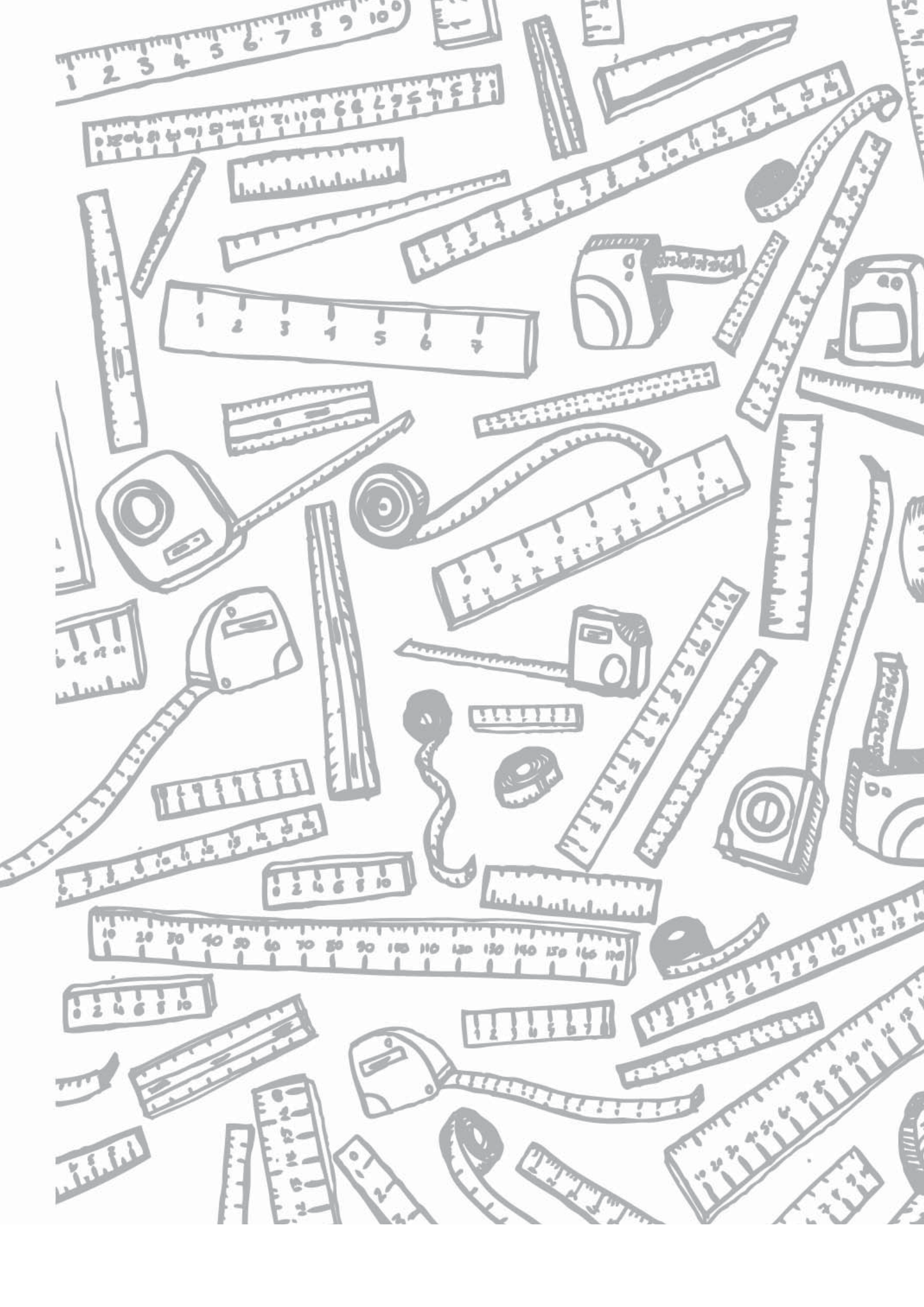
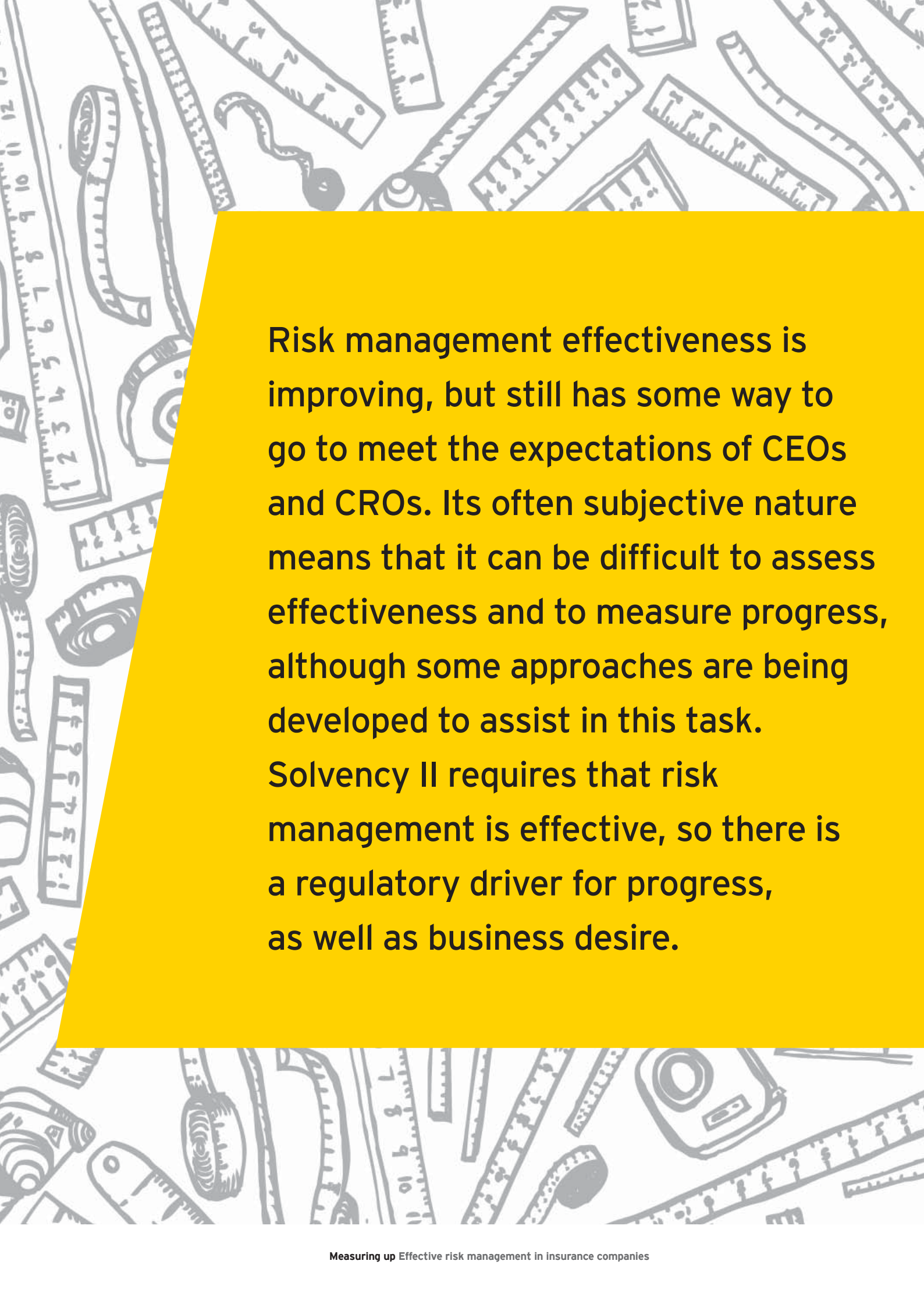




Measuring up

Effective risk management in insurance companies





Risk management effectiveness is improving, but still has some way to go to meet the expectations of CEOs and CROs. Its often subjective nature means that it can be difficult to assess effectiveness and to measure progress, although some approaches are being developed to assist in this task. Solvency II requires that risk management is effective, so there is a regulatory driver for progress, as well as business desire.



Effective risk management in insurance companies

Insurers' CEOs often express an undercurrent of dissatisfaction with the contribution made by their firms' risk management framework and capability to the success of the enterprise. The combination of people and processes intended to support the business in dealing with uncertainty is often not perceived to be optimal.

Common questions from CEOs include:

- ▶ Now I have suitably skilled people in my risk function, how can we make sure they are focused on the right areas of business uncertainty?
- ▶ Now that we have a good risk management framework by design across all three lines of defense, how can I make sure it is actually effective in practice, globally?
- ▶ I've spent a lot of money on risk management, so how can I make sure I get maximum benefit from it?

Interestingly, in our dialogue with CROs we frequently address similar areas but often there can be different challenges for CEOs and CROs on these matters. For CROs, the challenges can typically include:

- ▶ CRO association with legacy risk management processes that didn't quite hit the mark the first time around from the CEO's perspective.
- ▶ Lack of clarity of responsibility between the three lines of defense, resulting in different expectations from the CRO
- ▶ Limited engagement from the CEO in bringing about behavioral change in the business

CROs and CEOs want progress

The robust logic behind effective risk management means that it is desirable for all businesses. Ensuring that risk management frameworks are effective seems to be the next big risk management challenge for businesses because:

- ▶ CEOs and CROs want their risk capability to be effective.
- ▶ There are regulatory drivers requiring it. For example, Article 44 (1) of the Solvency II Directive contains statements such as, "The risk management systems shall be effective and well integrated into the organizational structure and in the decision making process... proper consideration of the persons who effectively run the undertaking or have other key functions." The directive uses the term, "risk management systems" (RMS) to describe what some might understand to be "enterprise risk management" (ERM).

Understanding the degree of effectiveness is important, but often hampered by the lack of a comprehensive structure for the assessment. As a result, assessments can sometimes be too general or overly subjective.

Approaches to measuring effectiveness

We have seen two types of approaches being used internationally to measure risk management effectiveness. One approach tends to be subjective, principles-based and flexible, and the other tends to be more process-driven and rules-based.

How would these be used in practice? Under the first method, a "maturity profile" approach might be used to arrive at a percent effectiveness score. At the other end of the spectrum is the absolute method, whereby a "yes/no" answer to a series of questions could be used often via a sign-off or attestation process. Both have their merits, and there are many hybrid approaches being used.

There are also dangers with both approaches if there is an expectation of full effectiveness, which we have sometimes found to be unrealistic for large and complex international insurance businesses, as anything short of full effectiveness may be frowned upon (sometimes unreasonably) by management or supervisors.

Whatever a firm's preferred approach, there is the need to understand the level of effectiveness in proper context. We think it is important that the coverage is comprehensive and that the conclusions are constructed properly.

A structured approach to measuring effectiveness

We have listened to what CEOs' and CROs' expectations are for more effective risk management in their business and they typically agree on the need for assessing risk management frameworks comprehensively. Effectiveness assessments should address the extent to which the:

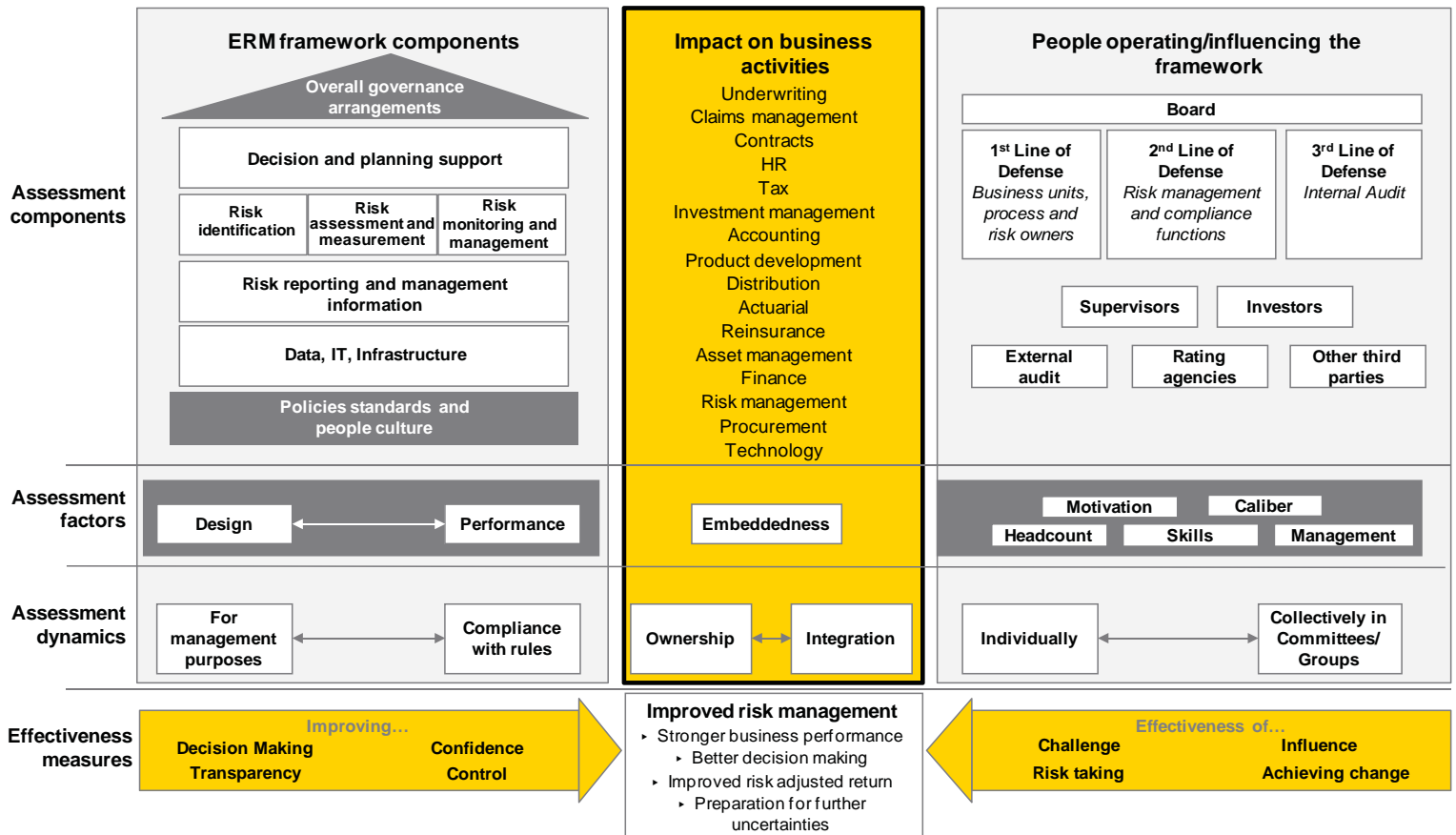
- ▶ Different risk management components in an ERM framework are designed and performed to improve decision making, control, transparency and confidence
- ▶ Individuals operating the framework (from all lines of defense) have sufficient skill, caliber and motivation to ensure effective risk taking, challenge, influence and change

- ▶ Level of embeddedness of the above in business activities improves risk management by supporting strong business performance, better decision making, improved risk adjusted return and better preparation for future business uncertainty

It is interesting to note that while Solvency II requires risk management frameworks to be effective, many Solvency II readiness programs are only really dealing with the design and implementation of components and, as a result, many insurers are not yet planning to assess or ensure effectiveness as part of their readiness programs. There would seem to be a gap, but the extent of challenge from supervisors is likely to be a key determinant in the degree of focus that firms give to such programs.

Given the fundamental business benefit to be derived from more effective risk management frameworks, effectiveness improvement should be desirable to CEOs and CROs even in the absence of regulatory pressure. This type of effectiveness framework provides a useful way for these forward-thinking businesses to harness greater value from their risk management investment.

Risk management effectiveness





In terms of overall risk management effectiveness for the purposes of Solvency II readiness, insurance firms should consider the recommendations in the chart below:

Solvency II readiness recommendations

Action	Comment
Assess risk management effectiveness using a robust framework in order to ensure that readiness plans and activities are complete.	Very few Solvency II readiness programs are using a structured framework for understanding effectiveness.
Address the effectiveness of all components of the ERM framework required by Solvency II (frequently referred to as the "Risk Management System" and related components) for all risk categories.	Many programs are focused only on design effectiveness of the RMS components, rather than including their operating effectiveness.
At a minimum, address the effectiveness of the key individuals operating the framework.	Vacant roles/resource needs tend to be addressed in SII programs, but the capability of those already in place is not yet frequently addressed.
Consider how senior executives will describe the effectiveness of their framework in the own risk and solvency assessment (ORSA) documentation.	High level of awareness on the need to describe effectiveness but more limited consideration so far of the potential impact of describing anything other than "fully effective"
Consider the process by which those making effectiveness "attestations" in the ORSA and other documentation will obtain sufficient information to make their statements.	Once ownership issues relating to these "attestations" are resolved, it is likely that there will be more activity relating to the methods and routes by which assurance will be provided on an ongoing basis.
Use dry runs for assessing both the readiness of processes, as well as the way in which the process output is interpreted and used (as this is a key aspect of the use test)	Although dry runs are being built into readiness plans, the focus tends to be towards the production of the output rather than on the use of the output.
Ensure risk management effectiveness progress can be linked to remuneration structures.	Many programs are ensuring that remuneration structures "don't encourage inappropriate risk taking" but many have not yet worked out how risk management effectiveness improvement would be linked to remuneration.

The many components in the effectiveness framework show that there are a large number of ways in which effectiveness can be improved. In relation to the CEO/CRO interface, the following are examples of actions and behaviors we've observed in practice which seem to make a positive difference on this particular dynamic.

Some ideas for improving effectiveness in the CEO/CRO interface

CEO actions	CRO actions
Challenge the CRO to ensure that contributions to uncertainty/scenario planning are focused on likely business challenges in the period ahead and not just on extreme events.	Ensure that discussions regarding contingency planning (for disaster management purposes) and scenarios for capital modeling are distinct from dialogue relating to month-to-month business uncertainties and, more likely, situations resulting from client, competitor or distribution channel actions.
Request that past and future risk management investment is evaluated with direct reference to specific goals of the business.	Relate all discussions regarding change in risk levels to specific goals of the business.
Challenge your business units to ensure risk information provided by the risk management function is taken into account for strategic and operational decisions.	Use the first line of defense to ensure that risk management instructions to the business units do not come from the second line.
Encourage your CRO to actively engage with CFOs around balancing risk and return.	Avoid pursuing de-risking without sufficient consideration of potential upside or economics of increased control.
Ensure your firm's risk appetite is properly articulated when making decisions.	Highlight any deficiencies in expressions of, and/or use of, risk appetite and risk tolerances.
Ensure that good "tone at the top" follows on from staff communications and is also evidenced in high-level management and board meetings.	Discuss ways in which you might be able to support the CEO further in ensuring the tone from the top stays consistent behind closed doors at the senior level.
Ensure that you are clear on what you expect from your second line of defense and also that first line of defense has sufficient capability to enable the second line to remain firmly in its intended role.	Challenge the CEO if you believe the first line capability is insufficient, making it clear why that interferes with your ability to deliver on your second line responsibilities.

This chart provides a very brief overview of the different components in the risk management effectiveness review structure, as we understand that some components will be more familiar than others.

Further explanation of the risk management effectiveness framework

	ERM framework components	People operating/influencing the framework
Assessment components	These are the risk management processes, controls and other mechanisms designed as the formal framework for the management of risk so they form a solid base for assessment. These are the typical components that many insurance supervisors would expect to see in Solvency II frameworks and related gap assessments. They are typically described in risk management manuals or similar documents which provide overviews and details of the different components.	This covers the effect people and culture have in relation to the effectiveness of a risk management framework. Each of the three lines of defense (line management, risk and compliance, and internal audit) used by the board and executive management therefore need to be considered, along with other stakeholders, as they all play a part in influencing the overall effectiveness of risk management in the firm.
Assessment factors	When assessing the components, it is important to consider both the design and performance of each components i.e. is the design “fit for purpose” and is it actually operating as intended. Some Solvency II readiness programs are currently addressing design gaps only.	The roles of the three lines of defense and others need to be clear, but that would normally form part of the framework component discussion. The quality of execution can be assessed using factors such as motivation, caliber and skills (including people capacity). These are the factors which, if not properly aligned, can undermine even the best designed risk management framework. Frequently, maturity profiles can be a good way to calibrate the assessment factors.
Assessment dynamics	In understanding fitness for purpose, it is important to consider the context. Is a component primarily designed to ensure compliance with regulation or has it been designed primarily to meet the desire of management? These could be argued as being the same thing, but when assessing effectiveness both should be considered as there are some occasions where the requirements of management may be greater than regulatory guidance or rules.	Assessment factors for each line of defense are usually the main aspects considered. However, it is also critical to assess the collective behavior and capability across teams and lines of defense, because collaboration is important for risk management to be fully effective.
Effectiveness measures	The effectiveness of the components can be measured in a number of ways, including the use of key risk indicators, and variables used can include the extent to which the components improve transparency, decision making, confidence and control. As these are factors that are often important to CEOs, they form good measures.	If the dynamics are working well, then effectiveness of the people operating the framework should present itself in a number of ways, such examples can be used as measures, including the effectiveness of risk taking, challenge, influencing of others and the bringing about of change in the business.

Conclusion

If the risk management framework components are effective and the people operating the components are too, then effective risk management should be achieved in the business activities of the firm (in an embedded way, where appropriate).

With such an outcome, individuals should feel proper ownership of what they do and their respective risk management responsibilities will integrate with each other. Improved risk management effectiveness should therefore be measurable in these activities by way of:

- Stronger business performance
- Better decision making
- Improved risk adjusted return
- Better preparations for further uncertainties

This should be attractive to firms and their shareholders, as well as to supervisors, so we anticipate greater assessment of risk management effectiveness as firms seek to pursue realization of the benefits from improvement.



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EYG No. EG0072

1107-1273345 NY



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