

Shine a light on ERM

How does my approach to enterprise risk management (ERM) compare to my peers or to industry expectations? That's not an unnatural question for financial services companies in today's business environment of heightened risk awareness. Gap analysis can help throw light onto uncertain areas of company risk management explain Tom Hettinger and Andrew Harley.

Introduction

In 1992, in one of the earliest efforts to define the ERM process, the US Committee of Sponsoring Organizations of the Treadway Commission put forward that it is effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of the entity's objectives.

It divided the ERM process into eight components: (1) internal environment (2) objective setting (3) event identification (4) risk assessment (5) risk response (6) control activities (7) information and communication, and (8) monitoring.

Still with us?

While this was one of the more authoritative early definitions of ERM, it is by no means the only one, and the practice of ERM has moved on substantially since the 1990s. It is hardly surprising, therefore, that companies struggle to infer exactly what ERM means to them and in what form it should be applied.

Given the fallout from economic events of the past 1-2 years, most companies, particularly those in financial services, appreciate the need for a better framework for understanding and managing risk. Ensuring the programme they are deploying is right for the level of risk within the business, is incorporating best practice, and is moving them towards a better run business can be harder to evaluate objectively.

In developing tools to support companies in this area, EMB has come up with a six part gap analysis methodology that we believe simplifies such an assessment:

- Governance
- Decision making
- Risk modelling
- Integration
- Operational risk
- Benchmarking

Although we look at these components individually in this paper, it is essential that risks are considered in aggregate and holistically, if the full benefits of ERM are to be realised. A silo risk assessment approach will miss interactions, aggregations and concentrations that, when considered together, may result in very different decisions being taken across the organisation.



Governance

Many companies have added the specific or designated role of chief risk officer as a senior member of the management team in recent years. Furthermore, enterprise risk committees are common, and risk management is typically no longer just a report into a firm's audit committee. It is all part of the continuing risk education of boards.

Polls undertaken by EMB in November 2006 and again in December 2009 show the emerging picture. In 2006, when asked 'Who owns your ERM process?', 20% of respondents replied that it was in the hands of a risk management team, including a separate ERM function. By the end of 2009 this had risen to 31%, including a chief risk officer.

Another interesting trend to note from the two surveys is the delegation of responsibility for risk management by CEOs. According to our surveys, the percentage of CEOs who own the ERM process has dropped from 18% to 8% in three years. Conversely, more CFOs appear to be in the driving seat of ERM, with one in five companies reporting them as their functional risk head.

The fact that risk management is being allocated a boardroom seat is to be welcomed. The identity and role of the figurehead occupying that seat is not, however, necessarily the critical factor.

What is more important is that there is clear ownership and authority from the top down. Risks with both up-side and down-side, as well as their associated risks, will continue to emerge no matter how effective your risk management framework. Gap analysis should therefore focus on whether there is a robust approach to identifying and managing emerging risks. Have the company's risk management leaders been able to create an environment for effective communication and data capture? Can support and governance structures be relied upon, and is there a culture of openness to underpin these structures?

Decision making

One of the key aspects of ERM is defining a consistent risk tolerance for the business. But if that definition doesn't match up to company goals, then what is the point?

Let's not forget that an ERM approach should not regard all risk as necessarily bad. Indeed, most risks have a potential upside and the assessment framework should consider both the potential pros and cons of a particular course of action. This all encompassing approach helps companies to link risk/reward with strategy and appetite.

By aligning risk management to wider strategy, it will also ensure that the risk tolerance is aligned to the interests of company stakeholders, since each group has the potential to affect the company's ability to achieve its objectives.

For example, regulators will become nervous if levels of capital cover stray outside certain boundaries, a rating agency downgrade could be disastrous to the business' ability to raise funds, stock markets will typically react unfavourably to news that 'isn't in line with expectations', and policyholder and intermediary sentiment can quickly turn against an organisation in the face of an uncertain outlook - as we have seen very vividly, very recently.

In order to lend further credibility to any defined risk tolerance, it is also worth using an external risk metric. This is an area not much explored by many companies. As part of our December 2009 poll of US companies, only 9% said their risk tolerance was based on external (rating agency) metrics. 38% cited the use of internal benchmarks, while the remainder were either unsure about any external benchmarking or did not answer.

Risk modelling

The complexity of risks faced by many financial services companies in our increasingly global and interdependent economy means that risk and financial models are almost indispensable in helping them to understand and quantify their risks. Most professionals and commentators now appreciate that the problems associated with models during the banking crisis were, as it transpires, more a failing of the governance around those models.

Perhaps unsurprisingly the percentage of companies building and using internal models in our surveys has nearly doubled between 2006 and 2009.

The focus here should be on whether companies have their key risks, and their associated interdependencies, modelled. It is also important to understand how a model is influenced by the techniques used to build it, and to be able to stress test the key assumptions and scenarios within the model.

Based on our experience, common 'gaps' in modelling occur from factors such as replication of critical risks across entities, including economic scenario generation and the compound effect of catastrophe losses. Failure to understand the dependencies between their risks is a source of substantial under-estimation of potential financial losses.

Of course, companies are not, nor should they be, run by models. Valuable a support tool as models are, management teams frequently need to change direction or alter strategies to take account of market realities and developments. From a risk management perspective, however, the operation of models needs to be able to recognise these interventions in a joined-up fashion and project the financial impact going forward in areas such as capital reserves, asset balance and, for insurers at least, reinsurance purchase.

Integration

Regardless of how companies are evaluating risk, it should be done on an integrated basis. For insurers, are significant decisions such as reinsurance and mergers and acquisitions linked into capital requirement calculations? Conversely, levels of economic capital need to be factored into risk-adjusted decisions in areas such as pricing and reinsurance. All of the axes of risk assessment need to interrelate.

From an organisational point of view, if capital management is assigned to one area of the business, is it taking advantage of the expertise in other areas such as reserving, pricing and asset management?

Operational risk

One of the hardest aspects of ERM is developing robust assessments of operational risk.

The diversity of methodologies in use is illustrated by our December 2009 poll. Asked how operational risk is included in their risk management process, 19% indicated they use a risk register only; 17% use risk registers with a flat load into a capital model; 10% use explicit risk models; and a further 5% have explicit risk models that tie into other models.

Clearly, there is a lot of variability around what may constitute a best practice methodology. However, the underlying requirements of any technique should be to ensure that the probability and severity of events is being recognised, the dependency between operational risks is understood, and the knock-on effects of specific operational risks, such as changes in agency terms on loss ratios, is included in modelled risks.

Benchmarking

The danger with any approach to modelling risks and wider ERM is that an internal view of the world evolves. The scenarios used to evaluate and model risk, the parameters

used and the dependency assumptions between those parameters, and the range of economic forecasts selected, will all benefit from periodic external benchmarking. For economic forecasting in particular, EMB has been at the forefront of developments to reduce the reliance on historical data to predict future economic events. The use of a technique called 'relative entropy' enables a wide range of economic data and opinions to be 'overlaid' on what historical analysis suggests will happen in the future. Primarily, this enables current knowledge and analysis to be incorporated and assigned different confidence levels in order to reassess and stress test capital requirements and asset management strategies.

Conclusion

Effective ERM in companies does not come with a road map. Nor can it, since the start and end (if indeed there is an end) points will be different for each organisation.

Companies therefore need to develop their own checks and balances for making sure that their ERM programme is truly capturing, reflecting and mitigating the current risks they face within a business strategy. This is all the more important when markets and consumers are now so quick to penalise those companies whose risk management is perceived to be flawed.

Solutions are not straightforward. ERM reaches, or should reach, into every part of the organisation and should be helping companies to identify 'good' risk, as well as 'bad'. That's why an easily understood assessment framework can help.

Gap analysis has become a tried, tested and trusted business technique. Used appropriately, it can help illuminate previously impenetrable aspects of ERM and keep your programme on track.

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Tom has over 17 years of experience and joined EMB after working in reinsurance brokering and actuarial consulting. Before joining our team, Tom was chief actuary for the tenth largest reinsurance broker in the world, John B. Collins Associates, and was a principal with a well-respected independent actuarial consulting firm. Tom's current main practice areas include ERM, loss reserving including its direct implication on ERM, and the implementation of predictive modelling solutions.

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