RISK MANAGEMENT THROUGH THE BUSINESS CYCLE

2010 CAS Annual Meeting

Washington, DC

November 9, 2010

Agenda

- The theory of plural rationalities
- The four seasons of risk
- The four risk management strategies
- The insurance cycle
- Rational adaptability – a radical ideal
- Practical harmonization – the inelegant solution

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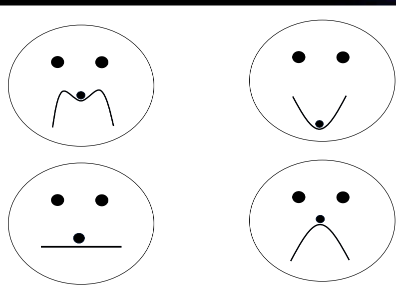
Plural rationalities



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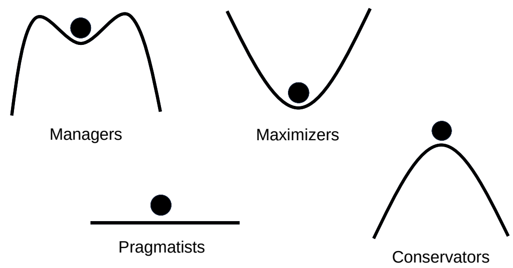
Four views of risk



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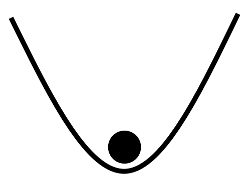
Maximizers' view

- Risk is not very important – profits are important
- It's fine to accept large risks, as long as the price is right
- Risk is mean reverting:
  - Gains will always follow losses
  - The best companies will have larger gains and smaller losses over time



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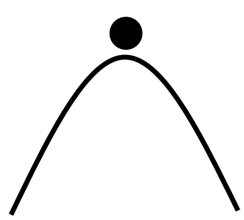
Conservators' view

- Increasing profit is not as important as avoiding loss
- Need to tightly limit risks
- The world is in a delicate balance
  - Any major change could send things into ruin



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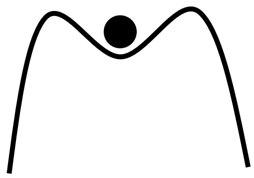
Managers’ view

- Risk is measurable and controllable
- Risk and reward should be carefully balanced
- Experts are best suited to
  - Help find risks offering the best rewards
  - Manage these risks to keep firm safe



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Pragmatists’ view

- The future is totally unpredictable
- You can’t control risk so there is no point in trying
- It is usually best to
  - Avoid major commitments
  - Keep options open
  - Seek freedom to react to changing conditions

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Poll question #1

- Would you say that your own risk attitude is:
  - Maximizer
  - Manager
  - Conservator
  - Pragmatist

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Poll question #2

- Would you say that your firm's predominant risk attitude is:
  - Maximizer
  - Manager
  - Conservator
  - Pragmatist

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Dynamic beliefs

- Risk attitudes change with
  - Changes in environment
  - Changes in risk capacity
  - New experiences
- This is true of
  - Individuals
  - Groups
  - Firms

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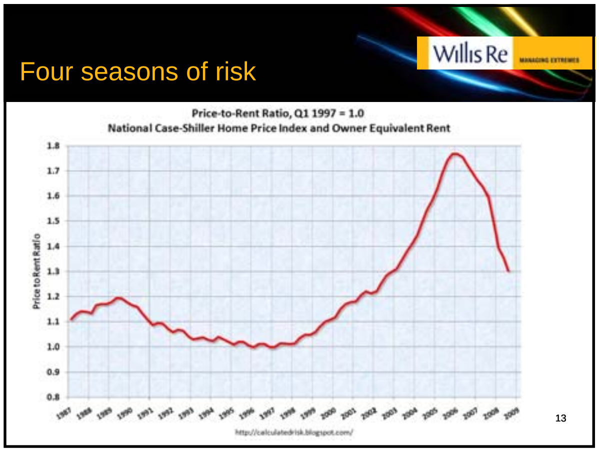

Four seasons of risk
Willis Re
Price-to-Rent Ratio, Q1 1997 = 1.0
National Case-Shiller Home Price Index and Owner Equivalent Rent
Price to Rent Ratio
http://calculatedrisk.blogspot.com/
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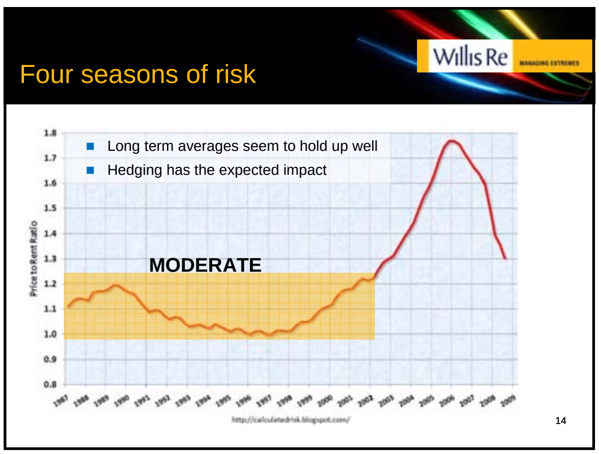

Four seasons of risk
Willis Re
Long term averages seem to hold up well
Hedging has the expected impact
MODERATE
Price to Rent Ratio
http://calculatedrisk.blogspot.com/
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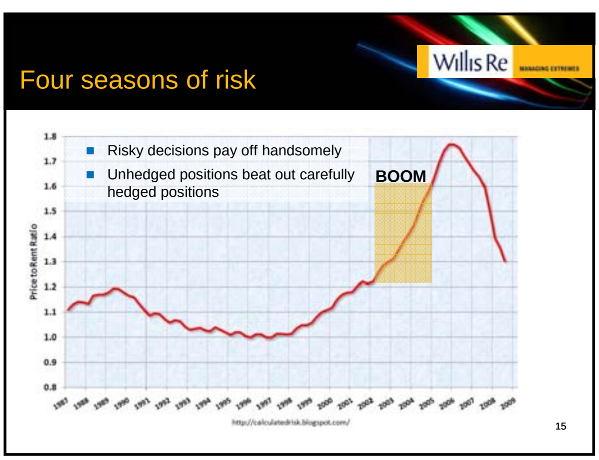

Four seasons of risk
Willis Re
Risky decisions pay off handsomely
Unhedged positions beat out carefully hedged positions
BOOM
Price to Rent Ratio
http://calculatedrisk.blogspot.com/
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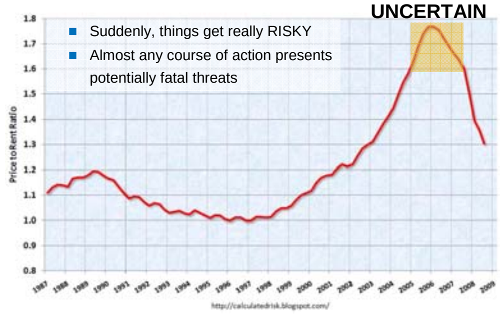
Four seasons of risk

- Suddenly, things get really RISKY
- Almost any course of action presents potentially fatal threats



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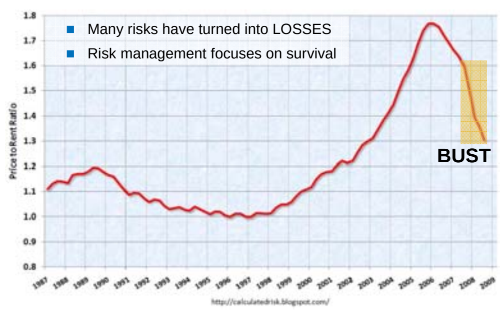
Four seasons of risk

- Many risks have turned into LOSSES
- Risk management focuses on survival



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Poll question #3

- In 2007 and 2008, the risk environment for my business was:
  - Moderate
  - Boom
  - Uncertain
  - Bust

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Risk environment impacts risk attitude

During the **BOOM** Attitudes shift towards **Maximizer**	During the **BUST** Attitudes shift towards **Conservator**
In **UNCERTAIN** times Attitudes shift towards **Pragmatist**	In **MODERATE** times Attitudes shift towards **Manager**

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Poll question #4

- How many times has your firm's risk attitude changed between 2006 and now?
  - 0
  - 1
  - 2
  - 3 or more

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Risk management strategies

- Diversification
- Loss controlling
- Risk trading
- Risk steering

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Diversification

- Oldest type of risk management
  - Spread exposures across different classes of risks
  - Avoid large risk concentrations
- Formal diversification programs set targets for the spread of risk
  - Maximums and minimums for various classes of risk
- ERM adds idea of interdependencies across classes
  - Provides better quantification of the benefits of risk spreading

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Loss controlling

- Most traditional form of risk management
  - Identify and mitigate the most significant risks
- Commonly practiced by non-financial firms
  - Also applies to financial risk
    - Careful underwriting of loans / insurance policies
    - Claims management & credit workout
- ERM has added inclusion of an aggregate, firm-wide view of risk

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Risk trading

- Newer form of risk management
  - Arose from trading desks and the insurance industry
- Focus on getting the price of risk correct
  - Requires complicated models of risk, reward, and economic capital
- Can be applied on a transaction-by-transaction or other “siloed” basis
  - Establishment of a consistent risk valuation on a firm-wide level is risk trading ERM

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Risk steering

- Applies the ideas of risk trading at a macro level to the major strategic decisions of the firm
  - Seeks the optimal risk / reward balance
  - Tries to steer the firm in that ideal direction
- Fundamentally an enterprise-wide approach
- Some seem to think that only risk steering is “real” ERM

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Favorite risk management strategies

- Conservators favor loss controlling
- Maximizers favor risk trading
- Managers favor risk steering
- Pragmatists favor diversification

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Poll question #5

- The predominant risk management strategy of my firm is:
  - Diversification
  - Loss controlling
  - Risk trading
  - Risk steering

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The insurance cycle

- Stage 1: Here Comes the Flood
  - Capital floods into the insurance sector, increasing capacity
- Stage 2: Relax
  - Premiums fall / underwriting standards loosen
- Stage 3: Slip Sliding Away
  - Profits erode and turn into losses
- Stage 4: Gloom Despair and Agony
  - Severe underwriting losses are realized
- Stage 5: Tighten Up
  - Insurers tighten underwriting standards and raise premiums
- Stage 6: Happy Days
  - Dramatic increase in profits

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The insurance cycle

- Power, influence and membership among factions shift over the cycle
  - Recently successful strategies gain influence
  - Recently unsuccessful strategies lose influence
- At each stage, all four types still exist in each company
  - Each with a different
    - Reaction to recent events
    - Suggestion for company tactics
    - Level of influence on decisions
- This dynamic fuels the cycle for market as a whole
  - At each point in time, firms following a particular strategy tend to drive market behavior

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Here comes the flood

- Profit maximizers ascendant
  - Have many ideas for growth
- Conservators still focused on losses of the last down cycle
  - See no need for growth
  - Typically marginalized in decision-making process now
- Pragmatists worry about the firm's ability to handle the increasing volume of business
- Risk-reward managers' studies and reports not as popular as they once were

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Relax

- Profit maximizers still rule the roost
  - Point out that profit margins still healthy
  - Growth still their preferred strategy
- Pragmatists now coming around to the growth idea
  - Market dominated by firms in which the coalition of profit maximizing sales staff and back-office pragmatists works to successfully grow the company
- Conservators and risk-reward managers marginalized
  - Messages of caution / analysis of the weaknesses of the business being written not welcome

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Slip sliding away

- Pragmatist voice takes the lead
  - The very worst business is shed
- Risk-reward managers aid the pragmatists by suggesting carefully selected tightening of underwriting standards.
- Conservators and profit maximizers fall out of favor
  - Conservators scream about impending doom
  - Die-hard profit maximizers claim things will turn around if the firm stays with an aggressive growth program
  - Neither of these messages suits the cautious / uncertain mood

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Gloom, despair and agony

- Conservators are given control
  - Start to cut business right and left
  - Massively strengthen reserves
  - Buy reinsurance at peak cost
- Though pragmatists and risk-reward managers may prefer a more moderate approach, they support these efforts
- Profit maximizers still in the doghouse
  - Argue that pockets of good business remain, if they could only write it

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Tighten up

- Risk-reward managers now ascendant
  - Company starts to grow, slowly, within carefully constructed guidelines
- Profit maximizers now working with the risk-reward managers to find ways to exploit opportunities
- Pragmatists also favor growth
  - Alarmed by ballooning expense ratios
- Conservators still shouting about unhealthy business being written
  - But influence wanes now that things are starting to turn around.

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Happy days

- Risk-reward managers remain in charge
- But face pressure from the profit maximizers
  - “We are losing out to the competition”
  - “Rates are too high, too many good risks are being rejected”
- Pragmatists generally support risk-reward managers
  - Carefully selected volume of business and low number of exceptions simplify processing
- Conservators’ group shrinking; influence much diminished

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Pro-cyclical factors

- During each stage
  - Group in control picks up followers
  - The other groups shed followers
  - Timing across firms not synchronized, but close enough to magnify the ups and downs of the market as a whole
- A retelling of the obvious?
  - But the 4 risk strategies were identified over 25 years ago by anthropologists seeking to explain completely different situations
  - Since then, these 4 groupings have been found over and over in many different contexts
- Can the insurance industry learn something useful from this framework?

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Rational adaptability

- Discipline means sticking to your strategy no matter what
- Adaptability means aligning
  - Risk attitude
  - Risk environment
  - Risk strategy

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Rational adaptability

Risk Environment	BOOM	BUST	UNCERTAIN	MODERATE
Risk Attitude	Maximizer	Conservator	Pragmatist	Manager
Risk Management Strategy	Risk Trading	Loss Controlling	Diversification	Risk Steering

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Poll question #6

- The chance that my firm could “get it right” and identify the changing risk environment and adapting our risk management strategy is:
  - 0%
  - 25%
  - 50%
  - 75%
  - 100%

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Be realistic

- Rational adaptability is an ideal strategy
- Almost impossible to simultaneously
  - Know when the risk environment shifts
  - Do what it takes to
    - Shift the firm's risk attitude
    - Execute the new risk strategy competently

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Harmonization

- A practical alternative
- An inelegant solution

- Keep all four risk attitudes in the discussion
- Create compromise strategies

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Conclusions

- As with any other strategy, harmonization must be more than superficial
  - Important to truly value all views of risk
  - Really believe that there is no totally wrong view
- Keep your eye on the rational adaptability ideal
  - Your course should be somewhere between “stay the course” and rational adaptability
  - Over time getting closer and closer to the ideal

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