance Products
- An Immunized Portfolio (Asset Cash Flows Provide for Liability Cash Flows)
 - Mitigates Market Risk
 - Mitigates Reinvestment Risk
- Improper ALM is the Primary Reason Insurers are Underperforming Currently

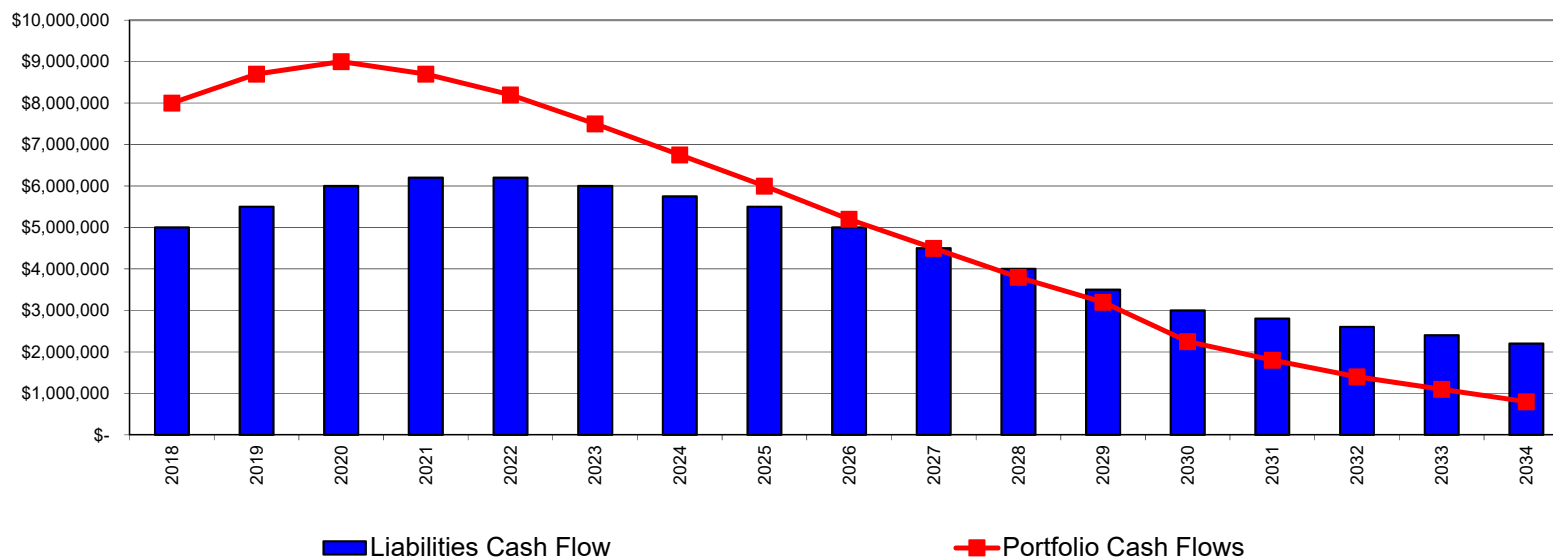
ALM RISK

Asset Cash Flow in Comparison to the Liability Cash Flow



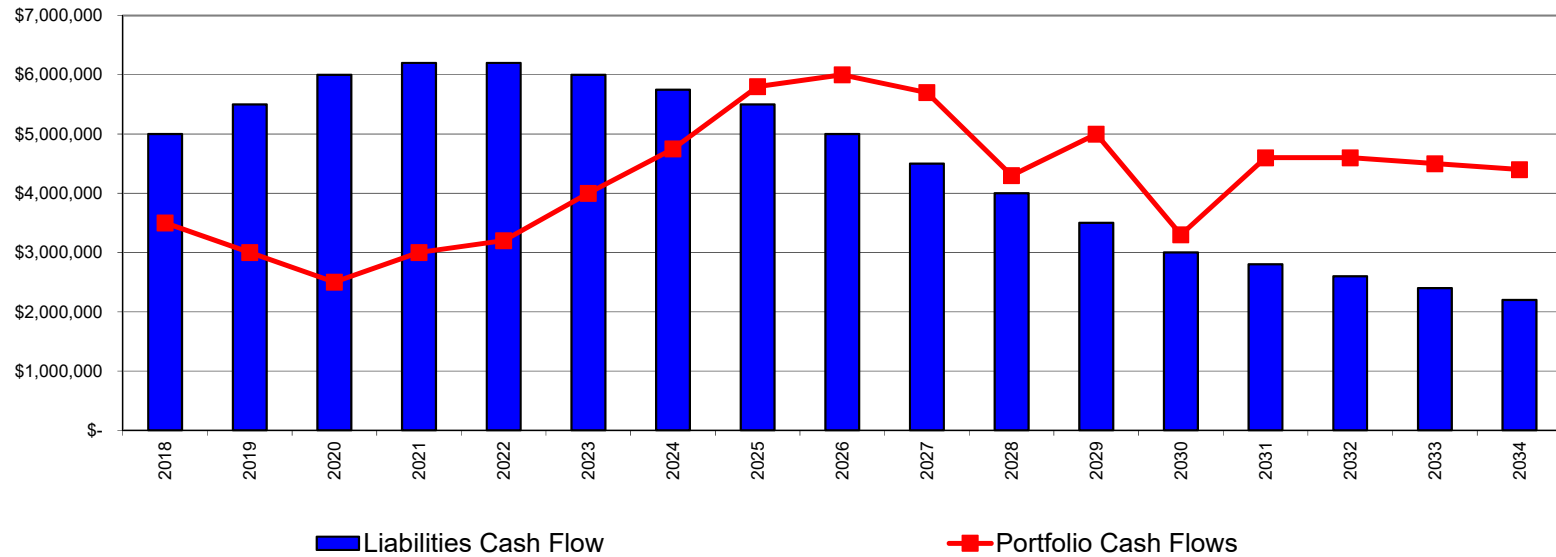
ALM RISK

Asset Cash Flow in Comparison to the Liability Cash Flow – Reinvestment Risk



ALM RISK

Asset Cash Flow in Comparison to the Liability Cash Flow – 300 Basis Point Increase in Interest Rates (Market Risk)



The ERM Process – ERM Policy

Sample Contents of a Potential ERM Policy

- Vision..... |
- Introduction..... |
- Definition of (ERM)..... 2
- Risk Appetite Statement..... 2
- Approach and Structure..... 2
 - Key Driver of Risk Management..... 3
 - Principles of Risk Management..... 3
 - Capacity for Risk..... 3
 - Risk Specific Categories..... 3
 - Regulatory Requirements..... 3
- Roles and Responsibilities for Risk Management... 4
 - Board Oversight..... 4
 - The ERM Committee..... 4
 - Chief Risk Officer..... 4
 - Risk Category Sub-committees..... 4
- Specific Risks and Policies to Mitigate Risk..... 5
 - Investment Risk..... 5
 - Underwriting Risk..... 7
 - Operational Risk..... 8
- Appendix A – ERM Committee and Sub-Committees 9

The ERM Process – Other Documents

- The ERM Policy Connects all Company Policies
- The ERM Program Runs Throughout the Entire Organization Like Tree Branches and Roots
- Examples of External ERM Policies
 - ALM Policy
 - Diversification Policy
 - OTTI Policy
 - Cyber Risk Policy
 - Disaster Recovery Policy

The ERM Process - Documentation

- Establish ERM Meeting Frequency in the ERM Policy
- Establish ERM Reporting within the ERM Policy
 - Keep it Simple
 - Keep it Organized (Time-line check list)
 - Follow Through with all Reporting Requirements
- Maintain Good Minutes

The ERM Process - Review

- Minimum of Annual Policy Review
- Strategic Planning Process
- Annual Board Approval

Summary

- Begin the Process
- Understand ERM is Already a Part of the Organization
- ERM is a “Living Breathing Process”
- ERM Regulations will Change and Adjust

FINAL OBSERVATION

Unseen Risk and Historical Observations



Questions

