ENTERPRISE RISK MANAGEMENT

ERM

Symposium

Where Cutting Edge Theory Meets State of the Art Practice

2012 ERM Symposium
April 18-20, 2012

Washington Marriott Wardman Park
Washington, D.C.

ERM for the smaller company

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Why Enterprise Risk Management?

- Rating agency expectations
  - Reduce the likelihood that the rated entity will not live up to its stated objectives
- Regulatory expectations
  - Reduce the likelihood that there will be a default on customer obligations
- Just good business!
    - Maximize stakeholder value

Risk Management Framework

Reporting

Risk Policy

Risk Report
- Risk Profile (Heat Map)
- Discussion of high risks
- Assessment against appetite
- Emerging risk identification

Risk Analysis
- Asset Liability Management
- Sensitivity / Stress testing
- Pricing reports
- Business cases

Risk Register
- Identify all risks
- Assess likelihood / consequence
- Measurements / triggers
- Mitigation plans

Governance

Board of Directors
- Risk Committee

Executive Risk Committee
- Chaired by CEO
- Includes Chief Risk Officer

Corporate Risk Department
- Chief Risk Officer
- Supported by actuarial / modeling

Operations Risk Committee
- Risk network
- Project teams

Tone at the Top

Risk Culture

ERM Industry trends

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ERM in large versus small companies

- Large insurers tend to have specialized and segmented staff (e.g. reporting, pricing, hedging, etc.)
- Small and mid-sized insurers have actuarial staff that “do it all”, requiring detail oriented generalists (oxymoron)
- In smaller companies, management often use senior actuaries as key members of team
- In many ways, suggestions for a smaller insurer’s ERM parallel that of larger firms
- Implementation of ERM in large versus small companies will be different

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Profile of typical smaller insurer

- Less complex liabilities compared to larger insurers
- Focus upon areas where company has expertise and provides value to consumer
- Key functions are outsourced when expertise can’t reasonably be cultivated “in house”
- Operating performance lacks diversification
- Financial flexibility limited
- Excess capital

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Example of “Top Down” Risk Appetite Statement and Bottom-Up Risk Profile Analysis at smaller companies

Connecting the “top down” risk appetite statements with bottom-up risk profile analysis for management actions for smaller companies

Top Down

Capital / Rating Risk

Regulatory
Economic
Rating Agency

Capital at risk by BU/risk
Risk profile analysis for capital consumption and potential loss of capital

Earnings Risk

GAAP

Earnings at risk by BU/risk
Earnings at risk and relative proportion of whole company’s earnings

Other Risks

Assessment of “gaps” between appetite statements and risk profile embedded in the business

Management action alternatives such as sales volume , change in product design, and/or change hedge strategies

Bottom Up

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A practical approach to building a robust risk appetite at smaller companies

Draft risk appetite statement and assess current risk profile

Assess completeness of risk appetite

Establish consistency between risk appetite and operating limits

Update risk monitoring and reporting to align with risk appetite

Top-down approach

Identify strategic objectives → **Draft risk appetite statement**

Bottom-up approach

Inventory of risk measurement tools → **Assess current risk profile, exposures and limits**

Identify gaps between risk appetite statement and risk profile → Confirm risk appetite statement and calibrate operating limits → Confirm risk monitoring and reporting process

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Components of a risk appetite statement to consider for a smaller company

Component	Capital	Earnings	Liquidity	Brand
Framework	Economic	GAAP	Accessible cash	Key indicators
Description	▸ Focused on safeguarding ongoing capacity to satisfy customer and debt obligations ▸ Ensuring capital needs are consistent with capital available ▸ Monitor both available and required ▸ Measured over defined time horizon and calibrated to confidence level consistent with target ratings	▸ Ensuring that value growth and dividend capacity are not compromised by acute incidences ▸ Addresses stability and capacity to control risks within ranges close to expected outcomes	▸ Emphasis on pre-planning to safeguard liquidity in a crisis ▸ Plan needs to incorporate regulatory (statutory) constraints to actions within and movement between regulated entities ▸ Test multiple scenarios to identify most-stressful worst case	▸ Focused on ensuring going-concern viability ▸ Understanding the essential enterprise features that buttress stakeholder confidence is key ▸ Translation of feature dynamics into measurable indicators needs ongoing review and refinement

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Finding and Articulating Your Risk Appetite

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Do You Currently Have an Enterprise Level Statement of Your Firm's Risk Appetite?

A. Yes, a Risk Appetite Statement has been Developed and Ratified

B. We are in the Process of Developing a Risk Appetite Statement

C. No, but we plan to initiate a process to develop one soon

D. No, we currently have no interest in formalizing a risk appetite statement.

E. I don't know

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Topics

- Kansas City Life Risk Management Background
- What is "Risk Appetite"?
  - Benefits of a Well Articulated Risk Appetite Statement
- Finding Your Risk Appetite
  - Process
  - What a Risk Appetite Statement Should Say
  - Getting Started: Drafting
  - An Example
- Challenges in Developing a Risk Appetite Statement
- Now That You're "Done": Next Steps

KCL's Risk Governance Structure

Board of directors	• Sets "Tone at the top" • Review and approve the organization's business strategy and risk appetite • Monitor management performance against set risk appetite and tolerance limits
Risk Oversight Committee	• Sets "Tone at the top" • Provides oversight and strategic direction for the Company's risk management efforts • Oversees the Annual Risk Assessment Process • Reviews assessments of the Company's overall risk position relative to its capital position • Encourages consistency and excellence in risk management practices • Reviews and/or develops Policies and risk tolerance limits for submission to the Board for approval • Maintains clear responsibilities and accountabilities for risk management across the organization for each major risk category; • Reviews and assesses the integrity and adequacy of the Company's risk management processes; • Leverages risk information into decision making process

Investment Committee

- Credit Risk
- Asset Liability Management

Personnel Committee

Steering & Disclosure Committee

- Financial Reporting and Disclosure

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Risk Oversight Policy

- Risk Management Overview
- Philosophies and Objectives
- Risk Governance Framework
- Risk Limits
- Risk Committee Responsibilities
- Reporting, Exceptions, Review

Primary Risk Categories

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Siloed

Functional Risk Management

Informal Communication Among Risk Managers

Inconsistent Risk Management And Measurement Techniques

SRM

Independent Reporting to Executives and Directors

Organized

Centralized Risk Management Administration

Formal Communication Among Risk Managers

Consistent Risk Management and Measurement Techniques

ORM

Risk Aggregation Mechanism (Model)

Overriding Risk Policy

Coordinated Reporting to Executives and Directors

Integrated

Organized Risk Management, plus

IRM

Statement of Risk Appetite

Articulated Risk Thresholds

Risk Monitoring Mechanism (Dashboard)

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Integrated Risk Management, plus

Strategic Deployment of Risk Capital

Risk -adjusted Performance Measurement

Emerging Risk Analysis

Strategic Risk Analysis

Source:
Todd Henderson

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What is “Risk Appetite”?

- The risk that an organization is willing to take to achieve its strategic objectives
- Risk Appetite should be consistent with the organization’s risk capacity, and it’s culture
- Each organization is likely to have a range of appetites / tolerances for different types of risk, which must be aligned under an overall risk appetite framework
- Risk Appetite will change over time as circumstances change

Risk Capacity, Appetite, Tolerance, Targets and Limits

Terminology	Definition
Risk Capacity	The Limit of Risk that can be taken by the organization
Risk Appetite	The risk that an organization is willing to take to achieve its strategic objectives
Risk Tolerance	How much risk the organization is prepared to take at a risk type and/or business unit level
Risk Limits / Targets	Specific thresholds or targets for key risk metrics across classifications

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A well articulate risk appetite statement sets the tone for the organization, assuring that risk taking activities reflect the interest of all stakeholders. It aligns management and the Board.

- Business Drivers
  - Alignment of Strategic Objectives and risk taking
  - Promote appropriate risk taking within prescribed risk tolerances
  - A powerful tool for managing risk, and enhancing overall performance

- Regulatory and Rating Agency Drivers
  - A well articulated Risk Appetite is an expectation
  - Firms are expected to demonstrate their risk appetite and tolerance for each relevant risk category

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Developing a Risk Appetite Statement

Project Planning	Initial Draft Risk Appetite	Reconcile with Risk Profile	Finalize and Ratify	Embed in Organization
Review Organizational Objectives and Strategies	Review of Literature	Calculate current risk profile for Key Risks	Discussion, Debate and Consensus Building	Link to Decision Making
Determine Organizational Risk Capacity	Identify key elements of a risk appetite statement	Aggregation of individual risks	Document results in a formal risk appetite statement	Performance Monitoring and Results
Review Past Events	Incorporate your key risks	Align risk profile and appetite	Approval by Board	
Consider Existing Risk Exposures and Capabilities	Develop a Discussion Draft		Communication throughout the Organization	
Team / Roles				

What a Risk Appetite Statement Should Say

- Reflect organizational objectives, strategy, and key aspects of the business, and alignment with a willingness and capacity to take risks
- Address both company wide risk appetite and individual risk tolerances
  - Market/Credit/Product/Strategic/Operational
- Includes the tolerance for loss for risks that can be reasonably quantified
- Includes qualitative statements for risks that may not be quantified
- Provides a description of how the Statement is periodically reviewed and changed

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Items Typically Covered in a Risk Appetite Statement: **Quantitative**

Factor	Example
Statutory Capital	• A maximum loss of statutory capital so that the organization can remain viable after an extreme loss event (or combination of extreme events) • We will conduct our operations in a manner that will maintain a RBC ratio of at least 500%. • Less than X% chance of Capital Loss greater than Y% • Actual Capital exceeds Economic Capital by X%
Earnings	• A maximum amount (or %) of annual GAAP earnings being less than budget • Less than X% chance of Earnings falling below $Y
Firm Value	• We will assume the amount and types of risk that maximizes enterprise value
Portfolio Management	• Line "A" reserves no more than X% of total reserves

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Items Typically Covered in a Risk Appetite Statement: **Qualitative**

Factor	Example
Reputation	We will manage / avoid situations or actions that could have a negative impact on our reputation
Market Growth	We will aggressively pursue strategies to meet our market growth objectives by improving our competitive position in Business line A and investing in additional distribution growth.
Target Financial Rating	We seek to maintain an enterprise-level rating of A or better (Note: Many consider this a quantitative factor)
Regulatory Standing	We will manage / avoid situations or actions that could have a negative impact on our regulatory standing

Getting Started . . .

	Willingness to accept risk				
	Low		Medium		High
	1	2	3	4	5
Earnings volatility				X	
Capital requirements			X		
Reputation	X				
Credit ratings		X			

We expect to assume a moderate overall level of risk in pursuit of our business objectives . . .

- **Growth:** We intend to grow life insurance sales at a higher rate than overall industry growth rates by achieving our distribution growth targets in target cities
- **Maintain strong capital ratios:** We will conduct our operations in a manner that will maintain a RBC ratio of at least 500%. (Less than X% chance of capital loss greater than $Y)
- **Maintain Strong Financial Ratings:** We will conduct our business in a manner that is consistent with an Excellent rating by A.M. Best.
- **Reputation:** When making decisions at all levels of the company, we will consider the impact to our reputation. We will manage / avoid situations or actions that could have a negative impact on our reputation

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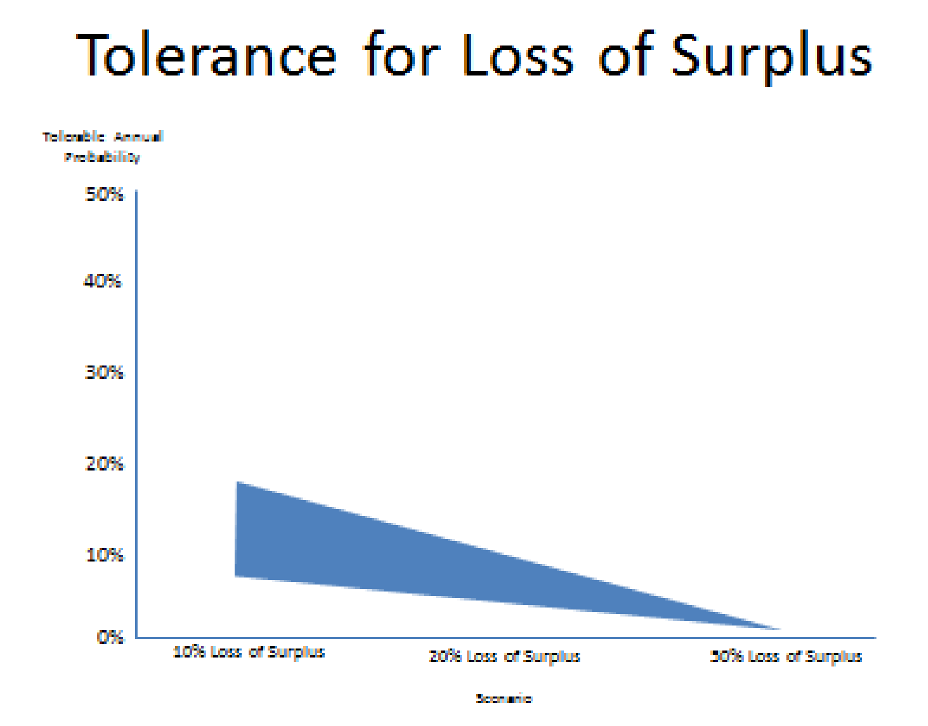
An Example (cont.)

- **Loss Exposure:** We will manage our operational activities and exposures to limit exposure to losses in annual expected GAAP earnings, so that the likelihood of earnings exceeding 50% of budget is 95%.
  - We will avoid excess credit risk by maintaining sound diversification standards and credit risk analysis so that the probability of an after tax loss of greater than $XX million is less than 5%
  - We will avoid excess mortality risk by maintaining sound underwriting standards and reinsurance limits so that the probability of an after tax loss of greater than $XX million is less than 5%
  - We will avoid excess equity risk by managing equity related exposures so that the probability of an after tax loss of greater than $XX million is less than 5%

Getting to Consensus

Considerations:

- Top-Down View of Loss
- Survey Key Participants
  - Board
  - Management Team
- Review Past Results
- Consensus Meeting



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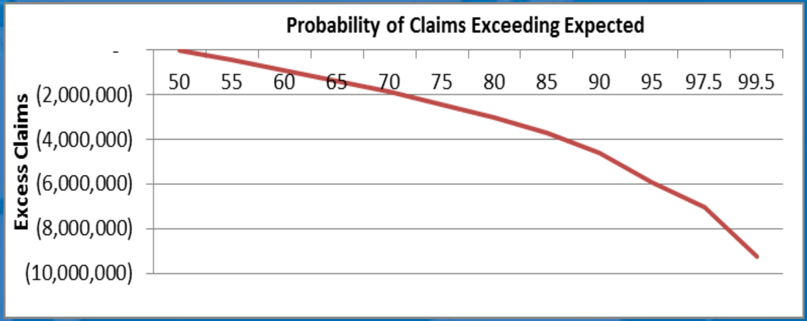
Demonstrating Alignment of Risk Appetite and Tolerances

Risk Appetite, Tolerance & Limits

Risk Appetite	Less that a 5% chance that GAAP Earnings fall Below Threshold Level
Mortality Risk Tolerance	• Less than a 5% chance that mortality exceeds budget by More than $6 million
Mortality Risk Limits	• Retention Limits, • Underwriting Limits and Guidelines, Concentration Limits

Potential Mortality Loss



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Risk Profile

	2008	2009	2011	Forecast
Strategic Risk	M	M	M	↗
Product Risk	L	L	L	↔
ALM	L	M	H	↘
Credit Risk	H	M	M	↗
Operational Risk	M	L	L	↔
Emerging Risk	L	M	M	↘

Challenges in Articulating Risk Appetite

- The process of creating and documenting a company's Risk Appetite *should* create tension
  - Different perspectives among management and among Board members
  - Balancing and Aligning business strategy and risk tolerances
  - Communication / Common Language
- Modeling
- Aggregation
    - Correlations are not often clear / little observable data
    - Correlations may change in the tail scenarios
- Integrating Strategic and Operational risks

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Now That You're "Done": Next Steps

- "Risk Appetite" is the centerpiece of an effective risk management program
- Embed in the Organization
  - Link to Decision Making
  - Performance Monitoring and Results

Reflects Business Objectives and Strategies

Aligned with the Capacity to Take Risk

Risk Appetite

Considers the Skills and Resources Required to Manage Risk Exposures

Reflects Views of all Stakeholders

Selected Resources

- A Practical Guide to Creating a Leading Practice Risk Appetite Statement, ERM Symposium, April 2010.
- Risk Appetite: The Foundation of Enterprise Risk Management, Towers Watson.
- Understanding and Articulating Risk Appetite, KPMG.
- Risk Appetite: The Strategic Balancing Act, Ernst & Young.
- What's Your Risk Appetite, Oliver Wyman.
- Defining Risk Appetite, Deloitte.
- Corporate Value of ENTERPRISE RISK MANAGEMENT, Sim Segal

Smaller company considerations

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Weaknesses observed at smaller companies

- Concentrated power in hands of a select few
- Reporting lines are compromised
- Risk managed in silos
- Lack of risk appetite statements
- Asset/liability management
- Credit risk
- Establishing and monitoring profitability metrics

Most smaller companies have the building blocks for a risk appetite framework

- Common building blocks
  - A strategy with defined objectives
  - Business-level plans and a planning process
  - Some explicit or implicit strategic risk statements
  - Some business-level limits and ranges
  - Some governance structure for business management and risk management

- The key next steps are to connect the company's strategic and business objectives, strategic-level statement and business-level limits and ranges
  - Will be an iterative process
  - Will highlight gaps at each level while leveraging the firm's existing capabilities
  - Should include clearly defined and practical milestones to demonstrate progress

Why isn't risk appetite at smaller companies further along?

- The focus on the need for strengthening the connectivity between strategic planning and risk management is fairly recent
- Risk appetite is a new mandate for management and the Board
- The crisis has the been the catalyst for the need to increase transparency between strategic objectives and risks taken to achieve these objectives
- There is a common recognition that risk appetite is important and may be a key step toward more effective risk management
- But so far, risk appetite has just been a concept with a lot of talk but no practical plan

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Risk management culture

- Company's philosophy towards risks
- Governance
- Risk appetite framework
- Communications (internal and external)
- Alignment of compensation structures and risk taking
- Embedding ERM in operations

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Embedding risk management culture in smaller companies

- Smaller companies face particular challenges in embedding risk appetite culture
- Best designed risk management process can be compromised if dysfunctional behavior exists
- Blind spots exist within organizations when executive management misses or chooses to ignore warning signals
- Effective risk management does not function in a vacuum and rarely survives a leadership failure
- The risk management function can review, inform, advise, monitor, measure; it cannot control and decide

Key indicators of “blind spots” in risk appetite framework

- Management does not involve Board in strategic issues
- Risk management responsibility is not adequately defined or linked to reward system
- Risk is not considered explicitly by management when updating business strategy or plan
- Risk management is an appendage to performance management
- Best designed risk management process can be compromised if dysfunctional behavior exists